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Internal Revenue Code Section 162(f): When Does the Payment of Damages to a Government Punish the Payor?

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INTERNAL REVENUE CODE SECTION 162(f): WHEN DOES THE PAYMENT OF DAMAGES TO A GOVERNMENT PUNISH THE PAYOR?

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I. INTRODUCTION

A podiatrist performs unnecessary surgeries and defrauds Blue Cross when receiving payment for the surgeries. Following indictment for mail fraud, the podiatrist settles with the Government and with Blue Cross agreeing to pay a $26,000 fine and $160,000 in restitution to the insurer. What are the income tax consequences?

Undoubtedly, the podiatrist must include in his taxable income in the year received the amount paid to him by Blue Cross because according to the Internal Revenue Code (the "Code") taxable income includes "income from whatever source derived."[1] When the podiatrist later pays the $26,000 fine and the $160,000 payment in restitution, may he deduct either in calculating taxable income? For expenses to be deductible, they affirmatively must be "ordinary and necessary expenses" paid "in carrying on any trade or business."[2] In addition, the expense must not fall within any of several affirmative disallowances. Section 162(f) of the Code provides that "no deduction shall be allowed . . . for any fine or similar penalty paid to a government for the violation of any law."[3]

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[1] I.R.C. § 61. In James v. United States, 366 U.S. 213 (1961), the Court conclusively established that gains from illegal activity are taxable income.

[2] I.R.C. § 162(a).

[3] I.R.C. § 162(f). Section 162(f) disallows a deduction. However, an expense that does not fall within the disallowance is not automatically deductible. It must also be an ordinary and

Consequently, the podiatrist may not deduct the fine, but what about the restitutionary payment? Several interpretative issues immediately arise: is the restitution a "fine?"; is it a "similar penalty?"; is it "paid to a government?"

In a second case, an investment banking firm announces that it has discovered that it committed irregularities and rule violations relating to auctions of U.S. Treasury securities. The United States Government investigates, and the firm agrees to pay $290 million in settlement of various civil claims without admitting or denying the government's allegations. Is the $290 million payment a "fine" or "similar penalty?"

Both of the above scenarios are actual cases and are the most recent reported examples of potential applications of section 162(f) of the Code. The podiatrist's case was litigated in the Sixth Circuit, and the split decision of the three-judge panel offered no insight towards the section 162(f) issue. Rather, the case was decided under a different section of the Code.[4] Other circuits that have interpreted section 162(f) disagree on whether restitution is deductible in light of section 162(f). The Second Circuit concluded that restitution almost always is deductible while the Ninth Circuit concludes that it almost always is not. The inconsistent manner in which the courts have handled the deductibility of restitution will be analyzed in Part IV of this Article.

The second case involved Salomon Inc.[5] Congress investigated the deductibility of the $290 million settlement payment, but the Treasury would not address the particular case before Congress. The Treasury stated only that deductibility of civil penalties is a

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necessary expense paid in carrying on a trade or business. In other words, the expense must meet the demands of § 162(a) of the Code. However, because the focus of this Article is § 162(f), I hereafter ignore the § 162(a) issue. Thus if an expense is not barred from deduction under § 162(f), it will be considered deductible and thus implicitly meets § 162(a).

[4] See Kraft v. United States, 991 F.2d 292 (6th Cir. 1993). Curiously for a circuit court, the three-judge panel produced three separate opinions. The court affirmed the district court's dismissal of Dr. Kraft's deduction of the restitution paid to Blue Cross but offered no holding with respect to § 162(f). Instead, the decision is based upon § 1341, which governs deductions when the income and associated deductions occur in different taxable years. Under § 1341, the original receipt of income must be under a "claim of right." Kraft had no claim of right because he knew that he illegally procured the reimbursements from Blue Cross. The panel did not reach the § 162(f) issue.

[5] Securities and Exchange Commission v. Salomon Inc and Salomon Brothers Inc, 92 Civ. No. 3691 (RPP) (S.D.N.Y. 1992), Securities and Exchange Commission Litigation Release No. 13,246 (May 20, 1992), available in LEXIS, Fedsec Library, Litrel File.

gray area depending upon whether the payments were "punitive" or "remedial" in nature and defined neither term. Salomon's financial statements disclose that the company deducted a substantial portion of the $290 million payment. Part IV of this Article describes the Salomon settlement and how section 162(f) applies to the transaction.

Part II of this Article demonstrates that the determinative issue in section 162(f) cases is whether the payment was intended to punish the payor.[6] To make this decision, courts have engaged in an unarticulated hierarchical analysis of three factors: 1) legislative intent with respect to the claim under which the government acted; 2) the facts and circumstances specific to the case; and 3) the method for calculating damages under the claim. However, no court yet has expressly acknowledged that its analysis is hierarchical. Part III discerns the hierarchy from the cases, demonstrates that it comports with the congressional intent behind section 162(f), and suggests that courts use the hierarchical analysis in a fashion consistent with other doctrines involving state-invoked punishments by civil law.[7] Consistent treatment of civil law punishments will illuminate the gray area currently clouding the application of section 162(f), and will require courts to define any "not-remedial" exaction as punishment.[8] The current application of sec-

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[6] The Supreme Court did not expressly approve punishment by civil law until 1989. See infra notes 63-66 and accompanying text. Congress and the Treasury had denied income tax deductions for state-invoked punitive civil sanctions since 1971, thereby demonstrating a recognition of punishment by civil law substantially predating the Supreme Court's approval of punitive civil sanctions. The lower federal courts denied these deductions even earlier.

[7] Only state-invoked punishments fall within § 162(f)'s disallowance because the amount of the punishment must be paid to a government. Punitive damages paid in a suit between private parties thereby escape § 162(f) and may be deductible. See infra note 19. This statutory distinction created for tax purposes mirrors the sharp distinction drawn for constitutional law purposes between state-invoked punitive civil sanctions and punitive damages awarded in civil suits between private parties. For example, in Browning-Ferris Indus. v. Kelco Disposal, Inc., 492 U.S. 257 (1989), the Supreme Court held that the Eighth Amendment's Excessive Fines Clause does not apply to private punitive damages. But see Austin v. United States, 113 S. Ct. 2801 (1993), where the Court concluded that state-invoked civil punishments, such as a civil forfeiture of property, are subject to the Excessive Fines Clause.

[8] The Supreme Court has decided that, for Fifth Amendment purposes, a civil sanction punishes to the extent that the sanction "may not fairly be characterized as remedial." United States v. Halper, 490 U.S. 435, 449 (1989) (holding that, while civil sanctions may punish, the Double Jeopardy Clause of the Fifth Amendment prohibits them from punish-

tion 162(f) permits courts to construe punishment more expansively, and some interpret "not-compensatory" as punitive.[9]

An exaction is remedial if it constitutes payment of less than "all the government's costs" resulting from the acts giving rise to the remedy.[10] "Costs" are defined broadly and include, in addition to traditional compensatory damages, damages under double-damages-plus-fixed-penalty provisions, damages for the government's investigative and prosecutorial costs, and damages recovered by the government on account of a third party's costs.[11] The outer limit of "costs" may be the aggregate external social costs created by the payor.

The "remedial" construction of when the payment of damages to a government is punitive is considerably narrower than the definition applied by courts and administrative agencies deciding tax cases. Consequently, a taxpayer remitting damages to a government that are "more-than-compensatory" but that reimburse the government for less than "all the government's costs" appears to lose a tax deduction because he is being punished. Yet the taxpayer is not regarded as punished for other purposes — such as his Fifth Amendment protection against double jeopardy or his Eighth Amendment protection against excessive fines. This result is not only unfair, it is inconsistent with the legislative history of section 162(f).

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ing a convicted defendant a second time). The remedy sought is critical to determining the nature of a legal action in various circumstances. For example, depending on the remedy, an action is either a suit at law or one in equity, thereby determining whether a jury trial is required under the Seventh Amendment. Tull v. United States, 481 U.S. 412, 416-17 (1987) (identifying as relevant two factors in the jury trial determination, the nature of the action and the nature of the remedy sought, but also noting that a characterization of the relief sought is more important than an "abstruse historical" search for the nearest 18th-century analog). Similarly, the focus on remedy to decide the purpose of a legal action exists in other areas of the tax law. In Burke v. United States, 111 S. Ct. 1867 (1992), the Court concluded that an action is a tort for purposes of section 104(a)(2) of the Code only if the remedy available to the plaintiff includes a broad range of damages.

[9] See infra notes 98-103 and accompanying text.

[10] *Halper*, 490 U.S. at 449.

[11] Id. at 443-46.

II. Denial of Tax Deductions for "Fines and Similar Penalties"

A. The Public Policy Disallowance of Income Tax Deductions

Prior to the enactment of section 162(f) of the Code in 1969, the federal courts had no statutory authority to deny income tax deductions for fines or similar payments. However, courts did deny deductions for fines and other objectionable expenses on public policy grounds. The Board of Tax Appeals originated the "public policy disallowance" in 1924 by denying a deduction for expenses incurred in successfully defending a perjury indictment.[12] The court reasoned that expenses involved in the commission of illegal acts are not "ordinary and necessary."[13] However, lower courts have also applied the public policy disallowance under other Code sections which do not require that preclusion of loss and personal deductions be based on whether such deductions are "ordinary" or "necessary."[14] The public policy disallowance thereby extended to more than particular statutory language like "ordinary" or "necessary." It was used as a free-wheeling sword to strike at any perceived tax "benefit" arising from malicious conduct.

As such, the public policy disallowance embodied a fundamental tension in income tax policy between neutral economic principles (which require that, in calculating taxable income, all expenses incurred in earning income are deductible regardless of merit) and social policy objectives (which examine the merit of the expenses incurred). When enacting the modern income tax in 1913, Congress clearly chose neutral economic policies. Senator Williams, who was in charge of the bill, remarked, "the object of this bill is to tax a

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[12] Backer v. Commissioner, 1 B.T.A. 214 (1924). But note that in 1966, the Supreme Court rejected the reasoning in *Backer* concluding that expenses incurred by a taxpayer when unsuccessfully defending a criminal prosecution were deductible as ordinary and necessary business expenses. Commissioner v. Tellier, 383 U.S. 687, 694 (1966) ("No public policy is offended when a man faced with serious criminal charges employs a lawyer to help in his defense. That is not 'proscribed conduct.' It is his constitutional right."). Treas. Reg. § 1.162-21(b)(2) codifies *Tellier*.

[13] *Backer*, 1 B.T.A. at 216 ("It would be an anachronism to say that such an act, so inimical to the public interest as to justify punishment for its commission, may at the same time be so recognized that the expense involved in its commission is sanctioned by the revenue law as an ordinary and necessary expense of carrying on a business.").

[14] John Y. Taggart, Fines, Penalties, Bribes, and Damage Payments and Recoveries, 25 Tax L. Rev. 611, 614 (1970).

man's net income; . . . [i]t is not to reform men's moral characters . . . ."[15] Congress rejected amendments that would have limited deductions to those incurred in a lawful trade or business.[16] Courts, however, have been more favorably disposed to the social policy effects of the tax law, perhaps because they, unlike Congress, must face specific facts head-on and cannot realistically grant the "benefit" of a tax deduction for socially objectionable behavior.

B. Internal Revenue Code Section 162(f)

In the Tax Reform Act of 1969, Congress reasserted its view that public policy "generally is not sufficiently clearly defined to justify the disallowance of deductions"[17] specifically allowed by the Code. Through codification of four specific applications of the public policy disallowance, Congress usurped the courts' authority to deny deductions on public policy grounds.[18] One of the four types of ex-

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[15] 50 Cong. Rec. 3849 (1913) (quoted in *Tellier*, 383 U.S. at 691-92).

[16] *Tellier*, 383 U.S. at 691.

[17] Senate Comm. on Finance, Tax Reform Act of 1969, S. Rep. No. 552, 91st Cong., 1st Sess. 274 (1969), reprinted in 1969 U.S.C.C.A.N. 2027, 2311, and in 1969-3 C.B. 423, 597. Proponents of public policy considerations often pressure Congress to increase the number of ordinary and necessary expenses that are disallowed a deduction. For example, witnesses before the House Ways and Means Committee recently suggested that taxpayers be denied deductions for "environmentally destructive business behavior." U.S. Economy, and Proposals to Provide Middle-Income Tax Relief, Tax Equity and Fairness, Economic Stimulus and Growth: Hearings Before the House Comm. on Ways and Means, 102nd Cong., 2d Sess. 1488-99 (1992) (Statement of Dawn Erlandson, Director of Tax Policy, Friends of the Earth).

[18] S. Rep. No. 552, supra note 17, at 273-76, reprinted in 1969 U.S.C.C.A.N. at 2310-13 and in 1969-3 C.B. at 596-98 ("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.").

This idea is incorporated in Treas. Reg. § 1.162-1(a) which states in pertinent part: "A deduction for an expense paid or incurred after December 30, 1969, which would otherwise be allowable under section 162 shall not be denied on the grounds that allowance of such deduction would frustrate a sharply defined public policy." The lower federal courts interpret the constraint upon them as narrowly as possible concluding that it pertains only to § 162, and thus the public policy disallowance lives on in every other section of the Code. Some courts even ignore the constraint with respect to § 162. In Car-Ron Asphalt Paving Co. v. Commissioner, 758 F.2d 1132 (6th Cir. 1985), aff'g 46 T.C.M. (CCH) 1314 (1983), the court disallowed, as not "necessary," deductions for kickbacks permitted under § 162(c). The *Car-Ron* decision not only ignored the 1969 Senate Report and the Treasury Regulations, but seemed to contradict an earlier decision of the same circuit court. In Raymond Bertolini Trucking Co. v. Commissioner, 736 F.2d 1120 (6th Cir. 1984), rev'g 45 T.C.M.

penditures denied deduction by Congress was "any fine or similar penalty paid to a government for the violation of any law."[19]

In describing the scope of the disallowance, the Senate Finance Committee Report on the Tax Reform Act of 1969 (the "1969 Senate Report") provided that "[t]his provision 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."[20] Interestingly, although the statute

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(CCH) 44 (1982), the Sixth Circuit had allowed deductions for kickbacks paid to the same person whom Car-Ron had paid. The Court in *Bertolini Trucking*, however, could not rule on whether or not the expenses were "necessary" because the Internal Revenue Service had already conceded that issue.

[19] I.R.C. § 162(f). The other three types of payments denied deduction were: (1) two-thirds of treble damages payments under the antitrust laws following a related criminal violation; (2) deductions for bribes paid to public officials; and (3) other unlawful bribes or kickbacks. I.R.C. §§ 162(c), (g). Note that punitive damages paid to a private plaintiff ("private punitive damages") were not included in the disallowances and are deductible provided the expense meets the other requirements of deductibility (i.e., expense is incurred in a trade or business and not subject to capitalization). See Rev. Rul. 80-211, 1980-2 C.B. 57 (holding private punitive damages deductible).

At first blush, it appears inconsistent that private damages are deductible while civil damages paid to a government as punishment ("public punitive damages") are not. However, such inconsistency can be reconciled with the tax law's general treatment of payments tainted by illegality. The distinction between private and public punitive damages for deduction purposes mirrors the distinction which permits deductions for expenditures made in connection with illegal business but disallows deductions for fines. In cases decided the same day, the Supreme Court in Commissioner v. Sullivan, 356 U.S. 27 (1958), allowed deductions for rent and wages incurred in conducting a bookmaking business, but, in Tank Truck Rentals v. United States, 356 U.S. 30 (1958), disallowed deductions for fines. In *Sullivan*, no government was a party to the transaction. (While governments have made bookmaking illegal in general, no government had yet brought an action specifically against Sullivan.) Conversely, in *Tank Truck Rentals*, a government brought an action specifically against the trucking company. It would be inconsistent for a government to punish an individual, yet allow the benefit of a tax deduction; therefore, Sullivan gets the tax deduction and the trucking company does not. Perhaps, only when the "conflict" rises to that level does Congress want to deviate from the net income tax.

Thus, the tax treatment differs depending on whether a government has acted in a specific case against a specific taxpayer or has acted in a more general manner (e.g., by outlawing bookmaking or establishing a regime of civil punitive damages). This difference explains other types of tax cases as well. For example, a taxpayer is allowed to depreciate illegally possessed slot machines up to the date of seizure, Rev. Rul. 74-528, 1974-2 C.B. 64, and is entitled to a cost of goods sold deduction when calculating gain upon the sale of slot machines, Rev. Rul. 74-531, 1974-2 C.B. 268. However, upon seizure he is denied a loss deduction under § 165 because the allowance of a deduction would violate public policy. Rev. Rul. 77-126, 1977-1 C.B. 47-48.

