When Litigation Settlements Face Fine or Capital Treatment

By Robert W. Wood

Robert W. Wood practices law with Wood & Porter, in San Francisco (http://www.woodporter.com), and is the author of *Taxation of Damage Awards and Settlement Payments* (3d Ed. 2008) and *Qualified Settlement Funds and Section 468B* (2009), both available at http://www.taxinstitute.com. This discussion is not intended as legal advice, and cannot be relied on for any purpose without the services of a qualified professional.

As a rule, plaintiffs in litigation have become pretty sophisticated about tax issues. Some plaintiffs even consult tax counsel as they are framing their complaint, ever vigilant that some tax-related seed planted early in the dispute might grow into a prodigious tax benefit down the road. Most plaintiffs are not quite *that* proactive about tax issues, but do start thinking about the tax implications of a recovery as a case is winding up. A few plaintiffs don't consider tax issues until tax reporting time the year following the settlement.

Defendants, on the other hand, have never been as sensitive to tax issues for several reasons. For one, by the very nature of litigation, the defendant is in a largely reactive mode, mostly trying to make the matter go away. Second, even for defendants who become convinced they will eventually have to pay something to settle the matter, paying something normally involves fewer opportunities for tax planning and orchestration than the act of receiving something.

Besides, in my experience, most defendants seem to think that anything they pay in this context, whether legal fees or damages, will be deductible no matter what. They can perhaps be forgiven for that blanket deductimania if they are operating a trade or business, and the lawsuit relates to their operation of that trade or business. In that context, most (but certainly not all) settlements and judgments are deductible.

Nevertheless, I've long thought we would see an increasing volume of authorities exploring a largely factual (or perhaps combined factual and legal) question: Are amounts paid to dispose of claims deductible (as most taxpayers think they are in every case) or rather nondeductible as penalties? I've found that there is often considerable room for taxpayers to negotiate language in settlement agreements that can help them when it later comes tax time.

It can also help in a subsequent tax dispute. First, of course, one must recognize the issue and know something about the legal landscape. Frequently, one can plan around some of the minefields. That is good, because the minefields seem to be increasing. Several prominent senators (among them, Finance ranking minority member Chuck Grassley, R-Iowa) have castigated the IRS and

the Justice Department for failing to ensure the nondeductibility of many prominent settlements.[1] That scrutiny should serve to heighten taxpayer interest in this topic.

Yet, it also seems to be heightening the IRS's scrutiny of the deductibility of damage payments. There are several recent cases that give evidence of this trend.

Wellpoint

In *Wellpoint Inc. et al. v. Commissioner*,[2] the Tax Court considered a company's deduction of three settlement payments totaling more than $113 million made to resolve lawsuits brought against the company by the attorneys general of Kentucky, Ohio, and Connecticut. The first issue in the case was whether those amounts were business expenses or penalties. The second issue was whether the legal and professional expenses Wellpoint incurred in defending the lawsuits were also deductible.

In a decision that will almost surely be appealed, Judge Diane L. Kroupa ruled that both the outsize settlement payments and the related legal expenses were capital expenditures that could not be deducted. As is so often the case in Tax Court litigation, many of the facts were stipulated. Wellpoint provided commercial health insurance through its subsidiaries doing business in all of the states in question. Many of Wellpoint's subsidiaries were Blue Cross/Blue Shield licensees.

In Kentucky, Ohio, and Connecticut, Wellpoint merged with Blue Cross and Blue Shield plans, the latter of which had stated charitable purpose provisions in their governing documents. Postmerger, the attorneys general of Kentucky, Ohio, and Connecticut began investigating some of the constituent companies, and they did not like what they found. There was clearly nothing charitable going on.

The basic complaint in each state was the same: that Wellpoint's subsidiaries continued to have lofty stated charitable purposes in their governing documents. That meant they received beneficial federal and state law treatment. To the three states, that meant Wellpoint should be viewed as holding those assets impressed with a charitable trust. In essence, the attorneys general in the three states argued that no charitable purposes were being met, and that the respective states therefore should logically be entitled to those assets.

