Cleaning Up: Tax Deductions for Restitution, Fines, and Penalties

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The axiom that taxes drive — or at least influence — many business decisions is generally accepted and rarely garners attention. Tax consequences inevitably seem to flow from everything in business, and that is as it should be. Still, there is occasionally outrage. In particular, tongues wag when a tax advantage accompanies bad or even deplorable conduct.

Senate Finance Committee ranking minority member Chuck Grassley, R-Iowa, long a key legislator in the tax arena, has been consistent in his attention to this issue. In 2003 Grassley raised concerns over the deductibility of a $1.4 billion settlement between the Securities and Exchange Commission and 10 financial institutions over underwriting practices. Grassley, along with Finance Committee Chair Max Baucus, D-Mont., and Sen. John McCain, R-Ariz., introduced the Government Settlement Transparency Act, which would have made nondeductible any payment to acknowledge actual or potential violations of law. The bill languished and was never passed.

In 2006 Grassley targeted the $615 million settlement Boeing paid to avoid criminal charges and settle civil claims. Boeing’s settlement capped a protracted Justice Department investigation into government contract improprieties. Grassley, McCain, and former Sen. John Warner expressed outrage that Boeing could deduct the $615 million, with taxpayers subsidizing Boeing’s misconduct. Eventually, Boeing announced it would not deduct the settlement.

In 2008 Grassley flagged the auction-rate securities settlements, again involving financial institutions. Citibank alone is buying back $7 billion in auction-rate securities, and paying a $100 million fine. Leaving aside the huge buybacks of securities, which have their own tax ramifications, the “fine or penalty” element was enough to get Grassley’s attention.

Allowable Deductions

In the absence of a law clearly barring deductions, it is not improper for taxpayers to consider tax advantages in settling disputes. In fact, despite Grassley’s umbrage, it seems incomprehensible that taxpayers would not consider tax treatment. The general rule is that payments in a business context (either by way of settlement or judgment) are deductible as business expenses.

However, section 162(f) prohibits a deduction for “any fine or similar penalty paid to a government for the violation of any law.” This affects both criminal and civil penalties, as well as sums paid in settlement of potential liability for a fine. The latter issue often causes controversy, for the likelihood a fine will be imposed may not be clear when a potential liability is satisfied.

Unquestionably, taxpayer incentives to orchestrate settlements with an eye on tax issues can be huge. After the Exxon Valdez oil spill, the U.S. government’s $1.1 billion settlement with Exxon reportedly had an after-tax cost to Exxon of only $524 million. Moreover, more than half the $900 million in civil damages Exxon paid were also deductible. Similarly, the after-tax costs of Marsh & McLennan’s $850 million settlement over bid rigging and conflicts of interest in 2005 were hundreds of millions less. The list goes on.

3See Senate Finance Committee Memorandum to Reporters and Editors, from Jill Gerber for Grassley, July 26, 2006, Doc 2006-14093, 2006 TNT 144-33.
5See Section 162(f).
6Reg. section 1.162-21(b).
penalty, the Tax Court concluded that section 162(f) applies both to criminal fines and to some civil penalties.

**Fines, Late Fees, and Compensatory Payments**

Section 162(f) bars a deduction for any fine or similar penalty paid to a government for a violation of law. However, a late filing fee designed to encourage prompt compliance with the law is not a fine for this purpose.15 Another exception concerns compensatory fines, imposed only to compensate a governmental entity for harm it has suffered, as distinguished from a fine with a punitive motivation.