[20] S. Rep. No. 552, supra note 17, at 274, reprinted in 1969 U.S.C.C.A.N. at 2311-12, and

denied the availability of a deduction for both "fines" and "similar penalties," the legislative history addressed only criminal fines. Two issues immediately arose: does section 162(f) apply to civil exactions, and if so, to which civil exactions does it apply?

Shortly after the enactment of the Tax Reform Act, an article by Professor John Taggart appeared presenting the arguments for and against narrowly reading section 162(f) to apply only to criminal fines.[21] Taggart argues that if section 162(f) is construed to extend to civil exactions, then it should deny deduction only of civil exactions intended to punish the payor. Taggart illustrates that definition by example, distinguishing "additions to tax" from another type of exaction — "penalties" for failure to comply with the Code's substantive requirements. He contends that the "additions to tax," found in subchapter A of chapter 68 of the Code, should be deductible because they clearly are not punishment. In contrast, assessable penalties exacted under subchapter B of chapter 68 are intended to punish and, therefore, should not be deductible.[22] For support, Taggart cites *Helvering v. Mitchell*,[23] where the Supreme Court held that the "addition to tax" charged as a result of fraudulent deficiencies in federal income tax with intent to evade tax[24] was not double jeopardy to a taxpayer acquitted of criminal tax

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in 1969-3 C.B. at 597.

[21] Taggart, supra note 14, at 649. Taggart traces the development of the general public policy disallowance from its inception through its codification by the Tax Reform Act of 1969. In contrast, this Article's analysis begins with the enactment of § 162(f) by the Tax Reform Act of 1969, referring to pre-1969 authorities only to the extent that they have been used to construe § 162(f). For the history of the enactment of § 162(f), see id. at 612-18, 638-45.

[22] "Additions to tax" include exactions for failures to file certain tax returns, information returns, and registration statements; for failures to pay income, stamp, and estimated tax; for tendering bad checks to the Internal Revenue Service; and for inaccuracies in tax returns attributable to negligence or fraud. "Assessable penalties" include exactions for willful attempts to evade tax, for failures to file certain information returns, for understatements of tax liability by income tax return preparers, for promoting abusive tax shelters, for filing frivolous income tax returns, for aiding and abetting understatements of tax liability, for failing to maintain certain records, and for failing to disclose certain matters.

[23] 303 U.S. 391 (1938).

[24] This sanction is usually termed a civil fraud penalty. Presently, 75% of that portion of the underpayment attributable to fraud is added to a taxpayer's liability. I.R.C. § 6663(a). That addition is a chapter 68, subchapter A "addition to tax" for which the Government has the burden of proof. I.R.C. § 7454(a) ("In any proceeding involving the issue whether the petitioner has been guilty of fraud with intent to evade tax, the burden of proof in respect of such issue shall be upon the Secretary [of the Treasury]").

fraud.[25] Taggart asserts that because the civil fraud penalty was not punishment for purposes of double jeopardy, it is not a "fine or similar penalty" for purposes of section 162(f) of the Code.[26]

C. Treasury Regulations Promulgated Under Section 162(f)

On May 27, 1971 the Treasury, by regulation, interpreted section 162(f) of the Code to include civil penalties thereby unambiguously rejecting the narrow interpretation of section 162(f) as applying only to criminal fines. In pertinent part, the regulatory definition included an amount "paid as a civil penalty imposed by Federal, State, or local law."[27] In a memorandum from the Commissioner of the Internal Revenue Service (the "Service") to the Assistant Secretary of the Treasury, the Service, which drafted the regulations, explained that "[a]lthough an inference may be made from a statement in the Senate Finance Committee report that a criminal conviction is required for section 162(f) to apply, it has been concluded that this statement should be interpreted as only an example of one of the situations to which that section applies."[28]

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[25] *Mitchell*, 303 U.S. at 398, 401 (concluding that the civil fraud penalty was not intended as punishment but as a remedial exaction to reimburse the Government for the heavy expense of investigation and loss resulting from the taxpayer's fraud).

[26] Taggart, supra note 14, at 640.

[27] Prop. Treas. Reg. § 1.162-21 (b)(2), 36 Fed. Reg 9637, 9639 (May 27, 1971). The full definition was as follows:

> (b) *Definition.* For purposes of this section a fine or similar penalty includes an amount
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> (1) Paid pursuant to a judgment of conviction or a plea of guilty or nolo contendere for a crime (felony or misdemeanor) in a criminal proceeding;
>
> (2) 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;
>
> (3) Paid in settlement of the taxpayer's liability for a fine or penalty (civil or criminal); or
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> (4) Forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty.
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> Such amount 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.

Id.

[28] Memorandum from the Commissioner of Internal Revenue to Edwin S. Cohen, Assistant Secretary of the Treasury 3-4 (Dec. 8, 1970), available in LEXIS, Fedtax Library, TM

While unambiguously stating that section 162(f) of the Code applies to civil exactions, the regulations did not clarify the manner in which 162(f) applies. The broad inclusion of any civil penalty in the definition suggested that *any* exaction carrying the "penalty" label would not be deductible. However, two particular provisions in the regulations imply that "penalty" might be defined functionally (i.e., defined by its effect rather than its name). The first provision, undoubtedly prompted by Professor Taggart's examples, applies the definition to "additions to tax" and "penalties" under the Code. Rejecting Taggart's position, the regulations provide that additions to tax as well as penalties would not be deductible.[29] Since additions to tax are not labeled penalties by the substantive law imposing them,[30] the regulations must contemplate that some criterion other than label defines penalty. Functional analysis is the only likely criterion, yet the regulations never disclose the determinative function of a "penalty."

The second provision suggesting functional analysis states that "compensatory damages . . . paid to a government do not constitute a fine or penalty."[31] Thus, a civil exaction, denominated a penalty by the substantive law imposing it, nonetheless could be deductible. The two examples thereby suggest a functional definition for "penalty," but the regulations never reveal the determinative function other than to state that compensation is not a function of a penalty.

The Senate Finance Committee commented upon the proposed regulation in its report on the Revenue Act of 1971 (the "1971 Senate Report").[32] The Committee agreed that section 162(f) of the

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File (citation omitted).

[29] Prop. Treas. Reg. § 1.162-21(b)(2), 36 Fed. Reg. 9637, 9639 (May 27, 1971).

[30] The additions to tax are provided in subchapter A of Chapter 68 of the Code; the operative provisions of such additions typically provide that, "in [the] case of failure [timely] to file any return . . . there shall be added to the amount required to be shown as tax on such return 5 percent of the amount of such tax . . . ." I.R.C. § 6651(a)(1).

[31] Prop. Treas. Reg. § 1.162-21(b), 36 Fed. Reg. 9637, 9639 (May 27,1971).

[32] Senate Comm. on Finance, Revenue Act of 1971, S. Rep. No. 437, 92nd Cong., 1st Sess. 73-74 (1971), reprinted in 1971 U.S.C.C.A.N. 1918, 1979-80, and in 1972-1 C.B. 559, 600. In the 1971 Act, Congress did not amend § 162(f), but did amend the public policy based disallowances codified in 1969. The 1971 Act's changes were to (1) delete the requirement in § 162(c)(2) that a criminal conviction occur before a deduction for a bribe or kickback is denied, (2) extend the disallowance beyond bribes and kickbacks to any other payment illegal under federal or generally enforced state law which subjects the payor to a criminal penalty or the loss of license or privilege to engage in a trade or business, and (3) broadly

Code extended to civil exactions, but it did not agree with the regulations' definition of which civil exactions are not deductible. The Committee used Taggart's example of "additions to tax" and penalties to illustrate the point. Rejecting the Treasury's position that all "additions to tax" are nondeductible, the Finance Committee essentially agreed with Taggart's position that "additions to tax" are deductible. However, it distinguished certain additions to tax — those for which the Government bears the fraud burden of proof — as nondeductible.[33] In addition, the Committee adopted functional analysis generally to distinguish deductible and nondeductible civil penalties by stating that section 162(f) disallows "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.*"[34]

The Treasury implemented the 1971 Senate Report to a minor

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deny a deduction for referral fees, kickbacks, and rebates in connection with medicare and medicaid. S. Rep. No. 437, at 73-74, reprinted in 1971 U.S.C.C.A.N. at 1979-80, and in 1972-1 C.B. at 599.

[33] S. Rep. No. 437, supra note 32, at 73-74, reprinted in 1971 U.S.C.C.A.N. at 1979-80, and in 1972-1 C.B. at 600. Thus, the addition to tax specifically addressed by Taggart, the civil fraud penalty, would not be deductible because, although it was a chapter 68, subchapter A "addition to tax," the Government bears the fraud burden of proof. However, for most chapter 68, subchapter A additions to tax, the Government does not have the burden of proof, and for those, whereas the Committee would permit a deduction, the regulation does not. See infra text accompanying notes 35-36.

[34] S. Rep. No. 437, supra note 32, at 73-74, reprinted in 1971 U.S.C.C.A.N. at 1979-80, and in 1972-1 C.B. at 600 (emphasis added). In full, the Committee commented as follows:

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

Id.

extent in December 1972. However, the Treasury ignored the report's instruction to apply functional analysis to distinguish deductible and nondeductible civil exactions and ignored the specific application of that distinction to civil tax exactions. The Treasury excepted from the penalty definition only "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,"[35] which essentially was a quotation of part of the 1971 Senate Report's discussion of civil exactions.

Commentators pointed out a clear conflict between the major points of the 1971 Senate Report and the Proposed Treasury Regulation.[36] In 1975, the Treasury addressed the conflict. The Treasury concluded that, contrary to its assertion in 1972, the 1971 Senate Report was wholly irrelevant in construing section 162(f) of the Code because the 1971 Act neither enacted nor amended section 162(f).[37] The Treasury consequently affirmed its 1972 decision to ignore the major points of the 1971 Senate Report and reversed its 1972 decision to exclude interest-like penalties from the disallowance because the only support for that exclusion had been the 1971 Senate Report.[38] Thus, after finalization in 1975, the regulations appeared to disallow deductions for all civil penalties and of-

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[35] Prop. Treas. Reg. § 1.162-21, 37 Fed. Reg. 25936, 25938 (Dec. 6, 1972). In addition, the newly proposed regulations added an example illustrating the application of § 162(f) of the Code to a civil penalty under the Clean Water Act. Prop. Treas. Reg. § 1.162-21(c) Ex. 2, 37 Fed. Reg. 25936, 25938. That example was litigated in True v. United States, 894 F.2d 1197 (10th Cir. 1990); see infra note 109.

[36] A January 30, 1975 internal Treasury memorandum refers to a comment received from Arthur Andersen & Co., dated February 5, 1973, which indicated that some taxpayers concluded that § 162(f) of the Code does not disallow the deduction of additions to tax imposed by subchapter A of chapter 68 of the Code. Memorandum from Donald C. Alexander, Commissioner of Internal Revenue, to Frederic W. Hickman, Assistant Secretary of the Treasury 4 (Jan. 30, 1975), available in LEXIS, Fedtax Library, TM File.

[37] Id. at 6-7. Every court to consider the issue has relied upon the "subsequent" legislative history in construing § 162(f) of the Code with the exception of one Tax Court case, Uhlenbrock v. Commissioner, 67 T.C. 818, 822 n.5 (1977) (specifically ignoring the 1971 Senate Report). Yet subsequent to *Uhlenbrock*, the Tax Court extensively relied upon the 1971 Senate Report. See infra text accompanying note 45.

[38] On February 20, 1975 the Treasury removed the language in the regulation excepting interest-like penalties from the penalty definition which had been included in December 1972 in response to the 1971 Senate Report. Treas. Reg. § 1.162-21 (as amended by T.D. 7345). On July 11, 1975 the Treasury finalized the "fines and penalties" regulation, defining the terms identically with the original proposed regulation of May 27, 1971. Treas. Reg. § 1.162-21(b) (as amended by T.D. 7366).

fered no guidance on the definition of "penalty" other than that "compensatory damages paid to a government" are not penalties, whereas "additions to tax" imposed under the Code are penalties.

D. Establishing That Purpose is Determinative

Shortly after the Treasury finalized the regulations, courts interpreted section 162(f) of the Code. No court has given more than passing consideration to the issue of whether section 162(f) applies only to criminal fines. Two courts that did consider the narrow interpretation of section 162(f) rejected it for one or more of three reasons: (1) the enactment's legislative history indicates an intent to codify the general common-law position, and pre-enactment cases had denied deductions for civil exactions,[39] (2) the post-enactment legislative history (the 1971 Senate Report) states an intent to disallow the deduction of exactions imposed under civil statutes which serve the same purpose as a fine exacted under a criminal statute, and (3) the conjunctive "and" in the statutory language "fines and similar penalties" must include something besides fines.[40]

The cases construing section 162(f) of the Code therefore proceed upon the assumption that amounts paid by taxpayers in civil suits to a government can serve the same purpose as a fine exacted under a criminal statute — i.e., punishment — and therefore an income tax deduction is denied. Thus, the notion that a government can punish a defendant in a civil proceeding, constitutionally suspect under due process principles until 1989, was accepted without murmur by courts deciding tax cases.[41]

Still unresolved, however, was the issue of to which civil exactions section 162(f)'s deduction disallowance applied. Professor

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[39] However, the Supreme Court never had denied deductions for civil exactions, and Tank Truck Rentals v. United States, the most prominent pre-enactment case, dealt only with criminal fines. 356 U.S. 30, 34-35 (1958).

[40] Adolph Meller Co. v. United States, 600 F.2d 1360, 1362-63 (Ct. Cl. 1979); Tucker v. Commissioner, 69 T.C. 675, 679 n.4 (1978).

[41] Kenneth Mann comments that, prior to the 1989 Supreme Court decision in United States v. Halper, 490 U.S. 435 (1989), for due process purposes, "the notion that the state could impose punitive sanctions in civil proceedings had become increasingly questionable." Kenneth Mann, Punitive Civil Sanctions: The Middleground Between Criminal and Civil Law, 101 Yale L.J. 1795, 1842 (1992). However, that notion was questioned neither by Congress in 1971 when construing § 162(f) of the Code nor by the Treasury in promulgating regulations (nor by the courts deciding the deductibility of civil exactions).

Taggart, the Treasury, and the Senate Finance Committee had explained their definitions of deductible and nondeductible civil exactions using the terms "additions to tax" and "penalties" (defined in chapter 68 of the Code) as examples. Strangely, the first two reported cases involved "additions to tax," thereby presenting to the courts the precise issue framed in the example governing the earlier debates.

In *May v. Commissioner*[42] and *Uhlenbrock v. Commissioner*,[43] the taxpayers filed tax returns and paid taxes late, thereby becoming liable for additions to tax for which the Government did not have the fraud burden of proof. The 1971 Senate Report unambiguously determined that section 162(f) of the Code would not apply,[44] but the Treasury regulations, as noted above, ignore the 1971 Senate Report and provide that section 162(f) denies deductions for all additions to tax.

In *May*, the Tax Court quoted the 1971 Senate Report's language disallowing deductions for additions to tax only where the government has the fraud burden of proof,[45] yet the Tax Court failed to note the manifest conflict between that quotation and the Treasury regulation. The Tax Court summarily concluded that Treasury Regulation section 1.162-21(b) governed and precluded the deduction.[46] In *Uhlenbrock*, the Tax Court, citing *May*, reached the identical conclusion but addressed the conflict in a footnote:

> We recognize that there is a contrary suggestion [to the court's holding that section 162(f) of the Code disallowed deductions for additions to tax for which the Government did not have the fraud burden of proof] in a post-enactment legislative commentary on sec. 162(f). But, that commentary is ambiguous at best. Under such circumstances, we are not disposed to give it more than passing notice; certainly it cannot be determinative of the issue involved herein.[47]

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[42] 65 T.C. 1114 (1976).

[43] 67 T.C. 818 (1977).

[44] S. Rep. No. 437, supra note 32, at 73-74, reprinted in 1971 U.S.C.C.A.N. at 1979-80, and in 1972-1 C.B. at 600.

[45] 65 T.C. at 1115.

[46] Id. at 1116.