Settling Up

After a period of scuffling, Wellpoint and its subsidiaries resolved the litigation in all three states by a transfer of cash. Yet, this was not the usual transfer of cash in a settlement payment. Indeed, in Kentucky, Wellpoint paid over $45 million, transferring the money to the Commonwealth of Kentucky for the specific purpose of creating a section 501(c)(3) organization to promote Kentucky healthcare.

In Ohio, Wellpoint forked over $36 million. The money was used to establish the Anthem Foundation, also targeting healthcare. In Connecticut, where the settlement payment was slightly more than $40 million, the money went directly into a newly formed charitable corporation to serve the health needs of Connecticut. The amounts to the three states were paid in 1999 and 2000 tax years. In those two tax years, Wellpoint deducted all the settlement payments, along with approximately $800,000 in related legal and professional fees.

Although those settlement agreements may sound unusual, in at least one respect they were not. The three settlement agreements made it quite clear Wellpoint was not admitting any liability and was only entering into each of the settlements as a compromise and to avoid further litigation. Consider that denial of liability question while reflecting on the Tax Court's decision.

Harsh but Fair?

Much of the Tax Court's opinion in *Wellpoint* is predictable. That is, the court starts with an analysis of the origin of the claim doctrine, noting that it had to determine the nature of the claim in each of the respective lawsuits. Few of us get a chance to talk about the cy-pres doctrine outside of academia, so this is a rare opportunity. The basic claim of the attorneys general in all three cases, said Judge Kroupa, was cy-pres.

For those (like me) with little Latin and even less Greek, cy-pres means that, when it would be impossible or illegal to give an instrument its literal effect, you should construe it so the intention of the party is carried out as near as it can be.[3] Thus, if property is dedicated to a particular charitable purpose, and that purpose is not being carried out, a cy-pres proceeding would seek to carry out the charitable purpose in a way that is as close as possible to the original purpose, even if the original cannot be replicated.

For example, suppose that a charitable gift is made for the purpose of abolishing slavery. A gift to abolish slavery becomes impossible to satisfy because slavery has already been abolished. Consequently, the gift might be reformed to provide necessities for victims of slavery.[4] Examples from a storied legal literature include many such quirky fact patterns.

With the assumed relevancy of cy-pres authorities, the Tax Court goes on to answer the question whether payments to resolve litigation over the cy-pres doctrine should be treated as deductible under section 162, or rather must be capitalized under section 263. Some of you may be scratching your heads thinking that whatever creative arguments the three attorneys general made, this sounds like roll-up-your-sleeves business litigation. Indeed, you might think that business expense deductions here would be obvious. Another alternative

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[1]*See* Wayne, ''3 Senators Protest Possible Tax Deduction for Boeing in Settling U.S. Case,'' *The New York Times*, July 7, 2006, p. C3. *See also* Senate Finance Committee Memorandum to Reporters and Editors, from Jill Gerber for Grassley, regarding the potential deductibility of Boeing's government settlement, July 26, 2006.

[2]T.C. Memo. 2008-236, *Doc 2008-22814*, *2008 TNT 209-7*.

[3]*See Black's Law Dictionary*, p. 387 (6th edition, 1990).

[4]*See Jackson v. Phillips*, 96 Mass. 539 (1897).

might be charitable contribution deductions, but we'll come back to that subject later.

Nevertheless, the Tax Court weighed in with a smattering of cases that say the costs of resolving litigation over title to property involve capital expenditures. From the usual cases standing for the proposition that title to property equals capitalization, the court went on to say that settlement payments and legal fees expended to resolve disputes over the ownership of assets are also capital in nature. The court cited *Anchor Coupling Co. v. United States*.[5] In contrast to the capitalization authorities, the court admitted that a deduction is usually allowed for expenses incurred in defending a business and its policies from attack.[6]

Title Fight vs. Just Business

Were those three lawsuits fundamentally about title to assets, or were they about Wellpoint's business and its ability to keep operating? You might think the company had a pretty good argument that dealing with the respective attorneys general of those three complaining states was really about Wellpoint's manner of conducting business. As such, Wellpoint argued that this should make the three settlement payments (along with the related legal fees) deductible. Indeed, Wellpoint noted that the lawsuits did not actually challenge title to specific items of property. According to Wellpoint, that made capitalization inappropriate.