Under that rationale, a fine that is essentially a reimbursement to the government for the amount of lost custom taxes has been held deductible.16 Similarly, a payment to the Clean Water Fund to avoid prosecution for water pollution was held deductible.17 However, the regulations take the position that civil environmental fines are nondeductible.18 Taxpayers often make every attempt to avoid penalty characterization in the environmental area and to emphasize the remedial effects (or intent) of payments.19

Even fines that may appear to be punitive on the surface may be deductible, as long as you can prove the requisite compensatory character. For example, liquidated damages imposed for the violation of truck weight limitations have been held to be deductible.20 Liquidated damages are often equated with penalties, but these statutory liquidated damages compensated the state for damage to the highways caused by overweight vehicles. Even when denominated as fines, liquidated damages imposed by contract have been viewed as compensatory on the same theory. Even the IRS has agreed with this position.21

**Determining Intent**

Notwithstanding these favorable theories for deducting fines or penalties, it can be difficult to show that a fine was imposed with a compensatory motive. For example, in **Talley Industries Inc., et al v. Commissioner**,22 a company and several executives were indicted for filing false claims with the federal government. The contracts in question allegedly resulted in a loss to the Navy of

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17G & B Restaurant Inc. v. Commissioner, 73 T.C. 1226 (1980).
18Reg. section 1.162-21(c), examples (2) and (7).
22T.C. Memo. 1994-608, Doc 94-10853, 94 TNT 244-9; rev’d and remanded, 116 F.3d 382 (9th Cir. 1997), Doc 97-18539, 97 TNT 121-31.
approximately $1.56 million. However, because of various potential liabilities, the settlement between Talley and the Justice Department was $2.5 million.

When Talley deducted the settlement, the IRS claimed it was a nondeductible fine or penalty. The Tax Court granted summary judgment for Talley, holding that the settlement payment was not a fine or penalty, except for a small amount ($1,885) earmarked as restitution. The Tax Court found that the government never suggested it was attempting to exact a civil penalty. Because the $2.5 million settlement was less than double the alleged $1.56 million loss, the court inferred that the settlement was too small to have been intended to be penal or punitive.

The Ninth Circuit then reversed and remanded. The Talley case on remand is extraordinarily detailed, with extremely specific findings of fact about many of the developments during the settlement. Even though the settlement agreement was silent about whether the parties intended the settlement to include double damages under the False Claims Act, the Tax Court concluded that the parties intended this. Then, the Tax Court turned to whether the payment was intended to compensate the government for its losses or to deter or punish Talley.

Talley argued that the government’s actual losses exceeded $2.5 million, so the settlement was purely reimbursement. The Tax Court was not persuaded, and noted that the settlement was a compromise of many issues. There was correspondence about the settlement offer, and Talley had actually tried to inject language in the settlement agreement reciting that the amounts would be treated as restitution. The government rejected this proposal, leading the Tax Court to conclude that Talley failed to carry its burden of showing remedial intent.

Talley went to the Ninth Circuit for a second time, and the Ninth Circuit again held that Talley failed to establish the compensatory nature of the disputed settlement.\(^23\) As Talley illustrates in its multiple iterations, intent can be hard to prove.

**Coordinated Issue Paper**

Perhaps because of the panoply of government settlements in the news these days, there seems to be renewed interest in, and focus on, this seemingly evergreen topic. Recently, the IRS confronted the question whether a taxpayer’s settlement payment to the Justice Department as part of False Claims Act litigation was deductible in its entirety, or rather must be split because of potential penalty characterization.\(^24\) A coordinated issue paper recites the general deductibility of all ordinary and necessary business expenses, and notes the prohibition of section 162(f).

Yet, says the IRS, the regulations make it clear that compensatory damages paid to a governmental entity are not deemed fines or penalties under section 162(f).\(^25\) The question in False Claims Act cases is whether a portion of the civil fraud settlement may represent a nondeductible penalty. In a False Claims Act settlement, the Service says that if the government’s intent in assessing multiple damages was punitive and not compensatory, the portion of the payment representing multiple damages (less specified relator fees) will be nondeductible.\(^26\)

The coordinated issue paper notes that the taxpayer has the burden of proving it is entitled to a deduction from any settlement amount. When a taxpayer enters into a settlement with a governmental entity under an authority other than the False Claims Act, the facts and law must be analyzed. That means a case-by-case determination will be needed.