[47] *Uhlenbrock*, 67 T.C. at 822 n.5 (citation omitted). The Tax Court's use of that precise portion of the 1971 Senate Report is selective. Indeed, in another case the taxpayer cited the 1971 Senate Report's fraud burden of proof language and argued that any civil penalty is a

After *May* and *Uhlenbrock*, the scope of "similar penalty" appeared especially broad because the Tax Court, accepting the Treasury regulations' position without analysis, had disallowed the deduction of an exaction not labelled a penalty by the substantive law imposing it.[48] The only discernible basis of the *May* and

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"similar penalty" only if the prosecuting government has the fraud burden of proof. Huff v. Commissioner, 80 T.C. 804, 822 (1983). The Tax Court disagreed, concluding that the fraud burden of proof language applied only for purposes of distinguishing deductible and nondeductible additions to tax under subchapter A of chapter 68 of the Code. According to the court, the fraud burden of proof did not apply to distinguish deductible from nondeductible penalties in general. Id. at 823-24. Yet in *Uhlenbrock*, that same language would have required a decision in favor of the taxpayer. The Tax Court ignored it and held that an addition to tax for which the Government did *not* have the fraud burden of proof nonetheless was not deductible. *Uhlenbrock*, 67 T.C. at 822. *Uhlenbrock* and *Huff* render the fraud burden of proof language a nullity. The language distinguishes neither additions to tax nor civil penalties in general.

In addition, the Tax Court has quoted the 1971 Senate Report summarily to conclude that chapter 68, subchapter B penalties are not deductible. Reid v. Commissioner, 42 T.C.M. (CCH) 1741, 1747 (1981). For subchapter B penalties, there is no conflict between the Treasury regulations and the 1971 Senate Report, because the Report said that § 162(f) of the Code denies deduction of all subchapter B penalties. However, the Tax Court, like the Treasury when promulgating regulations, does not explain how half of a sentence in a congressional report reflects legislative intent (when addressing subchapter B penalties), but the other half does not (when addressing subchapter A additions to tax). A Service ruling solved the conflict simply by omitting the fraud burden of proof language from its quote of the 1971 Senate Report. Rev. Rul. 78-196, 1978-1 C.B. 45. Similarly, the Tax Court often relies upon the 1971 Senate Report to rebut the argument that the 1969 Senate Report shows that § 162(f) of the Code is limited to criminal fines. Middle Atlantic Distributors, Inc. v. Commissioner, 72 T.C. 1136, 1142-43 (1979) ("The legislative history of section 162(f) has been called ambiguous. Certainly, however, by 1972 it was clear that section 162(f) was intended to include civil penalties 'which in general terms serve the same purpose as a fine exacted under a criminal statute.' ") (quoting S. Rep. No. 437, supra note 31, at 73, reprinted in 1971 U.S.C.C.A.N. at 1980, and in 1971 C.B. at 600). Southern Pac. Transp. Co. v. Commissioner, 75 T.C. 497, 652 n.177 (1980) (recognizing the temporal problem of a 1971 legislative report addressing a 1969 enactment, but concluding, "we believe the latter committee report [1971 Senate Report] accurately reflects the intent of Congress in enacting sec. 162(f)").

A comparison of *Uhlenbrock*, *Huff*, *Reid*, *Middle Atlantic*, and *Southern Pacific* suggests that, according to the Tax Court, the 1971 Senate Report accurately reflects enactment intent with respect to chapter 68 exactions only when the Report advances the Commissioner's arguments.

[48] The Code section at issue in *May* and *Uhlenbrock*, § 6651, is contained in subchapter A of chapter 68 of the Code. Subchapter A is headed "Additions to the tax and additional amounts," in contradistinction to subchapter B headed "Assessable penalties." Throughout § 6651, the operative concept is an *addition* to the tax otherwise due resulting from late return filing or late payment of tax. However, the heading of § 6651(b) (which provides that the addition to tax is imposed only on the portion of tax not timely paid) is "penalty imposed on net amount due." "Penalty" nowhere appears in the text of the section, but the

Uhlenbrock decisions is that, because the "additions to tax" were not interest, they were punishment. These decisions only gave greater support to the view that any not-compensatory payment to a government is not deductible.

The broad view of "similar penalty" continued to hold sway in *Tucker v. Commissioner*[49] in which the Tax Court addressed the general application of section 162(f) to civil penalties. The Tax Court did not apply functional analysis to decide whether the civil exaction assessed against the taxpayer under New York's Taylor Law, prohibiting public employee strikes, constituted punishment. The Tax Court noted only that the legislative history of the Taylor Law and a New York court decision termed the exaction a "civil penalty."[50] After *Tucker*, it appeared that any civil exaction dubbed a "penalty," however remotely, by the substantive law imposing it would not be deductible.

The next year the Tax Court changed its mind without reversing *Tucker*. Contrary to its *Tucker* analysis, in *Middle Atlantic Distributors, Inc. v. Commissioner*,[51] the Tax Court did not find the fact that the substantive law labeled a civil action a "penalty" to be determinative. Instead, the court distinguished among civil penalties stating that "it is clear that, if the deduction of a civil fine (or similar penalty) is to fall within the proscription of section 162(f), the fine must be one which punishes and/or deters."[52] The court apparently accepted the 1971 Senate Report's focus on a penalty's purpose and rejected the Treasury regulations' inclusion of any "civil penalty" within the disallowance. Thus, the Tax Court appeared to accept a functional definition of "similar penalty" based upon the penalty's purpose.[53]

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appearance of "penalty" in the heading apparently was sufficient for the Tax Court in *May* and *Uhlenbrock*, notwithstanding the subchapter A/subchapter B distinction in the 1971 Senate Report. At best for the Tax Court, there was one heading indicating that § 6651 of the Code is not a penalty and one indicating that it is. (Two other subsections of § 6651 contain the word "penalty" in their headings: "Increase in penalty for failure to pay tax in certain cases," § 6651(d), and "Increase in penalty for fraudulent failure to file," § 6651(f). Neither subsection was at issue in *May* or *Uhlenbrock*). It is fair to conclude that an exaction under § 6651 of the Code is not considered a penalty under the substantive law imposing it.

[49] 69 T.C. 675 (1978).

[50] Id. at 681.

[51] 72 T.C. 1136 (1979).

[52] Id. at 1143.

[53] Curiously, the Tax Court has not reexamined *May* and *Uhlenbrock* in light of its turn

All subsequent courts, except the Federal Circuit, have agreed that section 162(f)'s application depends upon the purpose of the state-invoked civil sanction.[54] The Federal Circuit apparently finds the penalty label determinative, but concedes that penalties are deductible if they represent interest charges for late filing or represent damages for injury to the government's business or property.[55] Thus, the Federal Circuit contemplates at least a limited purpose inquiry to decide if either of its two narrow exceptions applies.

III. A Systematic Approach to Deciding Section 162(f) Cases

A. Recognizing the Hierarchy

Courts deciding tax cases have been of many minds in deciding how to determine the purpose of a state-invoked civil sanction, but a consensus on a hierarchy of factors to use has emerged. The hierarchy consists of three factors: (1) legislative intent, (2) the particular circumstances at hand, and (3) the nature of the remedy.

At the top of the hierarchy of factors is the legislative intent with respect to the provision under which the government brings

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away from the use of an all-encompassing definition of "penalty" towards the use of a detailed "purpose" inquiry. The purpose of the "additions to tax" of subchapter A of chapter 68 is not to punish, for there is no declaration of punitive intent in the legislative history or the statute, and the manner of calculating the damages shows that additions to tax compensate the Government for the loss of use of money. The Tenth Circuit in dicta noted the precarious nature of the Treasury regulations' disallowance of all chapter 68 civil tax exactions, True v. United States, 894 F.2d 1197, 1204 n.18 (10th Cir. 1990), and with it the precarious nature of the Tax Court's decisions in *May* and *Uhlenbrock*.

[54] Authorities concluding that the purpose of a payment determines application of § 162(f) include the Second Circuit, Tenth Circuit, Sixth Circuit, Tax Court, and the Service's published rulings. See Stephens v. Commissioner, 905 F.2d 667, 673 (2d Cir. 1990); True v. United States, 894 F.2d 1197, 1204 (10th Cir. 1990); Mason and Dixon Lines, Inc. v. United States, 708 F.2d 1043, 1047 (6th Cir. 1983); Southern Pacific Transp. Co. v. Commissioner, 75 T.C. 497, 652 (1980); Rev. Rul. 88-46, 1988-1 C.B. 76. Only the Federal Circuit rejected the purpose inquiry in Colt Indus., Inc. v. United States, 880 F.2d 1311, 1313-14 (Fed. Cir. 1989), aff'g, 11 Cl. Ct. 140 (1986).

[55] In *Colt Industries*, the Federal Circuit wrote:

> The committee's comments [in the 1971 Senate Report] 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. . . . 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.

880 F.2d at 1313-14. See *Colt Indus.*, 11 Cl. Ct. at 146.

its claim. Courts deciding tax cases have discerned such legislative intent from three sources: (1) legislative history; (2) the place of the provision at issue in a statutory scheme; and (3) court decisions construing the provision at issue for purposes other than deductibility under section 162(f).[56]

If a court deciding a section 162(f) case cannot discern from legislative intent an intention to punish, or if it discerns both an intent to punish and an intent not to punish (a "dual purpose" case), then the next factor in the hierarchy is an examination of facts and circumstances specific to the case. Examples of these are the text of the judicial or administrative order imposing the sanction, a transcript of the sentencing proceedings, or the text of a settlement agreement compromising the litigation.

If neither legislative intent nor the facts and circumstances specific to the case are determinative, then the court examines the nature of the remedy available to the government upon proof of the claim to decide whether the purpose of the exaction is punitive. Here the cases often improperly conclude that if a remedy is not-compensatory, then it is punitive.

Although currently this hierarchy is discernible only by observation,[57] courts should recognize the hierarchy expressly, both be-

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[56] Obviously, a court decision construing the provision at issue for purposes of a § 162(f) deduction would be considered by the court as persuasive authority. The sources here are, for instance, court decisions deciding whether procedural rules for consumer class actions apply to an action brought under the provision at issue.

[57] The Service's most recent published rulings analyzing application of § 162(f) of the Code fit within the hierarchy outlined. In Rev. Rul. 88-46, 1988-1 C.B. 76, the Service concluded that a non-conformance penalty ("NCP") assessed by the Environmental Protection Agency ("EPA") was deductible because legislative history showed that the NCP was not-punitive and was one of two lawful alternative methods for receiving a certificate of conformity. Section 206(g)(1) of the Clean Air Act, 42 U.S.C. § 7525(g)(1), required the EPA to issue a certificate of conformity for any class or category of heavy duty vehicles or engines that exceeded a set emission standard. If the manufacturer paid a NCP, the manufacturer could exceed the regular standard but not an upper limit associated with that standard. The ruling noted the following: (1) the legislative history indicated that the NCP was to be set at a level that would eliminate the competitive advantage, if any, for the manufacturer of a nonconforming vehicle or engine, (2) the legislative history referred to the NCP as a performance penalty, irrespective of fault, and (3) the purpose of the Act, according to the legislative history, was to assure the achievement of the maximum emission reduction that reasonably could be technologically available, while at the same time not removing the nonconforming manufacturer from the market.

More recently, the Service concluded in Rev. Proc. 92-91, 1992-46 I.R.B. 32, that a $2000 per ton penalty imposed by section 411 of the Clean Air Act Amendments of 1990, Pub. L. No. 101-549, 104 Stat. 2584 (1990), "is punitive as indicated by the legislative history ac-

cause it conforms to substantial parts of the analyses applied in the pertinent cases and because it comports with the legislative history of section 162(f).

The legislative history of section 162(f) (the 1969 Senate Report) states an intent to codify and occupy the judicially-created public policy disallowance of deductions.[58] In *Commissioner v. Tellier*,[59] the most recent Supreme Court decision at the time section 162(f) was enacted, the Court stated that there are two elements needed to establish a public policy disallowance. They are governmental declaration of a policy and the immediate frustration of that policy if a tax deduction occurs.[60] Section 162(f) and its legislative history establish that frustration of governmental policy occurs when an exaction intended as punishment is tax deductible.[61] The 1971 Senate Report reiterates that the presence or absence of punitive purpose governs the deductibility of an exaction.[62] Consequently,

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companying the Act." Id. at 33 (citing H.R. Rep. No. 490 (Part 2), 101st Cong., 2d Sess. 5 (1990)).

However, in Revenue Ruling 78-196, 1978-1 C.B. 45, the Service concluded that a liquidity deficiency penalty imposed under regulations of the Federal Home Loan Bank Board upon a savings and loan institution that failed to maintain the prescribed level of liquid assets was a non deductible penalty. The ruling examined the manner of calculating the penalty, which was to take the amount of the deficiency and multiply it by the annual rate of interest plus 2% that would be charged to borrow such amount. The ruling concluded that the interest-like calculation did not remove the penalty from § 162(f), analogizing the liquidity deficiency penalty to additions to tax under chapter 68, subchapter A, of the Code. As noted earlier, the legislative history of § 162(f) indicates that additions to tax under subchapter A of chapter 68 are not deductible only where the government has the fraud burden of proof. The ruling makes a material omission by quoting the legislative history and redacting the fraud burden of proof language.

[58] See supra notes 17-18 and accompanying text.

[59] 383 U.S. 687 (1966).

[60] Id. at 694.

[61] Criminal fines are a boundary case of the general rule. While a penalty is a "similar penalty" only if it is intended to punish, the definition of "fine" does not expressly contain a purpose element. The Treasury regulations contemplate that "fine" includes all exactions paid pursuant to conviction or a plea of guilty or *nolo contendere* for a crime so intent to punish is not relevant to deciding the deductibility of criminal fines. But, whether "fine or similar penalty" means those exactions intended to punish or means criminal fines plus those exactions intended to punish makes little practical difference. The set of criminal fines not intended to punish probably is null because the invocation of criminal proceedings itself constitutes an intent to punish.

[62] See supra note 32 and accompanying text. It may be argued that the 1971 Senate Report is not relevant in construing § 162(f) because it does not relate to enactment or amendment of the statute. However, the issue is really immaterial because the 1971 Report only expressly states a point that the 1969 Report stated via incorporation by reference: intent to

the determinative issue in applying section 162(f) is, as virtually all courts have concluded, finding a governmental declaration that the exaction at issue is intended to punish.

Few cases have involved express declarations of punitive intent found in statutes, legislative history, or the facts specific to the case. That absence is not surprising because, prior to 1989, punishment by a government within a civil suit was constitutionally suspect. As late as 1980, in *United States v. Ward*,[63] the Supreme Court determined that a penalty punitive either in purpose or effect could not constitutionally be exacted in a civil setting.[64] It is understandable that legislatures and government officials prosecuting civil suits did not declare an intent to punish, for such declarations ran the risk of rendering their acts unconstitutional. However, in *United States v. Halper*,[65] the Court, without reversing *Ward*, held that a civil sanction properly may punish.[66] The Supreme Court reiterated its changed stance last Term in *Austin v. United States*.[67] The Court concluded that, although civil proceedings properly may punish, civil punishment (just like criminal punishment) may not be excessive;[68] thus, the Court held that "punishment" should be treated identically whether imposed by criminal or civil law.

While governments now may expressly punish via civil law, a collateral consequence of a declared intent to punish might continue to suppress such express declarations. Recent scholarship has

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punish defines the scope of the disallowance.

[63] 448 U.S. 242 (1980).

[64] Id. at 248-49.

[65] 490 U.S. 435 (1989).

[66] In *Halper* the Court never addressed the manifest conflict with *Ward*. It noted: "It is commonly understood that civil proceedings may advance punitive as well as remedial goals, and, conversely, that both punitive and remedial goals may be served by criminal penalties." However, the Court supported its position by citing only those civil cases in which punitive damages were permitted in suits between private persons. *Halper*, 490 U.S. at 447. See Mann, supra note 41, at 1842.

[67] 113 S. Ct. 2801 (1993).