Interestingly, the Tax Court agreed that it was Wellpoint's business practices that were being assaulted in those cases. Yet, that concession turned out to be a hollow victory, for here, the Tax Court diverged from the Wellpoint script. The Tax Court bought the argument that the origin of each claim was a dispute over the equitable ownership of assets allegedly impressed with charitable trust obligations.

Unfortunately for Wellpoint, the settlement agreement seemed like a good road map on that point. In each case, the settlement agreement called for the assets to be transferred to a section 501(c)(3) organization conforming to the charitable purpose the state attorney general sought to enforce. The Tax Court applied its logic to each of the three pieces of litigation separately, although with common effect.

For example, in the Kentucky case, the court found that the complaint, the settlement agreement, and the parties' respective descriptions of the nature of the suit all suggested that the case was actually about title to the alleged charitable assets. Indeed, with a kind of hoist-by-your-own-petard flair, the Tax Court pointed out that the $45 million Kentucky payment went to establish a section 501(c)(3) organization to address healthcare needs. Clearly, that sounded like an admission to Judge Kroupa.

As for Ohio, the complaint there also asserted that assets were impressed with a charitable trust. The Ohio attorney general sought the return of those assets to charitable purposes. That sounded just like the Connecticut filing, which also focused on the ownership of trust assets. The Tax Court pointed out that even the petitioner in the case (in financial statements and annual reports) had characterized the Connecticut suit as a dispute over title to assets allegedly impressed with a charitable trust. Talk about being hoisted by your own financial statements petard.

Not surprisingly, of course, the settlement documents in all three states deny the existence of a charitable trust, and assert something that is undoubtedly true: that Wellpoint was making the payment to avoid the interruption of its business or loss of goodwill. Instead of examining the facts, the Tax Court simply said it found this argument irrelevant. A taxpayer's motive for settling a case is not controlling in determining the deductibility of the settlement payment, the court said. For this proposition, Judge Kroupa cited *Woodard v. Commissioner*.[7]

Strictly Business

Backed into a corner with Kroupa giving no quarter, Wellpoint found itself arguing that those settlement payments were per se deductible because they were necessary to defend its business. Two cases underscoring such a rule are *BHA Enterprises Inc. v. Commissioner*,[8] and *AE Staley Manufacturing Co. and Subsidiaries v. Commissioner*.[9] The *BHA* case involved a taxpayer fighting to keep the Federal Communications Commission from revoking its broadcasting licenses, and settlement payments there were held to be deductible.

Still, Judge Kroupa found *BHA* inapposite, castigating as ''uncorroborated and self-serving'' the testimony presented by Wellpoint's witnesses that they could no longer do business if they lost those suits. *AE Staley* involved deductions for investment banking and printing costs incurred by Staley in an unsuccessful effort to defend its business against a takeover. Those costs were held to be deductible because they produced no future benefit.

Yet, Judge Kroupa also found *AE Staley* distinguishable because she found the future benefits accruing from the defense and settlement of these cy-pres cases to be manifest. They arguably enabled Wellpoint to convert the assets from charitable to income-producing purposes.

Legal Expenses

This brings us to legal expenses. Few readers at the end of this sad opinion would expect the legal expense issue to go the taxpayer's way. Predictably, in a short paragraph, Judge Kroupa concluded that the legal and professional expenses, like the settlement payments, were controlled by the origin of the claim doctrine. The Tax Court summarily concluded that the legal and professional fees here arose from defending against claims that had their origin in the equitable ownership of assets. Therefore, no deduction!

In some ways, of course, Judge Kroupa seems correct in her origin of the claim analysis. After all, the three cases here *were* brought seeking the imposition of a

[5]427 F.2d 429 (7th Cir. 1970).