**Restitution**

The deductibility of restitution payments is closely related to the authority for fines and penalties. Traditionally, the IRS has signaled that restitution payments to a penalty. For example, in *Jess Kraft et ux. v. United States*\(^27\) the Sixth Circuit held that payments of restitution to Blue Cross Blue Shield arising out of a criminal action for fraud were nondeductible. Although the restitution was paid to a private party and not to the government, the court held that the payments were nondeductible. Fortunately, some courts have disagreed and found restitution payments to be deductible.\(^28\) Indeed, even the IRS has sometimes treated restitution as deductible.

For example, restitution payments were treated favorably in LTR 200834016 (May 20, 2008), Doc 2008-18217, 2008 TNT 165-15. There, the IRS ruled that while a doctor could not deduct restitution payments as business expenses, he could deduct them as a loss incurred in a transaction entered into for profit. The restitution was paid to health insurance companies he previously defrauded.

The doctor practiced in New Jersey through his wholly owned professional corporation (an S corporation). He derived income primarily from insurance payments made on healthcare claims from his patients. The doctor was indicted for insurance fraud, pleaded guilty, and settled with the state of New Jersey. He paid a criminal penalty to the state, received a jail sentence, and agreed to provide restitution to the insurance companies. He made the required payments personally, and no restitution was paid to a governmental entity.

The question was whether the restitution to the insurance companies as part of his criminal plea agreement could be deducted under section 165(c)(1) or (c)(2).

\(^{22}\)See *Talley Industries Inc. v. Commissioner*, 18 Federal Appellate 661 (9th Cir. 2001), aff’d T.C. Memo. 1999-200, Doc 1999-21339, 1999 TNT 118-94.


\(^{24}\)See reg. section 1.162-21(b)(2).

\(^{25}\)See *Talley Industries Inc. v. Commissioner*, 18 Federal Appellate 661 (9th Cir. 2001), aff’d T.C. Memo. 1999-200, Doc 1999-21339, 1999 TNT 118-94.


\(^{27}\)See LMSB-04-0908-045, Doc 2008-19051, 2008 TNT 174-54.

Section 165(c)(1) allows a deduction for losses incurred in a trade or business, and section 165(c)(2) allows losses incurred in a transaction entered into for profit. Several cases stand for the proposition that a repayment of fraudulently obtained funds is not deductible under the first provision. The IRS therefore concluded there was no deduction available under section 165(c)(1) for the doctor’s restitution payments.

The deduction under section 165(c)(2) is another matter, for taxpayers who repay embezzled funds normally do qualify. The IRS even ruled that a convicted arsonist’s restitution payments were deductible under section 165(c)(2). A deduction is not allowed when payments are made in satisfaction of criminal liability, even if the payments are denominated as restitution. For example, in Bailey v. Commissioner, a restitution payment connected with a sentence was not deductible, even though it was applied as restitution in settlement of a class action. In Waldman v. Commissioner, the court noted that when a payment serves both law enforcement and compensatory functions, one must determine which purpose the payment was primarily designed to serve. The court looked to state law, concluding that the payment was not deductible because it was in satisfaction of a criminal liability.

In LTR 200834016 the restitution payment was made under New Jersey law, which called for restitution in addition to imprisonment or probation. Under New Jersey law, restitution was to be imposed if the victim suffered a loss and the defendant was able to pay. New Jersey law provided that fines were payments to punish the wrongdoer, while restitution serves to rehabilitate the wrongdoer and compensate the victims. Here, the IRS looked to New Jersey law, which provided that restitution was a payment solely to the victim.

The IRS also relied on New Jersey case law to determine that restitution was not punishment, and that while “restitution has aspects of rehabilitation and deterrence, which are also aspects of punishment, it is predominately non-penal in nature.” Taking account of all the authorities, LTR 200834016 concludes that the doctor’s restitution payments were deductible under section 165(c)(2).