[68] The Supreme Court never has held any criminal or civil fine unconstitutional under the Eighth Amendment. Respondent's Brief in Opposition to Petition for Writ of Certiorari at 26, Browning-Ferris Indus., Inc. v. Kelco Disposal, Inc., 492 U.S. 257 (1989), reprinted in 185 Landmark Briefs and Arguments of the Supreme Court of the United States: Constitutional Law 424 (Philip B. Kurland & Gerhard Casper eds. 1990). In *Browning-Ferris Indus.*, the Court held that the Excessive Fines Clause of the Eighth Amendment does not apply to punitive damages recovered in suits between private parties.

considered whether more than ordinary civil process is due defendants punished by civil law. In a recent symposium addressing punitive civil sanctions,[69] experts agreed that a civil defendant punished by a government should be afforded some form of criminal process and disagreed only on what constitutes punishment.[70]

However, except for a few late nineteenth century cases and a handful of opinions dealing with in rem forfeitures, the Supreme Court has consistently rejected the argument that a civil defendant is entitled to criminal process.[71] Yet *Austin* and *Halper* may signal a change. Last Term in *Austin*, the Court decided that the Eighth Amendment prohibits state-invoked civil sanctions from punishing excessively.[72] In *Halper*, the Court decided that the Fifth Amendment prohibits combinations of criminal and civil punishment which result in the imposition of multiple penalties.[73] At least in the modern cases, the issue of whether the criminal processes described in the Fourth, Fifth, and Sixth Amendments apply to persons punished by state-invoked civil sanctions is still to be decided.[74] While a legislature declaring that an exaction is punitive no longer fears that it is unconstitutional to litigate the exaction in a civil proceeding, it may run the risk that the civil proceeding will have to include at least some criminal process. The risk that courts will be required to provide criminal process at an increased cost is a possibility that may continue to suppress express declarations of punitive intent. Therefore, future courts may continue to utilize factor three of the hierarchy — inference of punitive intent from the nature of the remedy — to decide the majority of the section 162(f) cases.[75]

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[69] Symposium, Punishment, 101 Yale L.J. 1681 (1992).

[70] Mann, supra note 41, at 1862, 1870-71; John C. Coffee, Jr., Paradigms Lost: The Blurring of the Criminal and Civil Law Models—And What Can Be Done About It, 101 Yale L.J. 1875, 1876-77, 1885 (1992); Abraham S. Goldstein, White-Collar Crime and Civil Sanctions, 101 Yale L.J. 1895, 1899 (1992); Franklin E. Zimring, The Multiple Middlegrounds Between Civil and Criminal Law, 101 Yale L.J. 1901, 1907-08 (1992).

[71] Mann, supra note 41, at 1813-44.

[72] 113 S. Ct. 2801 (1993).

[73] 490 U.S. at 448-49.

[74] *Austin*, 113 S. Ct. at 2804, n.4. See, e.g., United States v. $30,440 in U.S. Currency, 1993 U.S. App. LEXIS 20976 (9th Cir. Aug. 20, 1993) (an ineffective assistance of counsel case, considering *Austin* and whether the Sixth Amendment's right to counsel "in all criminal prosecutions" applies to civil forfeitures, but obviating the issue by deciding that counsel was effective).

[75] If a legislature wants to apply economic coercion in a civil case without the require-

B. Refining the Hierarchy

The hierarchy of factors used to examine those places in which a governmental declaration of punitive purpose will be found, if one exists, accurately indicates which factor would prevail in case of a conflict. However, the manner by which courts and administrative agencies have applied the factors requires substantial refinement. First, courts and administrative agencies have accepted attenuated declarations of punitive purpose. Second, the Tax Court and the Service have arrogated power to "substance over form" analysis in derogation of the purpose of section 162(f).[76] Both have suggested that they would disregard declarations of not-punitive intent in legislative history or in the facts and circumstances of certain cases. Third, in applying nature-of-the-remedy analysis, many courts and the Service improperly have required the taxpayer to prove that the exaction was compensatory rather than that it was merely not-punitive, thereby misapprehending when the manner of computing damages shows that a remedy punishes the payor.

1. Legislative Intent

Seven cases have been decided on the basis of legislative intent. A brief look at the cases is illuminating. In *Tucker v. Commissioner*,[77] the Tax Court decided that the "penalty" label employed in New York legislative history and New York court decisions demonstrated that the purpose of a penalty was to punish striking teachers. The Tax Court in *Southern Pacific Transp. Co. v. Commissioner*[78] held that the purpose of the Safety Appliance Act was to protect employees from injury, basing its finding on other cases

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ment of providing criminal process, and the legislature believes that the necessary deterrent effect exceeds compensatory damages, it should act as follows: For due process purposes, as long as the legislature prices the exaction at or below "all the Government's costs" and does not declare a punitive intent, proceedings involving the exaction should be viewed as normal civil suits. Such an exaction, not being punishment, is deductible (or rather should be deductible upon proper application of § 162(f) of the Code). But, certainty on deductibility is a good result because now the legislature knows to price the exaction on an after-tax basis.

[76] In Gregory v. Helvering, 293 U.S. 465 (1935), the Court established the "substance over form" doctrine stating that "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." Id. at 469. Sometimes the doctrine is elevated to status of a substantive rule of tax law even though it is simply is a rule of statutory interpretation.

[77] 69 T.C. 675 (1978)

[78] 75 T.C. 497 (1980)

which had decided whether the Act applied to specific personal injuries.[79] The court also ruled that the purpose of the Twenty-Eight Hour Act was to prevent cruelty to animals in transit.[80] In *Huff v. Commissioner*,[81] the Tax Court determined that a California Supreme Court decision, involving an issue of civil procedure, showed that the purpose of a civil penalty exacted under the California Business and Professions Code was to punish. In *Waldman v. Commissioner*,[82] the Tax Court decided that restitution paid to victims of crime was not deductible because a criminal conviction is a condition precedent to the imposition of restitution.[83]

Two additional Tax Court cases summarily concluded that payments of parking tickets were not deductible. *Jackson v. Commissioner* reached this conclusion without offering a principled reason in the holding.[84] In *O'Connor v. Commissioner*,[85] the Tax Court was more forthcoming. There, the court stated: "It is clear that the governmental statutes or ordinances violated by petitioners were intended to ensure the orderly operation of motor vehicles on the highways."[86] The court did not indicate which statutes or ordinances were violated or from where their intent was discerned.[87] The Claims Court in *Colt Indus., Inc. v. United States* decided that congressional legislative history showed that the purpose of the federal Clean Air Act and Clean Water Act penalties at issue was to punish.[88]

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[79] Id. at 647.

[80] Id. at 644, 647. The Tax Court discerned its holding from the Act's title, "Twenty-Eight Hour Act [Care of Animals in Transit]," (brackets in original). Id. The court also based its decision on a Supreme Court case which determined the number of penalties for which a carrier was liable for violating rules governing the shipment of live animals via rail. The Tax Court implicitly equated those purposes with punishment.

[81] 80 T.C. 804 (1983).

[82] 88 T.C. 1384 (1987), aff'd by order, 850 F.2d 611 (9th Cir. 1988). The Ninth Circuit adopted the Tax Court's holding and reasoning by order.

[83] In the alternative, the Tax Court applied its civil penalty analysis concluding that two California Supreme Court cases indicated that, where a California sentencing court imposes the obligation to pay restitution, the payment is " 'imposed for purposes of enforcing the law' and hence is nondeductible under Section 162(f)." Id. at 1388.

[84] 34 T.C.M. (CCH) 1315, 1319 n.3. (1975).

[85] 52 T.C.M. (CCH) 499 (1986).

[86] Id. at 507.

[87] Perhaps the Tax Court believes that it can take judicial notice that all parking tickets are intended to punish.

[88] 11 Cl. Ct. 140 (1986), aff'd on other grounds, 880 F.2d 1311 (Fed. Cir. 1989). The Claims Court applied a balancing test to the language within the legislative history to the

None of the seven cases should have been decided on the basis of legislative intent.[89] The sources of legislative intent relied upon by each court did not declare that the penalty at issue was intended to punish. Some decisions attached talismanic significance to the presence of the word "penalty" in legislative history or in court decisions construing the provision at issue without further inquiry into whether there was a punitive intent behind the penalty. Others took a gestalt approach to the legislative history and found an expression of punitive intent even though such intent could not be derived from a summation of a statute's parts.[90]

The Supreme Court in *Tank Truck Rentals v. Commissioner*[91] cautioned against ranging too far afield in locating declarations of punitive intent. Prior to the enactment of section 162(f), the Court denied deduction of criminal fines under that statute's predecessor, the public policy disallowance. The Court noted, "[b]ecause state policy in this case was evidenced by specific legislation, it is unnecessary to decide whether the requisite 'governmental declaration' might exist other than in an Act of the Legislature."[92] Section 162(f) cases properly have expanded the search for punitive intent

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Clean Air Act penalties stating, "[t]he facts regarding the punitive nature of the civil penalty provisions outweigh the references in the report to a 'remedial' or 'deterrent' purpose." Id. at 144. In reference to the Clean Water Act penalties, the court held that "[t]he legislative history of the Clean Water Act does not provide significant insight into the question regarding the punitive nature of section 309(d) of the Act." Id. However, the court then concluded that, because legislative history referred to the Clean Air Act civil penalty provisions, the punitive objective of those provisions was incorporated by reference. Id. at 144-45.

[89] Note, however, that only two reached an improper result.

[90] In perhaps the most egregious case, the Tax Court in *Southern Pacific* decided that the words "Care of Animals in Transit" in the popular name of a statute declared a punitive purpose to penalties exacted under the statute. Yet these words do not appear in the statute's actual title. As printed in the Statutes at Large, the act had no official name; the title of the act reads:

> An Act To prevent cruelty to animals while in transit by railroad or other means of transportation from one State or Territory or the District of Columbia into or through another State or Territory or the District of Columbia, and repealing sections forty-three hundred and eighty-six, forty-three hundred and eighty-seven, forty-three hundred and eighty-eight, forty-three hundred and eighty-nine, and forty-three hundred and ninety of the United States Revised Statutes.

Pub. L. No. 59-340, 34 Stat. 607 (1906) (codified at 45 U.S.C. §§ 71-74 (1988)).

A note following 45 U.S.C. § 71 indicates that the chapter that includes sections 71 to 74 popularly is known as the "Live Stock Transportation Act," and also known as the "Cruelty to Animals Act," "Twenty-Eight Hour Law," and "Food and Rest Law."

[91] 356 U.S. 30 (1958).

[92] Id. at 34 n.6.

to legislative history and to statements by officials prosecuting civil cases. However, the Court's caution should be observed. Rather than relying on an attenuated inference based upon statutory titles or interpretations having little to do with a statute's punitive intent, courts should search for a direct declaration of punitive purpose.

While the asserted legislative intent did not support denial of deductions in five of seven cases, examination of the nature of the remedy supports the decisions. In none of those cases was the measure of the remedy loss to either the government or the victim. Two legislative intent cases[93] were decided wrongly both because the asserted declarations of legislative intent were inadequate and because the measure of the remedy was loss to either the government or the victim of the illegality. The nondeductible double-damages remedy recovered by New York in *Tucker* is indistinguishable from the deductible double-damages remedy recovered by the United States in *Middle Atlantic Distributors*.[94] In *Waldman*, the amount of restitution was measured by loss to the victims; thus, it should have been deductible.[95]

When the enacting legislature directly declares that a penalty is punishment or otherwise declares that the penalty is not deductible, that declaration should govern without resort to any other analysis. Placing legislative intent at the top of the hierarchy ensures that result and provides an incentive to enacting legislatures to state their intention with respect to deductibility of civil sanctions. Deductibility of civil sanctions always should be considered by the enacting legislature. Economic deterrence correctly requires that the deductibility issue be addressed.[96] A legislature need only state what should already be on its mind.

Where legislative intent rises to the level of a declaration of punitive or not-punitive intent, that intent should conclusively decide the section 162(f) issue. While the legislative history of section 162(f) demands this rule, the Tax Court has indicated that it might conclude otherwise. In *Southern Pacific*, the court wrote:

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[93] Waldman v. Commissioner, 88 T.C. 1384 (1987), aff'd, 850 F.2d 611 (9th Cir. 1988); Tucker v. Commissioner 69 T.C. 675 (1978).

[94] *Tucker* and *Middle Atlantic Distributors* are analyzed on this point in Part II.

[95] *Waldman* is analyzed on this point in Part III.

[96] Robert Cooter, Prices and Sanctions, 84 Colum. L. Rev. 1523 (1984).

> Petitioner's proposed distinction based on the type of conduct constituting the violation may not prove to be determinative in any particular case and would permit *the characterization given to a particular statute by the enacting body to be determinative of the deductibility* of an expense under Federal tax law. For example, if one locality characterized parking violations as misdemeanors while another characterized them as civil violations, a taxpayer in the first locality would be precluded from deducting the fine by sec. 162(f) while a taxpayer in the second locality would be permitted to deduct the penalty under sec. 162(a) since this type of conduct clearly cannot be categorized as inherently evil or reprehensible. Yet, it is exactly the same conduct engaged in by the taxpayer in the first locality.[97]

The Tax Court in *Southern Pacific* actually would use "substance over form" analysis in derogation of the purpose of the statute, not in furtherance of it. The statutory intent is clear. The purpose of section 162(f) of the Code is to deny a deduction when allowance of the deduction would "frustrate state policy in severe and direct fashion by reducing the 'sting' of the penalty prescribed by the state legislature."[98] However, when a state declares in a statute or in legislative history that the purpose of a civil exaction is not to punish the defendant, then there is no "sting" reduced by the deduction. Section 162(f) represents federal deference to states. The federal government did not wish to offend states by diminishing the sting of state-mandated sanctions. Therefore, it crafted a judicial rule, then enacted a statute in order to avoid reducing the sting of state punishments. In so doing, the federal government sacrificed the guiding principle of its net income tax—neutral economic principles—in order to accommodate state interests.

The federal government would stand section 162(f) on its head if it simply looked beyond a state's assertion of lack of punitive intent and concluded that, because a given conduct is punished in sister states, it must be punished in the forum state. One state may wish to set weight limits and levy criminal fines on overweight trucks while another may choose a deterrence scheme consisting of tolls or taxes based on vehicle weight. State A may criminalize

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[97] Southern Pac. Transp. Co. v. Commissioner, 75 T.C. 497, 653 n.179 (1980) (emphasis added).

[98] Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30, 36 (1958).

parking violations while state B may allow fines for such violations to be deductible. The differences in state approaches constitute federalism, not tax avoidance. It appears that the Tax Court is concerned with lack of uniformity. One wonders if the court envisions the Commerce Clause imposing uniformity on the punitive or not-punitive nature of civil monetary exactions.

The Tax Court rule would deny deduction not only of "stings," but of penalties that states other than the enacting state consider "stings." However, the legislature's declared intent should guide the inquiry. Even if an exaction declared non-punitive functions identically with a punitive exaction, asserted intent, rather than the intent of functionally equivalent exactions in other jurisdictions, should govern section 162(f). Function, derived from the manner of calculating damages, is relevant only if no declaration of punitive intent exists.

2. *Facts and Circumstances Specific to the Case*

If neither legislative history nor court decisions construing the statutory provision provide evidence that the penalty is intended to punish, a court should consider the next factor, the facts and circumstances of the case, to indicate the presence or absence of a punitive purpose.[99]

A number of cases illustrate how courts construe facts and circumstances to discern an intent to punish. In *S & B Restaurant, Inc. v. Commissioner*,[100] the Tax Court first examined the legislative intent implicit in the overall statutory structure of the Pennsylvania Clean Streams Law and found that the law had punitive and non-punitive aspects because it imposed criminal and civil penalties and at least one non-punitive aspect, the orderly development of consolidated treatment facilities. "Thus," the court noted, "the Clean Streams Law has a dual purpose and our task is to determine which purpose the payments in question were designed to serve."[101] The Tax Court then concluded that, in S & B's case, the payments were in furtherance of a non-punitive purpose and hence

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[99] Due to constitutional concerns, many statutes enacted prior to United States v. Halper, 490 U.S. 435 (1989), purposely avoided any references to intent regarding their punitive nature.

[100] 73 T.C. 1226 (1980).

[101] Id. at 1232.

deductible.[102] In *Bailey v. Commissioner*[103] the Sixth Circuit concluded that section 162(f) of the Code precluded deduction of a civil sanction paid pursuant to 15 U.S.C. § 45(l), discerning the purpose of the exaction from the district court order imposing it.[104] The Tax Court in *Allied-Signal, Inc. v. Commissioner* denied a business expense deduction for an $8,000,000 payment to a charitable trust based upon its review of the taxpayer's sentencing proceedings.[105] In *Stephens v. Commissioner*, the Second Circuit identified two facts and circumstances and emphasized that they combined to support its conclusion that Stephens' payment of restitution to the victim of his crime was neither a fine nor a "similar penalty," nor paid to a government.[106] Thus, in *S & B Restaurant*,

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[102] The court rested its conclusion on four grounds: (1) In contradistinction to a fine or penalty which usually is a fixed amount, S & B was obligated to connect into the municipal sewer system when it became available (at which time the payments to the Clear Water Fund would stop); (2) the payment was intended to approximate the charge S & B would have had to pay if the municipal facility had been available; (3) Pennsylvania would have blocked any attempt by S & B to build its own sewage treatment facilities; and (4) Pennsylvania, perhaps erroneously, believed that no practical environmental harm would be caused by S & B's continued discharges. The court found the state's agreement not to prosecute "merely incidental to the main purpose of the agreement." Id. at 1233.