[6]*See INDOPCO Inc. v. Commissioner*, 503 U.S. 79 (1992). *See also Commissioner v. Heininger*, 320 U.S. 467 (1943).

[7]397 U.S. at 578.

[8]74 T.C. 593 (1980).

[9]199 F.3d 482 (7th Cir. 1997), *Doc 97-19670, 97 TNT 129-9.*

charitable trust. Not only that, but that's the unequivocal way all three cases were settled. Still, I can see Wellpoint's, well, point.

It reminds me a little of *United States v. Gilmore*,[10] in which the taxpayer argued convincingly that the origin of his huge legal bills was an attempt to retain his business despite a bitterly fought divorce. The IRS argued even more convincingly that the origin of the claim *was* the divorce. As a divorce was purely personal — whatever might be its disastrous financial effects — Gilmore could claim no deduction.

The origin of the claim doctrine is like that, sometimes capable of more than one view, depending on the beholder and his or her particular lens.

Forest or Trees?

When litigating the common deductible or capitalizable question, it's always appropriate to stand back and look at the forest. By that, I simply mean that timing must be considered. So, while pondering the door number one of a deduction versus the obviously less attractive door number two of capitalization, think about the real dollar difference.

If the pertinent asset has been disposed of, either immediately or at least by the time of the tax litigation, the timing difference between a current deduction and capitalizing the payment may not be too severe. In fact, a year or two of timing difference can look like a virtual rounding error. Such an analysis in this case would be truly interesting, but there is nothing in the case to indicate exactly what would happen next.

Indeed, if Judge Kroupa's decision sticks on appeal and Wellpoint has to capitalize the entire amount, does it then amortize the amount? If so, over what period? To what asset does it attach?

In fact, isn't it clear that Wellpoint parted irrevocably with the monies going to the respective charities? Even assuming that Judge Kroupa is correct, I'm unclear whether Wellpoint would ever receive any tax benefit from those payments. But, that brings us to the next chapter in this mess.

Charitable Contributions

Every reader will have thought about the charitable contribution angle, at least in passing. If you can't deduct one way, why not another? Those payments were, after all, payments to charity.

A footnote in the opinion even notes that in the case of the Ohio litigation (with $36 million going to the Anthem Foundation), Wellpoint got an $8 million credit (from the state of Ohio) for Wellpoint's prior charitable contributions. That meant Wellpoint was required to pay only $28 million in cash of the $36 million settlement to resolve the Ohio case. This should make you wonder whether a charitable contribution deduction here wouldn't be unassailable.

But would it? There are cases in the charitable contribution arena that say you must have a donative or charitable intent. And, there are cases that deny charitable deductions when there is a quid pro quo for the "donation." Of course, there are also percentage limitations on charitable contributions. Nevertheless, perhaps we should assume Wellpoint could claim a charitable contribution deduction even if it meant taking it over several years.

As to donative intent and quid pro quo issues, however, how does one determine whether a purported gift is in the nature of a transfer for value, rather than being purely motivated by charity? The quid pro quo problem can arise with a charitable contribution made in exchange for something given now or in the future. Conveying an asset to a charitable organization as part of a deal or arrangement to get something back from the organization taints the contribution.

It can be viewed, in short, as merely a business deal.[11] One would think that there would be a fair amount of case law on the application of the quid pro quo concept. Most of the cases concern developers and real estate.

Quid Pro Quo Cases

For example, in *McConnell v. Commissioner*,[12] the Tax Court disallowed a deduction for a contribution of property to a municipality on the grounds that the transfer was motivated by an anticipated benefit "beyond the mere satisfaction flowing from the performance of a generous act." The court found the motives of the McConnells in transferring their interests in donated streets and sewers were: (1) to avoid responsibility for future maintenance of the streets and sewers; and (2) to enhance the value of their interest in the remaining property. In the Tax Court's view, this rendered section 170 inapplicable.