Restitution and Losses

Restitution also featured prominently in Jon T. Stephens v. Commissioner. After defrauding his employer (Raytheon), Stephens was sentenced to five years in prison and was ordered to pay a fine. However, the court allowed Stephens to make restitution to Raytheon for the amount he embezzled (plus interest). In return, the court changed his prison sentence to probation. Stephens had already paid tax on the receipt of the embezzled funds, so he deducted the restitution payment. Nevertheless, the IRS challenged the deduction.

In Tax Court, Stephens asserted that the restitution was deductible as an investment loss under section 165(c)(2). The IRS, however, asserted that a deduction was disallowed by section 162(f). In the alternative, the Service argued that if the governing provision was section 165, public policy considerations should prevent a deduction.

The Tax Court had no trouble determining that section 165 was the governing code section. While Stephens’s restitution payment was not an ordinary and necessary business expense, according to the court, it was part of a transaction for profit. The Tax Court noted that even though section 162(f) did not apply, the same considerations extend to deductibility under section 165(c)(2). Thus, the court held that Stephens could not deduct the payment, since it arose in his criminal conviction.

Stephens appealed to the Sixth Circuit, which reversed, allowing Stephens to deduct the restitution payment. The appeals court noted that absent an application of the public policy doctrine, Stephens was entitled to the deduction. The court framed the question as whether the deduction for restitution of embezzled funds “so sharply and immediately frustrates a governmentally declared public policy that the deduction should be disallowed.” The Sixth Circuit acknowledged that Congress codified the public policy doctrine in 1969 and that this codification was intended to be all inclusive.

However, this codification appears only in section 162, not in section 165. Nevertheless, the court noted that allowing Stephens a deduction under section 165(c)(2) would not severely and immediately frustrate public policy. Moreover, the court noted, if Stephens could not claim a deduction, there would be a double sting, since he had already paid taxes on the embezzled funds.

Interestingly, the court justified the application of the public policy doctrine by analogizing the situation before it to one arising under section 162(f), under which the public policy doctrine can no longer apply. Stephens’s restitution payment was primarily a remedial measure designed to compensate Raytheon. It was not a fine or similar penalty, and Stephens paid his former employer, not the government. The presence of a private payee should be sufficient to bar the application of section 162(f) and allow the deduction. Nevertheless, the court hedged its conclusion, noting that a payment to a private party will not always insulate restitution from the public policy exception of section 165.

34 See Kraft v. Commissioner, 991 F.2d 292 (6th Cir. 1993); see also Mannette v. Commissioner, 69 T.C. 99 (1978).
35 See Waldman v. Commissioner, 88 T.C. 1384 (1987), id. 850 F.2d 611 (9th Cir. 1988). See also Kraft v. Commissioner, 991 F.2d 292 (6th Cir. 1993).
36 850 F.2d 611 (9th Cir. 1988).
37 88 T.C. 1384 (1987), aff’d 850 F.2d 611 (9th Cir. 1988).
In *Russell Spitz v. Commissioner*, the taxpayer was the secretary-treasurer and 33 percent owner of Odin Corp. (a building contractor). Spitz was convicted of theft regarding building a house for Mr. Fosshage. As a condition of probation, the court ordered Spitz to pay $5,000 in restitution to Fosshage. Spitz deducted this $5,000 payment, and the IRS denied the deduction. Spitz paid the tax and brought suit for a refund in district court.

The IRS argued that the $5,000 payment was a fine or similar penalty paid to a government for a violation of law, and thus was nondeductible. The court disagreed and found the $5,000 payment neither a fine nor a penalty, since it was payment of an amount due and owing and was not paid to a government. In the alternative, the IRS argued that allowing a deduction would frustrate the defined state policy against theft by a contractor. Although the court did not address the codification of the public policy doctrine, it quickly disposes of the Service’s argument, noting that the IRS failed to establish in what way restitution of stolen funds frustrates state policy.

Not only did the court in *Spitz* disagree with the Service’s arguments and refuse to grant the IRS summary judgment, but on its own initiative, it granted summary judgment to Spitz, allowing him the deduction. Even though the court was quite taxpayer friendly, it did not reject the public policy argument. The court seemed to accept the legitimacy of the IRS’s public policy argument, but reasoned why the doctrine did not apply.