[103] 756 F.2d 44 (6th Cir. 1985), aff'g an unreported Tax Court order.

[104] The district court had found that Bailey "failed or neglected to obey terms of an [Federal Trade Commission] Consent Order" and ordered that Bailey "shall forfeit and pay to the plaintiff United States of America civil penalties in the amount of [$1,036,000]." Id. at 46. The district court had permitted Bailey, upon his request, to apply the penalty toward the settlement of his potential liability in a class action pending in another federal court, but provided that, "the ultimate disposition of these funds in no way shall alter their status as civil penalties." Id. at 46. The Sixth Circuit concluded that "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.' " Id. at 47 (quoting Southern Pac. Transp. Co. v. Commissioner, 75 T.C. 497, 652 (1980)).

[105] 63 T.C.M. 2672 (1992). Allied-Signal was fined $13,240,000, the maximum fine for the 940 counts to which it pleaded nolo contendere. Counsel for Allied-Signal and the sentencing court then reached an understanding by which Allied-Signal would establish and fund a charitable trust to help the environment (in exchange for which the sentencing judge would reduce the amount of the fine). The Tax Court concluded that, where the sentencing judge's statements indicated "that there may be a dual purpose for the payment, we must determine which purpose the payments in question were designed to serve." Id. at 2682. The Tax Court examined the record of the sentencing proceedings, quoted portions of it, and stated, "On these facts, we conclude that if there were a compensatory or remedial purpose for the payment, it was minimal." Id.

[106] 905 F.2d 667 (2d Cir. 1990), rev'g 93 T.C. 108 (1989). The court examined the transcript of the sentencing, found that the restitution was ordered after sentencing Stephens to five years in prison and a fine on each count, and concluded that the judge added the resti-

Bailey, and *Allied-Signal*, the courts found a governmental declaration of punitive intent entirely on the facts and circumstances of the case: the contents of the settlement agreement in *S & B Restaurant*, the order imposing the exaction in *Bailey*, and a transcript of the sentencing proceedings in *Allied-Signal*.

Facts and circumstances should be accorded less weight than legislative intent and more weight than the nature of the remedy. An explicit statement in a settlement agreement or order imposing a civil penalty reciting that the exaction punishes the defendant obviously constitutes a governmental declaration and should control despite the nature of the remedy.

A more difficult issue arises in settlements involving multiple claims where, under the facts of the case, punitive intent may exist with respect to certain claims but not with respect to others. While no court construing section 162(f) of the Code yet has addressed this point, in such cases, facts and circumstances are relevant for another purpose: allocating the total consideration paid among the claims settled. When describing the mechanics of allocating consideration among claims in a multi-claim settlement between a taxpayer and the United States, the Service's National Office declared that the upper limit on the allocation to a criminal charge is the maximum fine for the charge.[107] However, the National Office stated that in some circumstances, an allocation must be made to criminal charges that are dropped as part of the parties' agreement. To illustrate, in a Technical Advice Memorandum, the taxpayer was indicted on multiple counts, eventually pleaded guilty to fewer than all of the counts, paid the maximum fine for the admitted violations, and agreed to make a payment to a research trust fund. The National Office decided that some portion of the trust fund payment, limited by the counts' maximum fines, might have to be allocated to those criminal charges that were dropped. These allocable portions would not be deductible. The actual allocation would depend upon whether field agents learned the details of the claims within the contemplation of the parties.

When parties settle any litigation involving more than one claim, they may by agreement allocate the settlement payment among

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tution and an accompanying additional suspended five-year prison term primarily to reimburse the victim.

[107] Tech. Adv. Mem. 86-02-002 (Sept. 30, 1985).

the claims settled. The Service retains the authority to challenge the allocation if it thinks the allocation is contrary to the facts and circumstances of the case.[108] However, the Service's actual authority to reallocate is subject to significant limitation.

In *Madson v. Commissioner*,[109] the parties to a suit allocated no consideration to a particular claim under which the plaintiff obtained judgment,[110] and the Service lost its attack on that allocation. If a decision not to allocate consideration to claims in judgments cannot be challenged, even when that allocation serves the tax interest of a party, the Service appears especially misdirected in attacking failures to allocate consideration to dropped claims.[111]

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[108] If the parties do not make an allocation, then the Commissioner's right to force an allocation is clear. See Eisler v. Commissioner, 59 T.C. 634 (1973) (court allocated a settlement payment between deductible and capital expenditures where parties had made no allocation but it was clear that claims of both types had been settled), acq., 1973-2 C.B. 1. If the amounts are paid pursuant to a judgment, then the basis on which the trier of fact grounded the award determines allocation among the claims. Madson v. Commissioner, 55 T.C.M. (CCH) 1351, 1354 n.10 (1988). However, even with judgment allocations, the Service claims authority to disregard the allocation. Priv. Ltr. Rul. 84-37-084 (June 13, 1984) ("A written finding of a judge supervising the settlement of a lawsuit is a relevant factor, but not a conclusive factor that the Service uses in characterizing the nature of settlement amounts for federal income tax purposes.").

[109] 55 T.C.M. (CCH) 1351 (1988).

[110] In *Madson*, the taxpayer successfully prosecuted a state court suit alleging both a contract claim for improper discharge and a civil rights claim under 42 U.S.C. § 1983 for denial of equal protection of the laws. The state court found for Madson on both claims and stated that the measure of damages was the same under either claim. While the case was on appeal, Madson and the tort defendant settled. The parties allocated all consideration paid under the settlement to the civil rights claim possibly because such allocation served the individual interest of both parties. The tort defendant had insurance against the civil rights claim and, for Madson, damages received on account of the civil rights claim would excludable from gross income under § 104(a)(2) of the Code (while damages received on account of the contract claim would be taxable). See also Bent v. Commissioner, 87 T.C. 236, 250 (1986) (holding that all damages paid on account of 42 U.S.C. § 1983 claims are excludable from gross income even when lost earnings form part of the award, in contrast to recoveries under employment discrimination statutes which are not entirely excludable), aff'd, 835 F.2d 67 (3d Cir. 1987). The Tax Court gave effect to the allocation and found that the entire amount of the settlement payment was not taxable income to Madson.

[111] By the force of greater logic, a general release of all claims cannot be a reason to force allocation of consideration to claims not made but potentially available to the plaintiff. See Inaja Land Co. v. Commissioner, 9 T.C. 727, 734 (1947). Here the court stated:

> We think the respondent [Commissioner] places too much emphasis upon the release provision of the indenture. It is usual and customary in agreements of this character to incorporate a provision for the release and discharge of any possible past, present, or future claims and demands. The mutuality of the releases indicates the purpose was precautionary and protective rather than descriptive and in recognition of asserted claims and demands.

Further, the reasons for the Service not attacking settlement allocations in section 162(f) cases are even stronger than in usual cases.

The purpose of section 162(f) of the Code is to deny a deduction when allowance of the deduction would "frustrate state policy in severe and direct fashion by reducing the 'sting' of the penalty prescribed by the state legislature."[112] When a settling government has disavowed an intent to punish with respect to an entire settlement or has functionally done the same in an integrated settlement by allocating consideration to not-punitive claims, there is no "sting" to be reduced. Application of a "substance over form" analysis is nonsensical because it causes the federal government's taxing authorities to conclude that a state or agency of the federal government should have punished when the state or agency had indicated that it was not doing so.[113] Whether a government actually punished when it indicated that it did not, or a government did not punish but should have, is of no moment to the section 162(f) analysis. Section 162(f) merely denies deductions for declared punishments. Thus, contrary to the conclusion of Technical Advice Memorandum 86-02-002, if the taxpayer and the asserting government make an allocation of consideration and identify the punitive and not-punitive nature of the claims, the Service should not be permitted to challenge any aspect of the allocation.

Id.

[112] Tank Truck Rentals Inc. v. Commissioner, 356 U.S. 30, 36 (1958).

[113] No doubt well advised defendants may negotiate for a recital of no punitive intent or for an allocation of most or all consideration to not-punitive claims. State governments could begin negotiations by asserting punitive claims and then settle on the basis of not-punitive claims with the state and defendant splitting the "tax benefit" of settling. To illustrate, if the state's initial demand was $100 in satisfaction of punitive civil claims, and the parties settle for $125 in satisfaction of not-punitive claims, both the state and the defendant financially are better off than had the original demand been met. The state receives $125 versus $100, while the defendant pays $81.25 after taxes versus $100. (The calculation assumes a tax rate of 35% for the defendant and ignores the loss in income tax revenue sustained by the state if it has an income tax that parrots the deductions of the federal income tax).

The normally wary eye cast by the federal tax collectors upon parties dividing potential federal revenues is misplaced in § 162(f) cases. The federal interest is not to reduce "stings." If a state represents that an exaction is not a "sting," then § 162(f) of the Code does not apply. Instead, the normal federal rule of a net income tax applies. Obviously, other factors will influence a state's decision to disavow punishment. Sometimes, perhaps often, the state will choose punitive claims in order to apply the stigma associated with punishment.

3. *Nature of the Remedy*

Because of frequent inconclusiveness of the two higher order factors, the lowest order factor — inference of punitive intent from the manner by which damages are calculated — should decide most tax cases concerning section 162(f) of the Code. In the future that may change, depending upon the due process consequences of punishing by civil law. For many existing exactions, however, the nature of the remedy will govern.

There are four cases in which the courts have denied deductions based upon the nature of the remedy.[114] The Tax Court in *Middle Atlantic Distributors, Inc. v. Commissioner*[115] decided that a statute had a dual purpose and that the facts and circumstances did not indicate a punitive intent. The court ultimately concluded, based upon the measure of damages, that the "penalty against goods" was not-punitive.[116] In *Henson Robinson Co. v. Commissioner*[117] the Tax Court concluded that the amount of a penalty was not based upon damage to the government. The court held that a penalty paid to an Illinois county under Section 60-7(4) of the Illinois Antitrust Act was nondeductible because the purpose of that section could not have been to compensate the government.[118] A better justification for the Tax Court's decision would be that, because the measure of recovery under the penalty section

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[114] However, all of the legislative intent cases actually should have been decided by nature-of-the-remedy analysis.

[115] 72 T.C. 1136 (1979)

[116] Id. at 1141. As evidenced by the settlement agreement between the United States and the taxpayer, the payment was only "reimbursement for lost revenue and other damages," (id. at 1145) since the Customs Service had a "policy of reducing the . . . 'penalty' claim, which is perforce originally for the goods or their full value, to an amount equal to 1 times the revenue loss . . . where there is no culpable intent." Id. at 1144 (citing 19 C.F.R. § 171.1(a)(1)(iv) (1975)).

[117] 48 T.C.M. (CCH) 508 (1984). Note that the court based its decision on a likely erroneous reading of Illinois law.

[118] The court based its decision on the fact that a different section of the Illinois Antitrust Act provided compensation in the form of treble damages. Id. at 509-10 (citing People ex rel Fahner v. Climatemp, Inc., 428 N.E.2d 1096 (1981)). A close reading of *Climatemp*, however, shows that the decision undermines the Tax Court's reasoning rather than supports it. The Appellate Court of Illinois concluded that Illinois could maintain actions either for a "penalty" under § 60-7(4) or for treble damages under § 60-7(2), but not both. *Climatemp*, 428 N.E.2d at 1098. The Tax Court's reasoning in *Henson Robinson*—that the penalty under § 60-7(4) could not be compensatory damages because § 60-7(2) is the compensatory damages section of the Illinois Antitrust Act—depends upon the simultaneous application of the two sections, a possibility which *Climatemp* prohibits.

is not loss to the government, recoveries under it are punitive, in contradistinction to a recovery under the treble damages section which is measured with respect to loss to the government.[119]

In *Mason and Dixon Lines, Inc. v. United States*[120] the Sixth Circuit decided that the purpose of a "liquidated damages" exaction imposed in addition to a fine for operating an overweight truck must not be punishment because only the fine was punishment. In *True v. United States*[121] the Tenth Circuit and the district court sharply divided on whether the remedial scheme of the Clean Water Act demonstrated that a penalty paid under it was deductible.[122]

In nature-of-the-remedy analysis, the threshold question is whether the amount of the remedy exceeds the loss resulting from the acts giving rise to the remedy.[123] If the exaction exceeds that loss, then the exaction punishes, but only to the extent of the excess. Exactions in excess of loss punish because the capacity of a government to require a person to pay an amount of money not related to the loss caused by that person defines punishment. Pun-

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[119] Under that view, an action by the State of Illinois under § 60-7(4) is punitive and leaves open the application of § 162(f) of the Code to treble damage recoveries by Illinois under the Illinois Antitrust Act.

Note that after the liability at issue arose in *Henson Robinson* (1975), but before the Tax Court decision (July 12, 1984), Illinois had amended § 60-7(4), by adding to the end of subsection (4) that "[n]othing in this subsection shall impair the right of any person to bring an action under subsection (2) of this Section," thereby apparently reversing the *Climatemp* holding. 1983 Ill. Laws 236 § 1 (effective Jan. 1, 1984). That amendment was not in effect when Henson Robinson's liability arose, nor was it included in the text of the Tax Court's opinion quoting § 60-7(4). *Henson Robinson*, 48 T.C.M. (CCH) at 508 n.2.

[120] 708 F.2d 1043 (6th Cir. 1983), rev'g 48 A.F.T.R.2d (P-H) ¶ 5032 (E.D. Tenn. 1981).

[121] 894 F.2d 1197 (10th Cir. 1990), rev'g 603 F. Supp. 1370 (D. Wyo. 1985).

[122] The District Court concluded that the purpose of the Clean Water Act penalty at issue was "remedial and compensatory," both because the penalty was imposed regardless of fault and because the proceeds were used for costs of administration and cleanup.

The Tenth Circuit decided that neither the strict liability standard nor the use of the proceeds to finance cleanup costs made the penalty "primarily compensatory." The court found that the legislative history of § 162(f) demonstrated an intent to include strict liability penalties because that legislative history stated an intent to codify the general court position and because a prior decision of the Supreme Court had applied the public policy disallowance to penalties for violations of strict liability statutes. On the use-of-proceeds point, the Tenth Circuit noted that, while the use of the proceeds for financing cleanup costs indicated that one purpose of the penalty was "compensatory and remedial," it was not the principal purpose, concluding, "[t]he civil penalty in section 311(b)(6) strikes us on balance as serving a deterrent and retributive function similar to a criminal fine." Id. at 1205.

[123] See United States v. Halper, 490 U.S. 435, 448-49 (1989).

ishment does not remedy a loss. It "serves the twin aims of retribution and deterrence."[124] "Loss" for this purpose is not bounded by the traditional definition of compensatory damages. It is a much broader notion, defined by all the government's costs.[125] The Supreme Court recently affirmed those two points in decisions outside the tax area. No one yet has brought them into the section 162(f) analysis.

a. More-than-compensatory Does Not Mean Punitive

Court and administrative decisions under section 162(f) improperly conclude that when a remedy consists of other than "compensatory damages," the purpose must be to punish the defendant.[126] That proposition is false. Damages exist that resist the classical definition of compensatory damages because they exceed ordinary notions of compensation, yet damages also exist that do not match with the traditional definition of punitive damages because they do not punish. The Supreme Court recently dubbed these damages as "damages in the 'gray' zone."[127]

The false dichotomy drawn between compensatory damages and punishment requires the taxpayer to prove that the damages paid to a government were compensatory, a more onerous burden than showing that the damages were not-punitive. Such a requirement construes section 162(f) as if it read, "No deduction shall be allowed under subsection (a) for any not-compensatory payment of damages to a government for the violation of any law." The source

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[124] Id. at 448 (citing Kennedy v. Mendoza-Martinez, 372 U.S. 144, 168 (1963)).

[125] Id. at 449.

[126] The Tax Court's phrasing of the issue in one § 162(f) case is illustrative of the improper compensatory/punitive dichotomy: "Where 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." Waldman v. Commissioner, 88 T.C. 1384, 1387 (1987) (citing S & B Restaurant, Inc. v. Commissioner, 73 T.C. 1226, 1232 (1980)). In *Waldman* the court held that restitution was not deductible because it should be treated as a criminal fine; and if regarded as a civil exaction, it is not-deductible because compensation is not its primary purpose. In True v. United States, 894 F.2d 1197, 1205 (10th Cir. 1990), the Tenth Circuit implied that a penalty would be not-deductible unless it was "primarily compensatory." Even some courts finding exactions deductible embrace the dichotomy; they conclude that the exaction is deductible because it is compensatory (rather than not-punitive). See, e.g., Stephens v. Commissioner, 905 F.2d 667, 673 ("Our review . . . convinces us that Stephens' restitution payment was more compensatory than punitive in nature.").