Similarly, in *Sutton v. Commissioner*,[13] the donor granted a perpetual easement that the court found was for the primary purpose of allowing the donor to develop his property. Thus, a charitable contribution deduction was denied. In contrast, in *McLennan v. United States*,[14] a deduction for a scenic easement was allowed notwithstanding a retained right to develop. The Court of Federal Claims held that the McLennans had transferred the easement with donative intent, and with an exclusive conservation purpose.

In the court's view, the McLennans were concerned about the pristine quality of the surrounding land, and were also aware that the grant of the easement would reduce the total value of their property. The government contended that the McLennans were motivated by tax savings rather than by a desire to preserve and protect the land. Here, the Court of Federal Claims was convinced that the taxpayers met the donative intent and conservation purpose thresholds, so it allowed the deduction.

Contributions to charity to resolve litigation seem relatively uncommon, but there is at least some practical precedent. Some of the landmark state antitrust litigation against Microsoft was resolved in part by "charitable"

[10]372 U.S. 39 (1963).

[11]*See* reg. section 1.170A-14(h)(3)(i).

[12]T.C. Memo. 1988-307, *aff'd without opinion* (3d Cir. 1989).

[13]57 T.C. 239 (1971).

[14]23 Cl. Ct. 99 (1991).

contributions of Microsoft products to schools.[15] I don't know, but I suspect Microsoft deducted those charitable contributions. Presumably if they were not charitable contributions, they were business expenses.

Plan B?

It is also worth reflecting briefly on what Wellpoint could have done differently. Normally, I would advocate drafting a settlement agreement to focus on tax issues. Here, that might have meant underscoring (in recitals or elsewhere) the fact that Wellpoint was having its manner of doing business challenged in those three states. Moreover, it might be wise (even if self-serving) to indicate that Wellpoint was making the settlement payments to be able to continue in business. Arguably, that's what the suit was about.

Even so, I am not so sure that would have helped here. Indeed, the three states had each framed the dispute as involving title to assets. Yet fundamentally, there was no court ruling that said the states owned the assets and that Wellpoint did not. Instead, there were three settlement agreements, each of which explicitly called for a transfer of assets (cash) to some entity at the behest of the state.

Maybe it's a dumb question, but on those facts, if one thinks about the legal expense first, and concludes that capitalization is appropriate, to what would you capitalize it? With no court ruling that the assets were always owned by the state, or by a charity, the assets were presently owned by Wellpoint until the time of the transfer. The transfers occurred over two years, between 1999 and 2000. One might think that if legal expenses were incurred in connection with capital assets in those two years, and the assets were disposed of in 1999 or 2000, that disposition would trigger the loss.

Clearly, that must not be the case, because this relatively small timing difference would probably have been resolved before trial, and there is no discussion in the case of how capitalization would work here. Nevertheless, it is tempting to think that Wellpoint would be capitalizing the property it gave away. If this theory were correct, there would presumably have been no Tax Court case. Wellpoint would surely have simply agreed to capitalization followed by immediate disposition of the capitalized asset.

Instead, what the IRS and Tax Court presumably had in mind is that Wellpoint would capitalize the amounts for its own stock. Thus, it would achieve a tax benefit only on a sale or liquidation of the company. Even with all this, it is still possible that creative drafting in the three settlement agreements might have given Wellpoint some better arguments in this case.

Field Attorney Advice

The second piece of unhappy news on this topic comes from the IRS itself in FAA 20084301F.[16] This field attorney advice involved facts that, although different from the Wellpoint facts, raise related issues. As in Wellpoint, three states are involved in the field attorney advice.

Here again, the question is whether ordinary and necessary business expense treatment is available. Rather than the alternative of capitalization as presented in Wellpoint, however, the question here was whether section 162(f) instead prevented a deduction entirely.

In the list of potential taxpayer nightmares, section 162(f) treatment is arguably even worse than capitalization treatment, because section 162(f) prevents any deduction ever. The key, of course, is just what is considered a fine or a penalty within the scope of section 162(f).

In FAA 20084301F, Electrotoy was a consumer products manager operating in states X, Y, and Z. The respective states sued in federal district court accusing the company of price fixing. The states claimed Electrotoy's practices were anticompetitive. The three states sought injunctions as well as civil penalties. Eventually, the parties filed a consent decree and final judgment.