**Violation of Public Policy**

The IRS still occasionally objects to the deductibility of payments based on public policy. The government has generally raised the issue when a legal action involves penalties or punitive provisions, and the settlement or judgment could have a similar taint. This occurs despite the Supreme Court determination in 1966 that the IRS could not disallow deductions under a general public policy theory.\(^{40}\)

While the nondeductibility of fines or penalties under section 162(f) was designed to replace restrictions on public policy grounds,\(^{41}\) when a payment is made to a private party that will definitely reduce the amount of a government-imposed fine, it can be argued that allowing a deduction for the payment subverts the purposes of the section. That was the issue in *Allied-Signal Inc. v. Commissioner*.\(^{42}\) The court denied any deduction for an $8 million payment because there was a virtual guarantee the court would reduce the criminal fine dollar for dollar.

Unlike in *Allied-Signal*, facts are often ambiguous. Plus, even when the public policy moniker is not used, its spirit sometimes emerges. Thus, in *Oden v. Commissioner*,\(^{43}\) the Tax Court disallowed a sole proprietor’s deduction for compensatory damages in a defamation suit brought by an ex-employee. There was malice in the defamation, and the Tax Court found some actions so extreme that a deduction should not be available. Still, it is hard to justify this result given the explicit limitation in section 162(f) to fines and penalties.\(^{44}\)

The mere fact that liability is based on fraud, breach of fiduciary duty, or mismanagement is generally not enough to prevent a payment from being deductible, as long as the liability arose out of the taxpayer’s trade or business. Examples include:

- damages caused by a taxpayer’s fraud in negotiating a lease were held deductible;\(^{45}\)
- damages paid by a stockbroker for improperly churning a client’s account were held deductible;\(^{46}\)
- damages paid by a director for breach of fiduciary duty to a corporation were held deductible;\(^{47}\)
- damages paid by an executive for mismanagement and misuse of corporate assets were held deductible;\(^{48}\) and
- punitive damages paid by a corporation to a victim of a fraudulent scheme in settlement of a breach of contract and fraud action were held deductible.\(^{49}\)

If the payment itself is illegal under federal law, the deduction will be disallowed.\(^{50}\) Thus, when a taxpayer sought to deduct a payment made to an arsonist to burn down his own building, no deduction was allowed.\(^{51}\) Yet, the regulations flatly state that an amount otherwise deductible under section 162 will not be made nondeductible because the deduction would frustrate public policy.\(^{52}\)

Nevertheless, even that does not obviate all of the line-drawing. In a blow to the traditional notion that virtually any legal expense (of a noncapital and nonpersonal nature) is deductible, in *Daniel Frances Kelly Jr. v. Commissioner*,\(^{53}\) the Tax Court held that the legal costs of defending against a sexual assault charge were nondeductible. The taxpayer in *Kelly* had been charged with criminal sexual assault, and sought to deduct his legal fees as a business expense. The Tax Court found the sexual harassment charges arose out of the individual’s personal activities, not out of business or profit-seeking activities. The court distinguished *Clark v. Commissioner*\(^{54}\) because of the personal nature of this claim.

In *Clark* the taxpayer had been wrongfully accused of assault with intent to rape during the course of his employment. However, Clark had been working within the course and scope of his employment, and he had not.

\(^{44}\)Regarding the deduction of Michael Milken’s settlement, see Lee A. Sheppard, “Milken’s Deduction for His Settlement,” *Tax Notes*, Mar. 9, 1992, p. 1189, 92 TNT 55-14.

\(^{45}\)Helbering v. Hampton, 79 F.2d 358 (9th Cir. 1935).

\(^{46}\)Ditmars v. Commissioner, 302 F.2d 481 (2d Cir. 1962).

\(^{47}\)Graham v. Commissioner, 326 F.2d 878 (4th Cir. 1964).