[127] Molzof v. United States, 112 S.Ct 711, 716 (1992).

of the inversion likely lies in the Treasury regulations which purport to read section 162(f) as allowing a deduction for damages paid to a government only if they are compensatory damages.[128]

In *Molzof v. United States*,[129] the Government similarly attempted to define "punitive damages" as "more-than-compensatory" to limit its liability in tort.[130] The Court held against the Government concluding that the Government's argument incorrectly read the exclusion of punitive damages as an inclusion only of compensatory damages.[131] The Treasury regulations under section 162(f), and the decisions concluding that only compensatory damages are not-punitive for section 162(f) purposes, commit the same error that the Government commits in *Molzof*. That is, they

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[128] See supra note 27 and accompanying text. The Treasury regulations by example provide that damages paid to a government under § 4A of the Clayton Act, 15 U.S.C. § 15a (1988) do not constitute a fine or penalty. Treas. Reg. § 1.162-21(b)(2) (1975). Until 1990, § 4A of the Clayton Act provided for single damages recovery by the United States as antitrust plaintiff, while private antitrust plaintiffs recover treble damages under § 4 of the Clayton Act. Section 5 of the Antitrust Amendments Act of 1990 extended the treble damages recovery to the United States. Pub. L. No. 101-588, 104 Stat. 2879, 2880 (1990). The Treasury regulations have not been amended. Consequently, they literally provide that a defendant may deduct a treble damages antitrust payment to the United States. This deduction is inconsistent with the disallowance of § 162(g) of the Code which prohibits deduction of two-thirds of treble damages paid under § 4 to a private plaintiff if the defendant has been convicted on a related antitrust violation.

[129] 112 S. Ct. 711 (1992).

[130] Under the Federal Tort Claims Act, the United States qualifiedly waives sovereign immunity for certain torts, "but *shall not be liable* for interest prior to judgment or *for punitive damages*." 28 U.S.C. § 2674 (1988) (emphasis added). At issue in *Molzof* was whether (1) damages for medical care that would duplicate free medical services already being provided by a veterans' hospital and (2) damages for the loss of enjoyment of life were "punitive damages" and therefore not recoverable in a medical malpractice action against the United States.

[131] *Molzof*, 112 S. Ct. at 716. The Court stated:

> The statutory language suggests that to the extent a plaintiff may be entitled to damages that are not legally considered 'punitive damages,' but which are for some reason above and beyond ordinary notions of compensation, the United States is liable for them 'in the same manner and to the same extent as a private individual.' These damages in the 'gray' zone are not by definition 'punitive damages' barred under the Act. In the ordinary case in which an award of compensatory damages is subsequently reduced on appeal, one does not say that the jury or the lower court mistakenly awarded 'punitive damages' above and beyond the actual compensatory damages. It is simply a matter of excessive or erroneous compensation. Excessiveness principles affect only the amount, and not the nature, of the damages that may be recovered. The term 'punitive damages,' on the other hand, embodies an element of the defendant's conduct that must be proved before such damages are awarded.

Id.

interpret an exclusion of *"punitive damages" from deductibility* as an inclusion in deductibility of only "compensatory damages" without acknowledging the existence of the "gray zone."

b. Only When Civil Damages Exceed "All the Costs" of a Government Does the Payment Punish the Payor

Damages that are more-than-compensatory are not necessarily punitive. Damages are intended to punish only if they exceed "all the costs" of the government. The Supreme Court in *United States v. Halper*[132] established the "all the costs" limit deciding that, for purposes of the prohibition against double jeopardy, a state-invoked civil remedy punishes to the extent the remedy exceeds "all the Government's costs."

Halper had submitted sixty-five claims to Medicare for reimbursement at the rate of $12 per claim when the medical service properly was reimbursable at only $3 per claim. Consequently, Halper was convicted on sixty-five counts of defrauding the Government, sentenced to imprisonment, and fined.

The Government then sued Halper under 31 U.S.C. § 3729, the Federal False Claims Act ("FFCA"). Under the FFCA in effect at the time of Halper's fraudulent acts, a person defrauding the United States was "liable to the United States Government for a civil penalty of $2,000, a sum equal to 2 times the amount of damages the Government sustains because of the act of that person, and costs of the civil action."[133] Having violated the FFCA 65 separate times, Halper appeared subject to a statutory penalty exceeding $130,000. Because the Government had already jailed and fined Halper for his acts of fraud, the Court considered "whether the statutory penalty authorized by the civil False Claims Act, under which Halper is subject to liability of $130,000 for false claims otherwise amounting to $585, constitutes a second 'punishment' for

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[132] 490 U.S. 435 (1989).

[133] 31 U.S.C. § 3729 (Supp. II 1984). The Act was amended by the False Claims Amendments Act of 1986, Pub. L. No. 99-562, 100 Stat. 3153, to increase the civil penalty to "not less than $5,000 and not more than $10,000 plus 3 times the amount of damages which the Government sustains because of the act of that person," and "the costs of a civil action brought to recover any such penalty or damages." 31 U.S.C. § 3729(a)(7) (1988). Had Halper been found liable under the False Claims Amendments Act of 1986, the civil penalty would have amounted to more than $326,775. See *Halper*, 490 U.S. at 438 n.3, 450 n.9.

the purpose of double jeopardy analysis."[134] The Court concluded that the Government improperly punished Halper a second time and found that the fixed damages penalty exceeded "all the Government's costs" resulting from Halper's frauds.[135]

The Court did not determine the amount of "all the Government's costs," but it remanded the issue for a fact finding. However, the Court did offer some guidance on making the "all the Government's cost" determination. The Court acknowledged that "it would be difficult if not impossible in many cases for a court to determine the precise dollar figure at which a civil sanction has accomplished its remedial purpose of making the Government whole, but beyond which the sanction takes on the quality of punishment."[136] Consequently, the Court made two observations before crafting a flexible rule. First, the Court noted that "a civil remedy does not rise to the level of 'punishment' merely because Congress provided for civil recovery in excess of the Government's actual damages."[137] Second, the Court "recognized that in the ordinary case fixed-penalty-plus-double-damages provisions can be said to do no more than make the Government whole."[138] The Court then adopted a rule of reason: civil damages recovered by a government are punishment when the damages bear "no rational relation to the goal of compensating the Government for its loss."[139]

In *Halper*, the Court was confronted with the same issue presented by the section 162(f) cases, i.e., when does a state-invoked civil remedy punish the defendant? Consider the situation after remand in *Halper*. The district court will decide "all the Government's loss" caused by Halper and enter judgment for that amount. When Halper pays the judgment, no portion should be denied deduction under section 162(f) because Halper has not been punished. However, Halper clearly will be forced to pay more-than-compensatory damages. Under the Fifth Amendment, damages more-than-compensatory but less than all-the-costs do not constitute punishment. The all-the-costs limit should define when

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[134] *Halper*, 490 U.S. at 441.
[135] Id. at 448-49.
[136] Id. at 449.
[137] Id. at 442.
[138] Id. at 449.
[139] Id.

damages punish for purposes of section 162(f).[140]

Last Term, the Court affirmed *Halper*'s pervasive definition of punishment, applying it in *Austin v. United States*[141] to conclude that civil forfeitures punish because they "cannot fairly be said solely to serve a remedial purpose."[142] The Court consequently concluded that, although civil forfeitures may punish, the Eighth Amendment prohibits them from punishing excessively.

Integration of the Court's decisions in *Halper*, *Molzof*, and *Austin* demonstrates that the Court has placed monetary exactions along a continuum of increasing severity: compensation, remedy, punishment, excessive punishment. *Molzof* addresses the compensation/remedy border, *Halper* the remedy/punishment border, and *Austin* the punishment/excessive punishment border.

For section 162(f) purposes, the *Halper* boundary is determinative. *Halper* establishes that punishment begins at the point where the damages paid by the defendant exceed "all the costs" resulting from the defendant's illegal conduct.

But what are "all the costs?" Two complementary models describe governmental regulation of conduct by economic coercion.[143] A "price" is a payment of money in exchange for the opportunity

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[140] In *Halper*, "punishment" was interpreted for purposes of the Fifth Amendment's prohibition of double jeopardy. However, for the purposes of § 162(f) "punishment" could have a different meaning. There is a strong argument that the definition of punishment by civil monetary exaction should be the same in both contexts. Consider the following possibility: on remand, the Government accounts for all its "damages and costs," and the district court decides that such amount is $35,000. By definition, $35,000 is the maximum amount that the Government may collect from Halper; one dollar more crosses the line into punishment.

Suppose that this Article's approach is rejected, and instead the Treasury regulations' disallowance of more-than-compensatory damages is applied so that deduction of some portion of the $35,000 payment is denied. The question then becomes whether the amount denied deduction as being more-than-compensatory imposes additional punishment for double jeopardy purposes. Has the carefully drawn line been crossed? Note that absent application of § 162(f), Halper would appear entitled to deduct the payment as an itemized deduction under §§ 162 and 63 because it is attributable to his trade or business of performing services for his employer. As an itemized deduction, it would be subject to certain limits like the two percent floor of § 67 and the overall limitation on itemized deductions of § 68. Nonetheless, Halper could lower his taxes by a deduction, and its denial could, perhaps should, be considered punishment for double jeopardy purposes. In Halper's case, the Double Jeopardy Clause may require that "punishment" be construed identically in both contexts.

[141] 113 S. Ct. 2801 (1993).

[142] Id. at 2806, 2810. The Court emphasized the point in a footnote indicating that a specific forfeiture shown to be solely remedial is not punishment. Id. at 2812 n.14.

[143] Cooter, supra note 96, at 1524-25.

to perform a permitted act. A price is intended to force an actor to pay for the external costs that his socially useful conduct imposes on others. While the activity may continue, the price shifts the resultant costs of the activity from society to the actor, and he internalizes negative externalities. In contrast, a "sanction" is a detriment imposed for doing what is forbidden. Sanctions dissuade the actor from engaging in the sanctioned conduct by imposing a significantly disproportionate increase in the expected cost of that conduct.

Professor John Coffee suggests that the price/sanction division should define when economic coercion punishes. A defendant paying a price is not being punished, but a defendant paying a sanction is. The immediate consequence of Coffee's conclusion is that a civil defendant who pays a price has not been punished and therefore is not entitled to any criminal process protection.[144] Professor Kenneth Mann debates Coffee's approach and argues that the payment of more-than-compensatory damages constitutes punishment. A defendant who pays such damages should be entitled to some, but not all, process due criminal defendants.[145]

Mann and Coffee's debate about due process, *Halper*'s double jeopardy decision, and section 162(f) all seek to define the same issue: when does the payment of damages to a government punish the payor? Mann's approach mirrors that of the Treasury under section 162(f). Both conclude that the payment of more-than-compensatory damages punishes. However, Coffee and the Supreme Court in *Halper* take the position that some greater measure of damages is required.

Halper defines the measure at which damages become punishment as the point at which a monetary penalty exceeds "all the Government's costs." Coffee interprets it as the aggregate external social costs caused by the defendant's conduct so it is possible that Coffee's definition encompasses a larger set of costs. Whether "all the costs" means "all the external social costs" is not as important in applying section 162(f) as is the realization that "all the costs" significantly exceeds compensatory damages. Both the Treasury Regulation promulgated under section 162(f) and the courts that have decided that more-than-compensatory damages are punitive

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[144] Coffee, supra note 70, at 1883-85.

[145] Mann, supra note 41, at 1869-71.

adopt an insupportably expansive view of punishment.

c. Does Section 162(f) Deny the Deduction of More-than-compensatory Damages Paid to a Government?

The Tax Court is the only court to address this point and has applied section 162(f) in situations in which taxpayers have paid more-than-compensatory damages to a government. The Tax Court cases addressing this issue have been inconsistent. One Tax Court case authoritatively denied deduction of the more-than-compensatory portion of a double-damages remedy paid to a government, but a later Tax Court case allowed deduction of the entire amount of a double-damages remedy. These cases appear to be irreconcilable.

In *Tucker v. Commissioner*,[146] the Tax Court disallowed deduction of the "double" portion of a double-damages remedy. Because Tucker participated in a strike against her employer, she became liable for a statutory penalty equal to twice her daily rate of pay for each day that she was out of work because of the strike.[147] The penalty was collected in two steps: (1) she received no pay for the days she was absent; and (2) subsequent wages were diminished by an amount equal to the pay foregone during the strike days. The Tax Court first concluded that the amount withheld in step (2) was includable in Tucker's income and then denied Tucker's deduction of the penalty under Section 162(f).[148]

In *Middle Atlantic Distributors, Inc. v. Commissioner*,[149] the

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[146] 69 T.C. 675 (1978).

[147] Section 210(1) of the New York Civil Service Law prohibits a public employee from engaging in a strike. Section 210(2)(a), headed "violations and penalties," provides that a public employee violating the prohibition shall be liable, under § 210(2)(g), as follows:

> Not earlier than thirty nor later than ninety days following the date of such determination [that the employee violated the prohibition of strikes], the chief fiscal officer of the government involved shall deduct from the compensation of each such public employee an amount equal to twice his daily rate of pay for each day or part thereof that it was determined that he had violated this subdivision; such rate of pay to be computed as of the time of violation. In computing such deduction, credit shall be allowed for amounts already withheld from such employee's compensation on account of his absence from work or other withholding of services on such day or days.

N.Y. Civ. Serv. Law § 210(2)(g) (McKinney 1983 and Supp. 1993).

The pertinent part of the statute has not been amended since the events occurring in *Tucker*. See *Tucker*, 69 T.C. at 677 n.2 (describing operation quoted above).

[148] *Tucker*, 69 T.C. at 681-82.

[149] 72 T.C. 1136 (1979).

Tax Court reached the opposite result when the taxpayer paid double damages to the Customs Service. Middle Atlantic paid $100,000 to the Customs Service in settlement of a statutory "penalty against goods" for importing goods by means of false statements. The court concluded that the "penalty against goods" was only "reimbursement for lost revenue and other damages" because the Customs Service had a policy of reducing the penalty, originally for the goods or their full value, to an amount equal to revenue loss.[150] The Tax Court did not identify the "other damages" besides lost customs revenue for which the penalty reimbursed. Thus it appears that the double damages consisted of lost customs revenue and a "penalty" equal to such revenue. Yet, the Tax Court allowed a deduction for the full amount.[151]

After *Halper*, the payment of more-than-compensatory damages should not be viewed as punishment for purposes of section 162(f) of the Code. While the line at which punishment is reached is not bright, *Halper* states "that in the ordinary case fixed-penalty-plus-double-damages provisions can be said to do no more than make the Government whole."[152] Consequently, after *Halper*, the exactions in both *Tucker* and *Middle Atlantic* clearly should be deductible; indeed, the only unresolved question is how much more than fixed-penalty-plus-double-damages may a government recover without punishing the payor?

IV. Application of the Systematic Approach to Two Situations

Examination of two situations for which application of section 162(f) of the Code presently is unresolved supports arguments for two important points regarding section 162(f) analysis: (1) recog-

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[150] Id. at 1144.

[151] In Grossman & Sons, Inc. v. Commissioner, 48 T.C. 15 (1967), the Tax Court considered whether a payment to the United States Government in settlement of an FFCA claim was nondeductible because the deduction would frustrate sharply defined public policy. As indicated in Part I, § 162(f) essentially restates that rule. In *Grossman*, the court allowed the deduction in full concluding that the deduction under the facts of that case would not frustrate public policy and finding the settlement to be in the nature of damages for breach of contract and therefore not-punitive. However, the court went to great length to draw and support a conclusion that the eventual settlement amount, $100,000, did not exceed the actual economic damages alleged by the government. It strongly implied that damages in excess of such amount would have been a not-deductible penalty. Id. at 27-29.

[152] 490 U.S. at 449.

nizing the hierarchy within the courts' reasoning and (2) changing the definition of punishment used in nature-of-the-remedy analysis from any "not-compensatory" remedy to any remedy exceeding "all the costs" of the violation. The two relevant situations that will be discussed are: (1) restitution ordered in a criminal case and (2) settlements with the Securities and Exchange Commission (the "SEC").

