



OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

LARGE & MIDSIZE BUSINESS

FROM: Associate Chief Counsel (INCOME TAX AND
ACCOUNTING)

SUBJECT: Characterizations or allocations of payments made in
settlement of litigation

This Chief Counsel Advice responds to your memorandum of January 30, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

X
Plaintiff A
Plaintiff B
Plaintiff C
year 1
year 2
year 3
year 4
year 5
Agreement
a
b
date 1
date 2

TL-N-4349-00

date 3

ISSUE

Whether the characterization or allocation of certain payments made by the taxpayer pursuant to the settlement of a lawsuit is fixed by the terms of the settlement agreement entered into by the parties to the litigation.

CONCLUSION

Where the terms of a written agreement in settlement of litigation were not arrived at in bona fide, arm's-length, adversarial negotiations, are inconsistent with the true substance of the plaintiff's claim or are entirely tax motivated, the Commissioner is not bound to respect the characterization or allocation of payments in the settlement.

FACTS

Beginning in year 1, Plaintiffs A, B and C filed suit against the Taxpayer. Although each suit was unique in the sense that it included counts specific to the state law of the jurisdiction in which filed, there was a general pattern to the suits. Each contained allegations that increased costs incurred by the plaintiffs

the suits also included one or more theories of recovery based on fraud or misrepresentation, in reliance on either common law concepts or state statutory schemes. The plaintiffs sought equitable relief and damages under state laws, including antitrust laws. Finally, the suits included theories of recovery based on state statutes.

In year 2,

By year 3,

which led to a proposed settlement.

The proposed settlement provided for payments and other non-monetary relief.

the

TL-N-4349-00

settlement package was rejected.

Meanwhile, in year 4,

the plaintiffs again undertook negotiations with the Taxpayer, and in year 4, reached settlement (the Agreement)

Section of the Agreement states that the parties wish to avoid continued litigation that the settlement is in release of all claims by . Section specifically denies liability . Section reiterates that the Taxpayer has entered into the Agreement solely to avoid litigation.

Section of the Agreement sets forth the terms and schedule of payments to be made by the Taxpayer pursuant to the settlement.

the Agreement contains detailed provisions regarding

Section of the Agreement provides as follows:

TL-N-4349-00

Payments to plaintiffs were made in year 3

for in year 3, the Taxpayer claimed section 162 business expense deductions amounts paid

LAW AND ANALYSIS

I.R.C. § 162 provides for a deduction for ordinary and necessary business expenses paid or incurred in carrying on a trade or business. Amounts expended by a taxpayer engaged in a trade or business to avoid or settle litigation may be deductible as ordinary business expenses. Welch v. Helvering, 290 U.S. 111, 114 (1933); Kornhauser v. United States, 276 U.S. 145 (1928); Old Town Corporation v. Commissioner, 37 T.C. 845 (1962); Ditmars v. Commissioner, 302 F.2d 481, 485 (2d Cir. 1962).

Whether a taxpayer may deduct under section 162 payments made in settlement of a claim depends on the "origin of the claim." The characterization of costs depends upon the nature of the activities giving rise to the claim and does not depend on the consequence or result. Woodward v. Commissioner, 397 U.S. 572 (1970); United States v. Gilmore, 372 U.S. 39 (1963); Anchor Coupling Co. v. United States, 427 F.2d 429 (7th Cir. 1970). Thus, the origin and character of the claim giving rise to the payment being deducted is controlling. To the extent that the litigation originates from a claim which is personal in nature rather than business, the amounts expended are nondeductible. Gilmore, supra. Likewise, a taxpayer settling a claim pertaining to the sale or acquisition of property will be required to capitalize rather than deduct the settlement payments. Kimbell v. United States, 490 F.2d 203 (5th Cir. 1974), cert. denied, 419 U.S. 833 (1974); Arthur H. DuGrenier, Inc. v. Commissioner, 58 T.C. 931 (1992). Section 162(f) disallows deductions for fines or penalties paid to a government for the violation of any law.

In the event that the litigation or settlement involves more than one claim, it is necessary to determine not only the nature and character of each claim but also the amount allocable to each. Hence, in situations where lump-sum payments are made in settlements of multiple claims and differing tax consequences will result

TL-N-4349-00

based on the allocation, an allocation by the Commissioner is necessary and proper. Srivastava v. Commissioner, 220 F.3d 353 (5th Cir. 2000); Rev. Rul. 75-230, 1975-1 C.B. 93; Rev. Rul 58-418, 1958-2 C.B. 18.