\(^{48}\)Great Island Holding Corp. et al v. Commissioner, 3 T.C. 150 (1945), acq., 1945 C.B. 3; and acq. sub nom., 1945 C.B. 7.


\(^{50}\)Rev. Rul. 82-74, 1982-1 C.B. 110.

\(^{51}\)Id.


\(^{54}\)50 T.C. 1330 (1958).
committed the rape. Clark’s legal fees were therefore deductible. In *Kelly* the sexual assault activity was not within the course and scope of his employment, nor was it conducted for a legitimate business purpose, so the deduction was denied.

Most tax advisers assume that claims made against an officer of a company for sexual harassment, gender or race discrimination, wrongful termination, etc., result in settlements that are deductible by the company. The indemnity obligation in the employment contract, governing documents, or under law. However, virtually all harassment and discrimination cases arise out of personal activity.

The kind of line-drawing done in *Kelly* is reminiscent of the origin of the claim test. Some of the seminal cases in this area, such as *United States v. Gilmore*, involve precisely such line-drawing. In *Gilmore* the Supreme Court determined that legal fees paid in a divorce were nondeductible personal expenses, even though the expenses related to fighting over a business. That setting did not make the fees business expenses, or even expenses to preserve or protect income. The origin of the dispute was purely personal.

Although it is understandable that authorities such as *Kelly* would seek to make sense of what may be perceived as tax advantages arising from abhorrent conduct, there should probably be a more systematic and reasoned approach than is currently used.

Illegal Payments

In *Commissioner v. Sullivan*, the Supreme Court allowed the taxpayer to deduct rent and wages paid by an illegal gambling operation, even though the rent and wage payments were illegal under state law. Similarly, in *Lilly v. Commissioner*, the Supreme Court upheld deductions claimed by opticians for amounts funneled to doctors who prescribed eyeglasses, even though the Court rebuked the ethics of the opticians and the affront their conduct represented to public policy. The Supreme Court has only rarely disallowed a deduction for public policy reasons. In fact, the Court has done so only when the payment was necessary, it was not ordinary. “Ordinary” was something “normal” or “habitual.”

The Sixth Circuit reversed, allowing the deduction. Bertolini could not have remained as the subcontractor if it had not made the payments, and this “but for” causation made the kickback just a cost of doing business. Interestingly, the court also restated the axiom that the IRS cannot disallow Bertolini’s deduction on public policy grounds.

Less than a year later, another subcontractor at the same construction site was also in front of the Sixth Circuit, attempting to reverse the Tax Court’s denial of his deduction for kickbacks to Festa, the same general contractor. The facts in *Car-Ron Asphalt Paving Co., Inc. v. Commissioner* are virtually identical to those in *Bertolini*. Yet, there was one difference sufficient for the Sixth Circuit to distinguish *Bertolini* and uphold the denial of a deduction for kickbacks in *Car-Ron*.

Although the kickback payments made by Car-Ron were legal under Ohio law, the court said they were “not devoid of criminal conduct.” The court then described Festa’s criminal prosecution for failure to report the kickbacks as income. In *Bertolini*, the IRS argued that the kickbacks were not ordinary. In *Car-Ron*, the IRS claimed the kickbacks were neither ordinary nor necessary. Referring back to *Tellier*, the Sixth Circuit notes that the “necessary” element of a deduction imposes only “a minimal requirement that the expense be appropriate and helpful for the development of the taxpayer’s business.”

Enigmatically, the court stated that the kickbacks were not helpful to the business, but were just a cost of the.
business. Even so, the court did not address the fact that Car-Ron’s continued mall construction business was actually conditioned on making the kickbacks. The payments were essential to Car-Ron retaining its contract at the mall construction site, yet deductions were denied.

Although the court acknowledged that the kickbacks were legal business payments under state law, it noted that courts “should never construe general language in tax statutes in a manner which rewards graft and corruption.” Thus, the court sought to interpret section 162 in a manner Congress made obsolete in 1969. Even more puzzling, the court distinguished a contemporaneous decision from its own circuit involving some of the same players and arising on virtually identical facts.