A. Restitution Ordered in a Criminal Case

Three cases have decided whether restitution paid by convicted defendants to victims of their crimes is deductible. The courts' conclusions widely vary. The federal district court in *Spitz v. United States*[153] succinctly concluded that section 162(f) of the Code did not deny deduction of restitution:

> The payment does not satisfy the criteria set forth in § 162(f). It is not a fine. Neither is it a penalty since it was payment of an amount due and owing. Finally, although the payment was funneled through the State Department of Public Welfare, it was paid to [the victim] Fosshage, not "to a government" within the meaning of § 162(f).[154]

Conversely, in *Waldman v. Commissioner*,[155] the Tax Court and the Ninth Circuit[156] denied a deduction because criminal conviction is a condition precedent to imposing restitution. Both courts essentially treated restitution for tax purposes as a criminal fine.

In the alternative, the Tax Court applied its civil penalty analysis. The court decided that, under California law, restitution is not-compensatory, but instead it enforces the law and therefore is not-deductible.[157] The Tax Court's facile civil penalty analysis equated the purpose of every remedy — enforcing the law — with the goal of punishing, a goal which is characteristic of only certain remedies. The court thus applied a false dichotomy of punishment and compensation. Both of the Tax Court's conclusions which were de-

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[153] 432 F. Supp. 148 (E.D. Wis. 1977).

[154] Id. at 149-50.

[155] 88 T.C. 1384 (1987), aff'd, 850 F.2d 611 (9th Cir. 1988).

[156] Waldman v. Commissioner, 850 F.2d 611 (9th Cir. 1988). The entire text of the Ninth Circuit's order reads: "We affirm the judgment substantially for the reasons stated by the Tax Court in its opinion in 88 T.C. 1384 (1987)."

[157] *Waldman*, 88 T.C. at 1388 (quoting Huff v. Commissioner, 80 T.C. 804, 824 (1983)).

rived from its analogies of civil penalties are erroneous. First, enforcement of the law and punishment are not coextensive. All remedies enforce the law. Second, the words "not-compensatory" and "punitive" are not coextensive. Finally, California restitution is not-punitive because its measure is always loss to the victim.

To support its assertion that restitution is not-compensatory, the Tax Court relied upon quotations from two California Supreme Court cases. The court quoted *People v. Lent*,[158] for the proposition that the measure of the amount of restitution "need not be limited to the transaction or amounts for which the defendant is actually convicted,"[159] and *People v. Richards*[160] for the assertion that "[r]estitution or reparation is not a substitute for a civil action to recover damages."[161] The first proposition, while true, does not establish the fact that restitution punishes. The second proposition is false because the Tax Court quoted the California Supreme Court out of context.

Lent and *Richards* decide an issue at the margin of restitution law in California. The two cases involve an interesting and extraordinary situation in which a defendant charged with two counts of fraud is convicted of one count, acquitted of the other, and ordered to pay restitution upon both counts.[162] Both cases hold that a sentencing court may order a defendant to pay a third party for losses not caused by the defendant's crime only if the sentencing judge makes a specific finding that either the defendant's behavior in the collateral transactions or his testimony regarding such transactions show a dishonest state of mind comparable to that for which he was convicted.[163] The court reasoned that only in such circumstances may the defendant properly be required to choose between accepting incarceration and materially correcting a wrong that he may not have committed.[164]

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[158] 541 P.2d 545 (Cal. 1975).

[159] *Waldman*, 88 T.C. at 1388 (citing *Lent*, 541 P.2d at 548).

[160] 552 P.2d 97 (Cal. 1976).

[161] *Waldman*, 88 T.C at 1387 (quoting *Richards*, 552 P.2d at 100-01).

[162] The Tax Court's citation to *Lent* and *Richards* as cases that are generally descriptive of the law of restitution in California is doubly curious. First, there was no suggestion that Waldman's restitution order included transactions for which Waldman had not pled guilty. Second, the Tax Court tainted all restitution in California because of its possible nondeductibility in marginal cases.

[163] *Richards*, 552 P.2d at 102-03; *Lent*, 541 P.2d at 548.

[164] *Richards*, 552 P.2d at 100. The *Richards* court indicated that, in *Lent*, the sentencing

Even in those two extraordinary cases the expansion occurs only in the class of victims. The measure of restitution remains the same: loss imposed on another individual.[165] California restitution, both in the main and at the margin as defined by *Lent* and *Richards*, is not-punitive because the measure of loss always is damage to victims, not retribution or deterrence.

The quotation from *Richards*, "Restitution or reparation is not a substitute for a civil action to recover damages,"[166] allegedly supported the proposition that restitution never can substitute a civil action. However, the California Supreme Court used that statement only to justify its rule that restitution ordinarily should not include losses for which the defendant is not convicted. Restitution when ordered and paid in ordinary and extraordinary cases is a substitute for a civil action for civil claims.

In 1982, after Waldman had paid his restitution but before the Tax Court had decided the case, section 1203.04 was added to the California Penal Code. The provision stated that "damages compensated for by restitution shall not be actionable in a civil suit against the defendant."[167] It recodified prior law and is consistent with a far-ranging codification and expansion of restitution in California. This expansion includes the 1982 statutes, adoption of Proposition 8 by statewide initiative on June 8, 1982, and statutory enactments pursuant to Proposition 8.[168] Consequently, in Califor-

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judge found a dishonest state of mind so the extraordinary restitution there was proper. In *Richards*, the court found that the defendant did not possess a dishonest state of mind. *Id.* at 103. Consequently, the court reversed the order requiring Richards to pay restitution to the victim on the charge for which he had been acquitted. Id.

[165] The statutory authorization for restitution in Waldman's case, California Penal Code § 1203.1, allows courts granting probation to require "that amends may be made to society for the breach of the law, [and] for any injury done to any person resulting from that breach . . . ." Cal. Penal Code § 1203.1 (West Supp. 1993). As such, the court always must tie the amount of restitution to the injury done to a person. The major goal of § 1203.1 is to "serve the salutary purpose of making a criminal understand that he has harmed not merely society in the abstract but also individual human beings and that he has a responsibility to make them whole." *Richards*, 552 P.2d at 100-01.

[166] *Waldman*, 88 T.C. at 1387 (quoting *Richards*, 552 P.2d at 100-01).

[167] 1982 Cal. Stat. 5403 (adding Cal. Penal Code § 1203.04). In 1983, California Penal Code § 1203.04 was repealed and reenacted in substantially similar form. Presently, § 1203.04(d) provides, "Restitution collected pursuant to this section shall be credited to any other judgments obtained by the victim against the defendant arising out of the crime for which the defendant was convicted." Cal. Penal Code § 1203.04(d) (West Supp. 1993).

[168] California Civil Procedure Code § 352.5, enacted in 1976, provides that the statute of limitations is suspended for the time during which an order for restitution is in effect with

nia, the measure of restitution is consistently loss to the victim, and restitution always substitutes for a civil action. Therefore, restitution is not-punitive and is thus neither a "fine" nor "similar penalty."

Because restitution is grounded as a remedy for victims, another indeterminacy to applying section 162(f) of the Code is added. It is unclear whether restitution is remitted to a victim or "paid to a government." In *Waldman*, after incorrectly deciding that Waldman's restitution was both a "fine" and a "similar penalty," the Tax Court turned to the issue of whether the penalty was "paid to a government." The court stated that "the characterization of a payment for purposes of section 162(f) depends on the origin of the liability giving rise to it"[169] and then premised its assertion on a tautology. The court reiterated the same reasons it had used to reach its decision that restitution was a "fine" and a "similar penalty." It then concluded that "[p]etitioner's payments of restitution were thus in satisfaction of his criminal liability to the State."[170]

Such reasoning renders "paid to a government" a nullity because all fines and similar penalties by definition are paid to a government. The court bolstered its conclusion with an inapposite citation to *Bailey v. Commissioner*[171] in which the Tax Court and the Sixth Circuit concluded that an amount paid by Bailey to plaintiffs in a class action was not deductible under section 162(f) of the Code.

Outside the original class action, a federal district court imposed a penalty for the violation of a Federal Trade Commission ("FTC") order. The amount of the penalty was calculated principally with regard to culpability, not with respect to a loss to any person.[172] The district court had plenary authority over the pay-

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respect to the acts or omissions giving rise to the civil liability. See also Phillip E. Hassman, Annotation, Propriety of Condition of Probation Which Requires Defendant Convicted of Crime of Violence to Make Reparation to Injured Victim, 79 A.L.R.3d 976, 992-93 (describing the case of People v. Stacey, 212 N.E. 2d 286 (Ill. App. 1965), in which the court indicated that restitution does not affect victim's right to institute a civil action, but a set-off might be ordered for restitution paid).

[169] *Waldman*, 88 T.C. at 1389 (citing Bailey v. Commissioner, 756 F.2d 44, 47 (6th Cir. 1985)).

[170] Id. at 1389.

[171] 756 F.2d 44 (6th. Cir. 1985), aff'g an unpublished order of the Tax Court.

[172] The mandate for districts courts to follow after finding 15 U.S.C. § 45(l) culpability is:

ment's destination and subsequently decided to direct the penalty to the victims. This re-direction may have funneled the money paid as a penalty to private parties, but it did not alter the penalty's status as having been paid to the government. In contrast, in *Waldman*, the government is not the recipient, and is at most a mere conduit of restitution to the victims. The sentencing court does not decide the destination of restitution; it determines only the amount of the victim's loss. California law *requires* that restitution be forwarded to the victim.[173] In short, in *Bailey*, the Government recovered the penalty as principal and redistributed it to victims. In *Waldman*, California recovered restitution as the agent of the victim.

In the Tax Court's next restitution case, *Stephens v. Commissioner*,[174] the court concluded that Stephens' payment of restitution was nondeductible because it "was made as a result of a criminal conviction and . . . it was ordered in lieu of an additional prison term and as a condition of probation."[175] The Tax Court did not alternatively apply its civil penalty analysis; thus, it affirmed *Waldman*'s first holding that restitution is nondeductible because

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"In determining the amount of such a civil penalty, the court shall take into account the degree of culpability, any history of prior such conduct, ability to pay, effect on ability to continue to do business, and such other matters as justice may require." 15 U.S.C. § 45(m)(1)(C).

[173] At the time that Waldman paid his restitution and the Tax Court decided the case, California Penal Code § 1203.1 provided, in pertinent part, "The court shall consider whether the defendant as a condition of probation shall make restitution to the victim or the Indemnity Fund if assistance has been granted to the victim . . . ." Cal. Penal Code § 1203.1 (West 1982). The *Waldman* court cited that section. 88 T.C. at 1388. The present version of § 1203.1 is substantially similar in pertinent part. Cal. Penal Code § 1203.1 (West Supp. 1993).

[174] 93 T.C. 108 (1989), rev'd, 905 F.2d 667 (2d Cir. 1990). At the threshold, the Tax Court decided whether the governing provision was § 162 of the Code or § 165 of the Code. It concluded that § 165 governed because restitution is not an "ordinary and necessary" business expense. Id. at 111-12 (citing Mannette v. Commissioner, 69 T.C. 990, 992-94 (1978)) (an expense must be ordinary and necessary before it is deductible under § 162(a), without which § 162(f) by its terms never can apply). The Tax Court did not address why in *Waldman* § 162 was held directly to govern, with no mention of § 165.

After deciding that § 165 and not § 162(f) controlled, the Tax Court made the point academic by incorporating § 162(f) into § 165, concluding (1) that public policy can disallow deductions under § 165, and (2) the public policy disallowance under § 165 is at least as broad as the limitations contained in § 162(f). Id. at 112. The court ultimately reduced the issue to whether Stephens' payment of restitution would be deductible in light of "the considerations involved in applying section 162(f)." Id.

[175] Id. at 113.

it constitutes a criminal fine.[176]

The Second Circuit reversed,[177] identifying two considerations and emphasizing that they combined to support the conclusion that Stephens' restitution was neither a fine nor paid to a government. The court expressly ignored the issue of whether either consideration alone would suffice. It first concluded that Stephens' restitution payment was "more compensatory than punitive in nature."[178] The court examined the transcript of the sentencing and found that restitution was ordered after sentencing Stephens to five years in prison with a fine for each count. It surmised that the judge added the restitution and an accompanying additional suspended five-year prison term primarily to reimburse the victim for loss.[179] The Second Circuit distinguished *Waldman* because Waldman's entire sentence was suspended on condition that he make restitution, thus indicating to the Second Circuit that the purpose of Waldman's payment was equally compensatory and punitive. The Second Circuit then found that Stephens' payment was made to the victim and "not to a government."[180]

The Second Circuit stands at odds with both the Tax Court and the Ninth Circuit on the application of section 162(f) of the Code to restitution. *Stephens* offered a superficial distinction of *Waldman* — all of Waldman's sentence was suspended upon payment of restitution while only part of Stephens' was — but the distinction is beside the point. The issue is whether the restitution itself was intended to punish the payor, not whether punitive intent also ex-

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[176] Had the Tax Court applied its civil penalty analysis in *Stephens*, it would have been forced to confront an important distinction between the collateral repercussions of Stephens' restitution and the Tax Court's view of the collateral consequences of Waldman's restitution. In *Stephens*, the Tax Court could not have concluded that Stephens' payment was not a substitute for a civil action because the payment actually was made in compromise of two civil actions filed by the victim. The settlement payment appears collaterally to have satisfied the restitutionary order against Stephens.

[177] Stephens v. Commissioner, 905 F.2d 667 (2d Cir. 1990), rev'g 93 T.C. 108 (1989). Before the Second Circuit, the parties apparently agreed that § 165 of the Code governed. Id. at 670. Therefore, the court did not address the first issue confronted by the Tax Court. In construing § 165, the Second Circuit agreed with the Tax Court's conclusion that § 162(f) is relevant in determining whether restitution is deductible under § 165 but did not agree that § 162(f) precluded the deduction. 905 F.2d at 672.

[178] Id. at 672-73. This conclusion again shows the pervasive nature of the false dichotomy of compensation and punishment.

[179] Id. at 673.

[180] Id. at 673-74.

isted with respect to some other remedies associated with the case. A search for punitive intent leads to the hierarchical analysis developed in Part II. Under the hierarchial analysis, a direct declaration that restitution is (or is not) intended to punish found in the statute, in the legislative history, or in the specific facts of the case, would govern. However, such direct declarations usually are not present.

Section 162(f) of the Code normally should not be utilized to deny the deduction of restitution payments because examination of the nature of the remedy discloses that restitution is not-punitive. First, restitution is not paid to a government; it is disbursed to the victim. The use of a court or probation office as a financial intermediary or escrow agent cannot affect this conclusion. Second, the normal manner of computing restitution does not demonstrate that its payment is intended to punish; the measure of damages is based upon loss to the victim. Restitution may be contrasted to a fine: a fine is principally measured with respect to deterrence or retribution while restitution is measured with respect to the victim's loss. Restitution normally does not serve the same purpose as a fine exacted under a criminal statute. Rather, it serves the same purpose as damages exacted under a tort claim. Section 162(f) of the Code assumes that punishment can occur in a civil suit; it should also recognize that reparation of damage can occur in a criminal suit.

B. Civil Settlements with the Securities and Exchange Commission

Civil settlements with the SEC offer fertile ground for future litigation under section 162(f) of the Code because of the enormous increase in 1990 in the SEC's ability to seek and assess civil penalties and the high dollar amount of such penalties.[181] A recent settlement of federal securities and other claims in *Salomon*[182] raises

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[181] Big-ticket penalties often encourage litigation because taxpayers have a strong incentive to avoid paying substantial fines. Note, however, that suits may involve small fines even though we would expect that, for cost-benefit analysis reasons, taxpayers would not litigate the denial of deductions for modest penalties. For example, in one case, the penalty consisted of only $1200. True v. United States, 894 F.2d 1197, 1201 (10th Cir. 1990).

[182] Securities and Exchange Commission v. Salomon Inc and Salomon Brothers Inc, 92 Civ. No. 3691 (RPP) (S.D.N.Y. 1992), Securities and Exchange Commission Litigation Release No. 13,246 (May 20, 1992), available in LEXIS, Fedsec Library, Litrel File. The term

many section 162(f) issues.