You have asked whether the Commissioner is required to treat amounts paid in settlement of a lawsuit in accordance with the characterizations and allocations of the Agreement . It is Service position that the Commissioner is not necessarily bound by the characterization of payments or the allocation of damages or settlement payments pursuant to either a state court judgment or a settlement agreement between the parties. The courts have agreed with the general proposition that the Commissioner will not always be bound by characterizations of tax attributes or allocations made by either the parties in litigation or a lower court. Commissioner v. Estate of Bosch, 387 U.S. 456 (1967); Bagley v. Commissioner, 105 T. C. 396 (1995), aff'd, 121 F.3d 393 (8th Cir. 1997); Robinson v. Commissioner, 102 T.C. 116 (1994), aff'd, 70 F.3d 34 (5th Cir. 1995), cert. denied, 519 U.S. 824 (1996).

As a general rule, the courts have tended to uphold the characterization or allocations in a settlement agreement where the record indicates there was a negotiated and bona fide settlement, arrived at in an adversarial proceeding at arm's length and in good faith. McKay v. Commissioner, 102 T.C. 396 (1995), vacated on other grounds, 84 F.3d 433 (5th Cir. 1996); Threlkeld v. Commissioner, 87 T.C. 1294, 1306-1307 (1986), aff'd, 848 F.2d 81 (6th Cir. 1988); Fono v. Commissioner, 79 T.C. 680, 694 (1982), aff'd without published opinion, 749 F.2d 37 (9th Cir. 1984); see also Mitchell v. Commissioner, T.C. Memo. 1990-617. If a taxpayer's claims were settled and express allocations were made in the settlement agreement, the court will carefully consider such allocations. See Byrne v. Commissioner, 90 T.C. 1000, 1007 (1988) (quoting Metzger v. Commissioner, 88 T.C. 834, 837 (1987), aff'd without published opinion, 845 F.2d 1013 (3d Cir. 1988)), revd. and remanded, 883 F.2d 211 (3d Cir. 1989); Bent v. Commissioner, 87 T.C. 236, 244 (1986), aff'd, 835 F.2d 67 (3d Cir. 1987); Glynn v. Commissioner, 76 T.C. 116, 120 (1981), aff'd without published opinion, 676 F.2d 682 (1st Cir. 1982).

Hence, in McKay where the parties to the litigation were "hostile adversaries," for each of the parties both economic and other interests were affected by how the payments were characterized and the taxpayer was not given freedom to structure the settlement on his own, the Tax Court accepted the express allocations in the agreement. In doing so, the court pointed out that while the express language in a settlement agreement is the most important factor for deciding the purpose of the payment for purposes of section 104(a)(2):

TL-N-4349-00

[w]e are not bound, however, by any factor or factors that are inconsistent with the true substance of the taxpayer's claim, nor are we bound by express allocations in a written settlement agreement if the parties did not engage in bona fide, arm's-length, adversarial negotiations.

102 T.C. at 482.

In contrast, in Robinson the taxpayer and the defendant bank reached a settlement with respect to a jury verdict awarding damages, lost profit and punitive damages. The state trial court entered a final judgment allocating 95 percent of the settlement proceeds to tortlike personal injuries. The Commissioner made a determination that the settlement allocation should be disregarded. The primary issue before the Tax Court was what portion of the settlement proceeds were excludable from gross income pursuant to section 104(a)(2). The Tax Court found that while the parties were adversarial with respect to the dollar amount, they were not adversarial on the issue of the allocation. Additionally, the Tax Court found that the taxpayer's preparation of the final agreement was uncontested and not the product of bona fide adversarial negotiations. Moreover, the court noted that where the State of Texas had no personal income tax, no State interest would be adversely affected by the allocation. Under those circumstances, the Tax Court pointed out that the state court might be inclined to approve the settlement with little deliberation. See also Mitchell v. Commissioner, T.C. Memo. 1990-617, (express allocation in settlement agreement rejected) aff'd, 992 F.2d 1219 (9th Cir.), cert. denied, 510 U.S. 861 (1993); Kightlinger v. Commissioner, T.C. Memo. 1998-357 (rejecting federal district court's characterization of proceeds received in settlement of case under its jurisdiction).