In it, Electrotoy agreed to an injunction against dictating the price of its products to retailers and agreed to pay an amount to the three states. The money was to be earmarked for use by the state attorney general for antitrust enforcement, for a consumer protection fund, or any other function allowed under state law. Significantly, Electrotoy admitted no liability, claiming that the consent judgment could not be used in any proceeding to show its guilt.

The field attorney advice includes a discussion of the Sherman Antitrust Act and the way in which states can participate and receive fines in the case of antitrust enforcement. In addition, each of the three states in question had state laws against price fixing and restraint of trade, and those laws provided for fines or penalties for violations.

Nondeductible Fine

After reviewing pertinent state law, the field attorney advice concludes that Electrotoy's payment to all three states to settle the antitrust suits under federal and state laws was not deductible under section 162(f). The field attorney advice notes that the settlement agreement did not explicitly allocate monies between federal and/or state law violations. Nevertheless, all three state statutes spoke only of fines being available to the states, not damages.

Moreover, the IRS said in the field attorney advice that the amount Electrotoy paid was below the maximum amount the law allowed for a penalty. Thus, if 100x was the maximum potential penalty, and Electrotoy paid 80x, the IRS found that this *by itself* was evidence that the entire payment Electrotoy made was a fine or penalty. This fact should suggest that the taxing authorities may be expected to draw inferences from the mere amounts involved. Some thought should be given to what, if any, evidence can be gathered to rebut such an inference.

The field attorney advice does recognize some ambivalence in the law of State Y and State Z as to whether antitrust monetary judgments were penalties or instead were compensatory damages. Nevertheless, the IRS notes in the field attorney advice that States Y and Z also filed their complaint under federal antitrust statutes, and that the aggregate Electrotoy payment was well within the federal penalty limits.

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[15]*See* Markoff, "Microsoft Finds Some Doubters for the Motives of Its Largesse," *The New York Times*, May 26, 2003.

[16]*Doc 2008-22706, 2008 TNT 208-16.*

Based on that, the IRS said it meant the payments here ''can reasonably be treated as a penalty.'' Finally, the IRS pointed out that the plaintiffs' complaint in all three states specifically requested civil penalties, and did not specifically request compensatory damages. For all of those reasons, the field attorney advice concluded that allowing any portion of Electrotoy's settlement payment to be treated as deductible damages was not in accord with the facts.

'No Admission' Language

Interestingly, the field attorney advice recognizes that Electrotoy could well argue that its payment was compensation for damages in the three states, or that it represented an amount outside of the antitrust law to settle the suit. Noting the (arguably boilerplate) statement in the settlement agreement that Electrotoy admitted no wrongdoing, the IRS flatly states that the admission of wrongdoing is not necessary for the deduction prohibition of section 162(f) to apply. It is necessary only that the payment be most properly characterized as a penalty, the IRS said. The National Office found that in spades.

Why? Electrotoy had simply paid money to settle antitrust allegations that, if proven at trial, could have led to a fine of up to $10 million. Electrotoy paid less than that, but the fine or penalty characterization stuck, the IRS said.

Conclusion

It is probably not likely that defendants will become as tax savvy as plaintiffs when settling litigation. Ultimately, most defendants probably do not need to be. In a large number of cases, the defendant will be engaged in a trade or business, and there will be some kind of tax benefit available for making settlement payments and paying legal fees to attorneys. In a majority of those cases, the tax treatment is likely to be full deductibility as an ordinary and necessary business expense, or at least as an investment expense.

Nevertheless, defendants also need to be concerned with tax issues. At one extreme, there are still cases in which neither legal fees nor settlement payments are deductible because of the personal nature of the dispute. Further along the continuum come cases in which either section 212 or section 162 expenses are differentiated as well as the dreaded capitalization concept. At the other extreme, we would find nondeductibility under section 162(f).

Particularly as the economy falters, defendants who do have to pay lawyers' fees and settlement or judgment amounts will want a tax benefit to ease the pain. Consider those issues as early as you can.