Policy considerations also seem present in Blackman v. Commissioner.67 Here, the taxpayer’s employer transferred him to a new city. On a visit home, he quarreled with his wife, gathered up some of her clothes, and set them on fire, burning down the house. Blackman was charged with arson and served two years’ probation. He deducted over $97,000 as a casualty loss under section 165(c)(3) on his 1980 return.

That section allows losses from property arising from fire, storm, shipwreck, or other casualty. The IRS argued that since Blackman intentionally set the fire, allowing a deduction would frustrate public policy. The Tax Court agreed, noting that allowing a deduction would severely and immediately frustrate an articulated public policy against arson.

Despite quite different facts, the court in Raymond Mazzei v. Commissioner,68 reached a similar result. There, Mazzei conspired to produce counterfeit U.S. currency. His coconspirators had no intention of scamming others with counterfeit currency, but they did intend to defraud Mazzei. When Mazzei provided them with thousands of dollars to duplicate, they fraudulently disappeared with his money. Mazzei claimed he incurred a theft loss under either section 165(c)(2) or 165(c)(3).

Not surprisingly, the IRS argued that allowing Mazzei a deduction would be contrary to public policy. In a similar case, Luther M. Richey Jr. v. Commissioner,69 a taxpayer was not allowed a deduction for a counterfeiting scheme based on public policy. Mazzei attempted to distinguish Richey, arguing that in Richey the taxpayers were actually counterfeiting currency, not simply being duped. Mazzei had done nothing more than attempt to undertake a counterfeiting scheme, and he was the victim (and not the perpetrator) of a crime.

The court was not sympathetic and considered Mazzei’s acts to be criminal and to clearly violate public policy. The court noted that Tellier70 set the standard for the disallowance of a deduction based on grounds of public policy. It then wrote that Tellier controls only for purposes of section 162, and does not apply to Mazzei’s case under section 165.

Conclusion

Restitution payments, compensatory fines, and remedial penalties all seem to be fair game for tax deductions, though the facts and the law are all important. It is awfully hard to summarize this area. It is no wonder that taxpayers negotiating with plaintiffs or regulatory bodies seek tax deductions for their payments. Notwithstanding Grassley’s concerns, that will probably continue.

In fact, because of the difficulty in harmonizing the case law, many taxpayers can perhaps be forgiven for believing that virtually all of their payments should be in the deductible category. This is a fact-intensive area. One has to consider the facts about particular conduct, and related criminal or other civil proceedings, real or perceived quid pro quos, the purpose and scope of a particular fine or penalty, the statutory or regulatory scheme under which the fine or penalty is awarded, and the particular nature and intent of any restitution. That multiplicity of factors makes this a tough area.

Yet engaging in bargaining over tax-driven language in settlement agreements may be somewhat one-sided. Interestingly, a Government Accountability Office study found that four large federal agencies (including the Justice Department) do not negotiate with companies over whether settlement payments are tax deductible. Instead, the GAO says, the agencies leave the IRS to handle that. Indeed, the Justice Department has said that as a matter of policy, its agreements are “tax neutral,” leaving the difficult issues of deductibility to the expertise of IRS tax lawyers.71

Without legislative action, which seems unlikely, a major shift in the focus of settlement discussions and the tax treatment of payments is probably not in the offing. Taxpayers can and should consider tax issues when they are resolving matters. Absent cross-pollenization from differing governmental entities (including the IRS), it is probably unreasonable to expect that the government as a whole will be as sensitive to these tax issues.

Moreover, the endemically amorphous restriction on the deductibility of fines and penalties — with “compensatory fines” and “nonpunitive penalties” being deductible — inevitably leads to line-drawing that probably must be done on a case-by-case basis. There is probably a better system for this. But until we have one, we’ve got to apply what we have.

6788 T.C. 677 (1987), aff’d without opinion 867 F.2d 605 (1st Cir. 1988).