You take the position that the language in section _____ of the Agreement is a factor in determining the deductibility of the payments but it is not determinative. Rather, in your view, an inquiry must be made into the facts and circumstances of the _____, and then a reallocation of the settlement amounts can be made among the various claims resolved by the settlement. In our analysis of the approach which has developed in the Tax Court, you should first look to the terms of the Agreement _____ and determine whether express allocations, if any, were negotiated by the parties in a bona fide, arm's length and adversarial manner. In the absence of bona fide and adversarial negotiations, or if settlement terms are inconsistent with the claims made by the plaintiff or entirely tax motivated, the settlement allocation may be disregarded. When assessing the tax implications of a settlement agreement, courts should neither engage in speculation nor blind themselves to a settlement's realities. Bagley v. Commissioner, 121 F.3d 393, 395 (8th Cir. 1997).

TL-N-4349-00

The facts provided to this office do not allow us to determine whether these are cases in which the Commissioner should look beyond the written terms of the settlement agreement to determine the proper character and allocation of payments. Prior to recharacterizing or reallocating the payments made pursuant to the Agreement, _____, you should first look _____ to determine if 1) it was a bona fide and adversarial settlement as to the allocation of payment between the claims, 2) its terms are consistent with the true substance of the plaintiff's claims, or 3) the allocation was not entirely tax motivated. If you conclude that any of these criteria are not satisfied, then it is appropriate to look to all facts and circumstances surrounding the settlement, including "the details surrounding the litigation in the underlying proceeding, the allegations contained in the payee's complaint and amended complaint in the underlying proceeding, and the arguments made in the underlying proceeding by each party there" in order to determine "in lieu of what were damages paid. Robinson v. Commissioner, 102 T.C. 116 (1994), rev'd in part on other grounds, 70 F.3d 34 (5th Cir. 1995), cert. denied, 519 U.S. 824 (1996).

Although we cannot at this time take a position or draw a conclusion with respect to whether the Commissioner should be required to respect the terms _____, we do make the following observations from the facts provided: While it appears that there were lengthy negotiations as to the terms of settlement in general, it is not clear that these negotiations extended to any purported allocations to the claims. In fact, the parties made no allocation among the various claims asserted other than to provide that no _____ payment _____ is made in settlement of _____ liability for _____.

_____. The Agreement contains detailed allocations between the parties as to amounts both paid by the Taxpayer and received by the plaintiffs. Yet, the purported allocation among the multitude of claims is cursory or superficial.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

You seek to make a reallocation of the settlement payments without first considering the authenticity of the settlement terms as agreed upon by the parties. While there appears to be evidence which may ultimately support a determination to allocate or reallocate the payments, we think that the better approach is to first carefully examine the settlement provisions as a whole before disregarding its terms. We recommend that in doing so, you consider the settlement as a whole and that you not look solely to the language of Section _____. It appears to this office that the allocation must also be read in light of Sections _____ and _____ of the Agreement which state that the agreement is in settlement of all claims.

[REDACTED]

[REDACTED]

[REDACTED] As the Fifth Circuit has pointed out, the appropriate test to be applied depends in part on the particular tax statute involved as well as the nature of the state proceeding. The courts have frequently held that in the section 104 area, the intent of the payor is a key determinant whether a settlement recovery is excludable from gross income. See Knuckles v. Commissioner, 349 F.2d 610, 613 (10th Cir. 1965); Agar v. Commissioner, 290 F.2d 283, 284 (2d Cir. 1961); Ray v. United States, 25 Cl. Ct. 535, 540 (1992), aff'd, 989 F.2d 1204 (Fed. Cir. 1993); Stocks v. Commissioner, 98 T.C. 1, 10 (1992). Yet, we are not convinced that the intent of the payor should be as significant a factor on the deduction side. After all, in the section 104 area, the payor is not the taxpayer and will, in general, have an interest which is adverse to that of the taxpayer. Conversely, on the deduction side, the payor is the taxpayer whose motives in making the payments will be self-serving.

Please call if you have any further questions.

HEATHER MALOY

By: _____
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