On August 9, 1991, Salomon announced that it had "uncovered irregularities and rule violations by its employees in connection with its submission of bids in certain auctions of Treasury securities."[183] On May 20, 1992, the government declared a resolution of its investigations into the matter. The investigation resulted in the filing of a complaint by the SEC, the entry of a consent judgment by a federal district court, and the execution of a settlement agreement between the United States and Salomon.[184]

Pursuant to the settlement agreement, Salomon agreed to make two payments totalling $290 million. A payment of $100 million was remitted to the registry of the court and a $190 million payment was sent to the U.S. Treasury. The amount paid into the court was used to create a fund for future private civil claims for compensatory damages arising from the activities alleged in the complaint. The funds channeled to the Treasury represented (1) a $122 million payment of civil penalties under the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 ("SERPSRA"), (2) a $55 million forfeiture to the Department of Justice Asset Forfeiture Fund pursuant to 15 U.S.C. § 6 and 18 U.S.C. § 981(a)(1)(c), and (3) a $13 million payment to the United States for potential claims of the Department of Justice under 31 U.S.C. § 3729, the FFCA, and common law.[185]

Salomon assessed the economic impact of the auction "irregularities," including the settlement agreement, in the notes to its financial statements. Salomon established and funded a reserve for "damages, settlement costs, fines, penalties, legal expenses and other related costs" of $385 million and stated that the after-tax cost would be $300 million.[186] Thus, it appears that Salomon believed that some portion of the $290 million paid under the settle-

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Salomon is used to refer collectively to Salomon Brothers Inc and Salomon Inc, the subsidiary and parent corporations, respectively.

[183] Id. at 4.

[184] Id. at 1.

[185] Id.

[186] During the 1991 third quarter, Salomon recorded a pre-tax charge of $200 million to establish the reserve, and indicated that such charge would cost $136 million after taxes. In the 1992 second quarter, Salomon added to the reserve with an additional pre-tax charge of $185 million and indicated that such additional charge would cost $164 million after taxes. Salomon Inc, Form 10-Q Quarterly Report Under Section 13 or 15(d) of the Securities Exchange Act of 1934 7-8 (June 30, 1992), available in LEXIS, Fedsec Library, Filing File.

ment agreement was deductible for federal income tax purposes.[187]

Whether in response to Solomon's notes in its financial statement or some other source, the House Ways and Means Subcommittee on Oversight apparently became aware that a portion of the $290 million payment would be deductible. Subcommittee Chairman J.J. Pickle called a hearing to review the settlement. Among the questions included in the hearing announcement was "[h]ow much, if any, of the settlement will Salomon Brothers be able to deduct from their taxes?"[188] At the September 29, 1992 hearing Representative Anthony presented the question of Salomon's deductions to the Service's Assistant Chief Counsel for Income Tax and Accounting Glen Carrington. Carrington declined to answer the Representative's question citing the prohibition on federal employees' discussing particular taxpayer's cases.[189] Carrington only generally addressed section 162(f) of the Code. He stated that: (1) deductibility turns on the "purpose" of the statute which created the penalty; (2) civil penalties that are "remedial" are deductible; and (3) civil penalties that are "punitive" are not deductible.[190]

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[187] Calculating what portion of the $290 million payment Salomon believed deductible depends upon two unknowns: 1) Salomon's combined federal and state tax rate and 2) the portion of Salomon's expenses, in addition to the $290 million paid pursuant to the settlement agreement, that is itself deductible. By making reasonable assumptions, it becomes clear that Salomon believed that a significant portion of the $290 million payment is deductible. Assuming that Salomon's combined federal and state income tax rate is 40% and that the entire amount by which the pre-tax charge exceeds the amount paid pursuant to the settlement agreement, $95 million ($385 million minus $290 million), is fully deductible, the $95 million in other payments would generate a tax deduction worth $38 million. Because the total tax benefit of the $385 million expense is $85 million, the $290 million payment would be expected to generate tax deductions worth $47 million. Using a 40 percent tax rate, that would mean that $117.5 million of the $290 million is considered deductible. Actually, it is likely that $113 million would be deductible: the $100 million civil claims fund and the $13 million paid to the United States for Federal False Claims Act and common law claims.

[188] Salomon Brothers' Agreement to Settle Federal Civil Charges Stemming From Its Role in 1991 Treasury Auction Scandal: Hearing Before the Subcomm. on Oversight of the House Ways and Means Comm., 102d Cong., 2d Sess. 2-3 (1992).

[189] This prohibition is found in § 6103(a) of the Code. Section 6103(a) states, in pertinent part:

> (a) General rule.- Returns and return information shall be confidential, and except as authorized by this title,-(1) no officer or employee of the United States . . . shall disclose any return or return information obtained by him in any manner in connection with his service as such an officer or an employee or otherwise under the provisions of this section.

I.R.C. § 6103(a).

[190] Salomon Brothers' Agreement to Settle Federal Civil Charges Stemming From Its

Representative Anthony asked Carrington to further explain the remedial/punitive dichotomy, but Carrington could not because he was unfamiliar with the underlying purpose of the securities statutes. Representative Anthony then asked the Service to address in writing the application of the remedial/punitive distinction to the claims settled in Salomon's case, but no written response was provided.[191] The consensus reached during the hearing was that the $100 million claims fund payment would be deductible, and the remaining $190 million would lie in a gray area depending upon whether the payments were punitive or remedial. No definition of punitive or remedial was attempted by the Treasury or the Committee.

A deduction for the $100 million paid into the claims fund is highly likely because those funds would clearly not be categorized as a penalty; rather, they are compensatory damages paid to investors. Treatment of the other $190 million may be illuminated by applying the remedial/punitive distinction developed in this Article to the SERPSRA claims, civil asset forfeitures, and FFCA and common-law claims.

1. Civil Penalties Under SERPSRA ($122 million)

Salomon paid $122 million in civil penalties under SERPSRA. To decide whether that amount is deductible, the first factor in the hierarchal analysis is whether legislative intent demonstrates that SERPSRA civil penalties are intended to punish. The legislative history of SERPSRA indeed demonstrates such a punitive intent.

SERPSRA worked a revolution in the SEC's enforcement powers by granting the SEC authority to go to court to seek civil penalties against any person for violation of any securities law or regulation.[192] Prior to SERPSRA, the SEC's general enforcement tools

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Role in 1991 Treasury Auction Scandal: Hearing Before the Subcomm. on Oversight of the House Ways and Means Comm., supra note 188, at 27.

[191] Id. at 29. The Hearing Report contains no written response from the Service and would have contained such a response if one had been provided prior to publication. In addition, a response was not otherwise provided to the Committee. Telephone Conversation with Patrick G. Heck, Assistant Counsel, Committee on Ways and Means Subcommittee on Oversight (June 28, 1993).

[192] Prior to SERPSRA's enactment in 1990, the SEC could seek civil money penalties only in insider trading cases. The Insider Trading Sanctions Act of 1984 had given the power to seek civil penalties against persons engaged in insider trading. In 1988, the power

were limited to seeking injunctions and disgorgement orders. Congress concluded that those enforcement means were inadequate because the threat of an injunction had very little deterrent effect and disgorgement required only that the violator give up his unlawful gains without any added cost.[193] Dissatisfaction with the prior regime, in which the measure of damages was actual loss, resulted in SERPSRA's grant of authority to seek or impose substantial money penalties determined principally without regard to loss.

The size of a SERPSRA penalty is governed by a three-tier structure focusing upon the culpability of the violator and the harm or potential for harm caused.[194] Within the three tiers for court-imposed penalties, the amount "shall be determined in light of the facts and circumstances."[195] For SEC-imposed penalties, the statutes provide six factors for the SEC to consider. The factors are:

> (1) whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;
> (2) the harm to other persons resulting either directly or indirectly from such act or omission;
> (3) the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior;
> (4) whether such person previously: (a) has been found by the SEC, another appropriate regulatory agency, or a self-regulatory

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was expanded to persons in authority positions ("controlling persons") who failed to take reasonable measures to prevent their "controlled persons" from engaging in insider trading. (SERPSRA additionally permits the SEC itself to assess civil penalties in SEC administrative proceedings against SEC-regulated persons.) House Committee on Energy and Commerce, The Securities Law Enforcement Remedies Act of 1990, H.R. Rep. No. 616, 101st Cong., 2d Sess. 16-17 (1990), reprinted in, 1990 U.S.C.C.A.N. 1379, 1383-84.

[193] Id. at 17-19, reprinted in 1990 U.S.C.C.A.N. at 1382-86. Senate Committee on Banking, Housing, and Urban Affairs, The Securities Law Enforcement Remedies Act of 1990, S. Rep. No. 337, 101st Cong., 2d Sess. 8-12 (1990).

[194] SERPSRA § 101, 15 U.S.C. § 77t(d)(2) (Supp. III 1991) (for court-imposed penalties sought by the SEC pursuant to the 1933 Act); SERPSRA § 201, 15 U.S.C. § 78u(d)(3) (Supp. III 1991) (for court-imposed penalties sought by the SEC pursuant to the 1934 Act); SERPSRA § 202(a), 15 U.S.C. § 78u-2(a) (Supp. III 1991) (for SEC-imposed penalties in SEC administrative proceedings).

[195] SERPSRA § 101, 15 U.S.C. § 77t(d)(2)(A) (Supp. III 1991); SERPSRA § 201, 15 U.S.C. § 78u(d)(3)(B)(i) (Supp. III 1991).

> organization to have violated the Federal securities laws, State securities laws, or the rules of a self-regulatory organization; (b) has been enjoined by a court of competent jurisdiction from violations of such laws or rules, or; (c) has been convicted by a court of competent jurisdiction of violations of such laws or of any felony or misdemeanor described in section 15(b)(4)(B) of this title;
> (5) the need to deter such person and other persons from committing such acts or omissions; and
> (6) such other matters as justice may require.[196]

Four of the six factors (factors 1, 3, 4, and 5) relate to the defendant's conduct rather than to the loss caused. Only one factor (factor 2) relates to the loss caused. The principal purpose of the penalties, as determined by the manner of calculation described in the statute and legislative history, is to punish. Therefore, the amount of consideration paid under the settlement agreement allocated to SERPSRA penalty claims ($122 million) would not be deductible.

2. Forfeitures to the Department of Justice Asset Forfeiture Fund Pursuant to 15 U.S.C. § 6 and 18 U.S.C. § 981(a)(1)(c) ($55 million)

Section 162(f) of the Code technically does not apply to deductions for forfeitures of property to a government because forfeitures are nondeductible under section 162(a).[197] Forfeitures are deductible, if at all, under section 165. A recent Tax Court case discerned a "unanimous line of authority" holding that property forfeited to a government is nondeductible under section 165.[198] Those decisions deny the deduction after concluding that (1) sec-

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[196] 15 U.S.C. § 78u-2(c) (Supp. III 1991). Although not required by statute, federal courts would be expected to use criteria very similar to those for SEC-imposed penalties when setting court-imposed penalties. The only other statutory difference between court-imposed and SEC-imposed penalties (in addition to the absence of an affirmative statement of the six criteria) is that court-imposed penalties may exceed the tier limits if the "gross amount of the pecuniary gain to the defendant exceeds the tier limits." See, e.g., 15 U.S.C. § 78u(d)(3)(B)(i) (Supp. III 1991).

[197] Stephens v. Commissioner, 905 F.2d 667, 672 (2d Cir. 1990), rev'g 93 T.C. 108 (1989).

[198] Smith v. Commissioner, 60 T.C.M. (CCH) 254 (1990) (citing Wood v. United States, 863 F.2d 417, 420-422 (5th Cir. 1989); Gambina v. Commissioner, 91 T.C. 826 (1988); Holt v. Commissioner, 69 T.C. 75 (1977); Bailey v. Commissioner, 58 T.C.M. (CCH) 1030 (1989); Pring v. Commissioner, 57 T.C.M. (CCH) 958 (1989); Gillan v. Commissioner, 55 T.C.M. (CCH) 1339 (1988); Styron v. Commissioner, 52 T.C.M. (CCH) 1373 (1987).

tion 165 includes a general public policy disallowance of losses if the allowance of a deduction would frustrate a sharply defined national or state policy, and (2) allowance of a deduction for property forfeited to a government would frustrate a sharply-defined policy.[199]

While there is no unanimous conclusion, the great weight of authority supports the idea that a deduction under section 165 of the Code is denied for property forfeited to a government because allowance of such a deduction would frustrate a sharply-defined national or state policy. Thus, consideration paid under the settlement agreement allocated to forfeitures ($55 million) would not be deductible.

3. Claims of the Department of Justice Under 31 U.S.C. § 3729 and Under Common Law ($13 million)

Under the FFCA, 31 U.S.C. § 3729, a person using a false statement to obtain payment from the United States upon a fraudulent claim is "liable to the United States Government for a civil penalty of not less than $5,000 and not more than $10,000, plus 3 times the amount of damages which the Government sustains . . . [plus] costs . . . ."[200] The FFCA was at issue in *United States v. Halper*[201] where the Court held that the Government's recovery constitutes punishment for purposes of the Double Jeopardy Clause only to the extent that the recovery "bears no rational rela-

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[199] This Article examines § 165 only to the extent that it incorporates § 162(f) principles, and Stephens v. Commissioner, 905 F.2d 667 (2d Cir. 1990), rev'g 93 T.C. 108 (1989), at 43, is the only case that meaningfully addresses the issue. Section 165 is discussed here only to complete the analysis of the Salomon settlement agreement. There are three important issues to note about the § 165 cases. First, the argument that the general free-wheeling sword of public policy did not survive enactment of the Tax Reform Act of 1969 has not thoughtfully been refuted. Second, the line of authority is not unanimous even within the Tax Court opinions. In Ramos v. Commissioner, 42 T.C.M. (CCH) 924 (1981), the taxpayer's boat was seized in the Bahamas for violating territorial fishing restrictions, and the § 165 loss deduction was permitted. Perhaps no "national or state policy" is offended when U.S. citizens violate foreign law and lose property. However, that position seems an unusual distinction, and the Tax Court has not yet harmonized *Ramos* with its other decisions. Third, the most defensible manner in which to deny the deduction under § 165 is to do so under the narrow grounds that the policy considerations embodied in § 162(f) deny the deduction because the measure of the penalty in a forfeiture action is not loss. The measure is the value of the property.

[200] 31 U.S.C. § 3729(a) (1988).

[201] 490 U.S. 449 (1989).

tion to the goal of compensating the Government for its loss . . . ."[202]

Part III of this Article argues that the Government's recovery should be considered punitive for purposes of section 162(f) of the Code only if it exceeds all the Government's costs. In *Halper*, the Government had to account for all of its costs in order to be awarded judgment against Halper in that amount. In *Salomon*, however, the burden of proving costs would be more difficult. Salomon was not criminally punished, so the civil FFCA and common law claims constitutionally could punish and should be regarded as punishment to the extent that the consideration allocated to the FFCA and common law is not-remedial. Salomon would have the burden of proving "all the Government's costs" under the FFCA and common law claims, and Salomon might have difficulty obtaining evidence to prove the costs of another person. However, if Salomon could prove such costs of the Government, either through information obtained during settlement negotiations or by FOIA requests, Salomon should be entitled to deduct the amount up to the Government's costs.

V. Conclusion

When a defendant pays money to a government pursuant to a criminal charge, the payment is a fine, and it may not be deducted for federal income tax purposes. When a defendant pays damages to a government pursuant to a civil claim, the defendant cannot deduct the payment if it was intended as punishment. The payment of civil damages to a government is punitive if the government has declared an intent to punish. Declaration of punitive intent will be found in the statute under which the government made its claim, in the resolution of the particular case, or by inference from the manner by which the damages are calculated.

For punitive purpose to be declared in a statute, legislative history, settlement agreement, or judgment, there must be a direct statement that the payment of the damages is intended to punish. Invocation of the "penalty" label in the heading or wording of a statute, settlement agreement, or judgment is not determinative, but certainly heightens the probability that a punitive declaration

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[202] *Halper*, 490 U.S. at 449.

will be found. Absent a declaration, punitive purpose will be inferred if the damages paid by the defendant exceed "all the costs" of a government or victim resulting from the acts giving rise to the remedy. If the damages exceed "all the costs," then the payment punishes, but only to the extent of the excess. The precise contours of the "all-the-costs" measure are not defined brightly. One commentator has suggested that it includes all the external social costs of the defendant's conduct. "All-the-costs" at least encompasses the ordinary fixed-penalty-plus-double-damages remedy, which may have the greatest impact on the application of section 162(f), for it clearly demonstrates that the compensatory damages limit advanced by the Treasury Regulation and some courts is not supportable. In the future, legislatures enacting penalties and government officials prosecuting civil cases may more frequently declare directly their intent to punish, in which case the application of section 162(f) will become straightforward. However, such direct declarations may continue to be infrequent because of the propensity of legislatures to avoid any claim for heightened process in civil cases. Thus, courts deciding tax cases will have to consider more thoughtfully the issue of when the manner of computing civil damages shows that payment of those damages to a government constitutes punishment for purposes of section 162(f).