



Wednesday, October 22
9:00 am-10:30 am

802 The Tax Implications of Fines, Penalties and Punitive Damages

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Faculty Biographies

Jason A. Reschly

Jason A. Reschly is a partner with Hush Blackwell Sanders LLP in Kansas City, Missouri. His role deals extensively in the area of cooperative taxation, cooperative joint ventures, and financing transactions for cooperatives and he dealt with the representation of a major bank in the tax-free acquisition of several banks in separate transactions.

Mr. Reschly has practiced in the tax law area for more than 20 years, handling corporate tax planning relating to reorganizations, purchases, divestitures, sales of business assets, and tax considerations with respect to financings. Previously, Mr. Reschly worked at Stinson Mag & Fizzell in Kansas City, Missouri and is a licensed certified public accountant.

He was named a 2007 *Missouri & Kansas* "Super Lawyer®," named *The Best Lawyers in America*®, and rated "Leading Individual" in *Corporate/M&A* (Missouri) by Chambers USA, 2008 The Client's Guide.

Christopher S. Swiecicki

Christopher S. Swiecicki is associate tax counsel for Ameren Corporation. His responsibilities include providing tax counsel to the corporation in the areas of federal and state income taxes, compliance issues, and is responsible for representing the company in tax controversy matters before federal, state, local tax authorities.

Prior to joining Ameren Corporation he was senior vice president of Regions Bank responsible for taxation in the areas of income, qualified and non-qualified employee benefit plans, executive compensation, fiduciary, and employment tax matters. He was previously in private law practice and with the accounting firm of Deloitte & Touche.

Mr. Swiecicki received his JD and LLM from Washington University School of Law in St. Louis, Missouri and is a graduate of Southern Illinois University.

Johann F. Thaheld

Johann F. Thaheld is the general counsel for Mobilisa, Inc. in Port Townsend, Washington. His responsibilities include intellectual property, mergers and acquisitions, corporate governance and compliance, Internet disputes, export controls, international agreements, data security and privacy, disaster response and recovery, data agreements, and government contracting.

Prior to joining Mobilisa, Mr. Thaheld served as president and general counsel for Dental Management Services Group, Inc. and in private practice. Before earning his law degree he worked in Washington, DC with Price Waterhouse as a CPA and senior computer

systems analyst. His systems development work included PBGC, Bureau of Engraving and Printing, Department of Navy, USAID mission to Sudan, Mobil, MCI, US Treasury, and US Customs.

He is a member of the board of directors of the Washington chapter of ACC and the Washington Wing of the Civil Air Patrol.

Mr. Thaheld received a dual BS from Oregon State University and is a graduate of Willamette College of Law.

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Agenda

- Economics of a Tax Deduction
 - Code Review
- Public Policy Exception Doctrine
- Section 162(f)
- Case Law
- Current Events

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- ***Economics of a Settlement (With a Tax Deduction)***
 - \$10,000,000 Settlement/Payment
 - 35% Tax Rate
 - \$3,500,000 Tax Deduction
 - \$6,500,000 Net Cash Outflow

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802 – Tax Implications

- ***Economics of a Settlement (Without a Tax Deduction)***
 - \$10,000,000 Settlement/Payment
 - 35% Tax Rate
 - \$0 Tax Deduction
 - \$10,000,000 Net Cash Outflow

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Scope of §162
(Ordinary and Necessary Expenses)

- Allows a deduction for the ordinary and necessary expenses paid or incurred during the tax year in carrying on a trade or business. The deduction is used by corporations in computing taxable income.

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- IRC §162
 - Allows a deduction for all the ordinary and necessary expenses paid or incurred in carrying on a business.
 - Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business.
 - Such expenses as travel, cost of materials, repairs, compensation for personal services, rentals, professional expenses, advertising, etc.

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What is ordinary?

- “Ordinary” is to be applied with reference to the relation of the expense to the particular business.
- What is deemed ordinary, is affected by time and place and circumstance.
- “Ordinary” in this context does not mean that the payments must be regular in the sense that the same taxpayer will have to make them often.

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What is an Expense for §162 Purposes?

- An expense must have been paid or incurred in the tax year,
- in carrying on a trade, business,
- it must be ordinary and necessary; and
- it must be reasonable in amount.

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What is necessary?

- The word “necessary” does not mean “indispensable.” It refers to an expense that is appropriate and helpful in carrying on the trade or business.

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Scope of §162
(Ordinary and Necessary Expenses)

- Thus, taxpayers who repay embezzled funds are ordinarily entitled to a deduction in the year in which the funds are repaid. *Stephens v. Comm.* 905 F. 2d 667 (2nd Cir. 1990).

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- Section 167
- There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence).

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- A taxpayer cannot current deduct an outlay for a capital asset.
- Section 263
 - A capital expenditure is an outlay of capital that results in the acquisition of property or permanently improves its value. Capital expenditures are not deductible as expenses.
 - The asset generally has a useful life of at least 1 year.
 - The prohibition against the current deduction of a capital expenditure does not mean that the investment may never be recovered or offset against income. If the property acquired is a depreciable asset; the amount expended is recoverable through annual depreciation deductions.

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- If a deduction is allowable under Section 162, an immediate tax benefit accrues because the taxpayer is permitted to reduce its taxable income in the current tax year. In contrast, if an item is capitalized, no immediate deduction is taken. Rather, the tax benefit is deferred until a later year either by way of depreciation deductions or upon sale of the asset.
- Thus, a taxpayer does not forever forfeit any tax benefit simply because Section 263 requires that an item be capitalized, rather the benefits are forestalled only until the property is used in a trade or business or otherwise disposed of.



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- The test which normally is to be applied is that if the improvement were to “put” the particular capital asset in efficient operating condition, then they are capital in nature. If however, they were made merely to “keep” the asset in efficient operating condition, then they are repairs and are deductible. *Dominion Resources Inc. v. U.S.*, 83 AFTR 2d 99-1350.



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- Tank Truck Rentals, Inc. v. Comr. 356 U.S. 30 (1958)
 - “The test of non-deductibility always is the severity and immediacy of the frustration [of public policy] resulting from allowance of the deduction.”



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- Frustration of Public Policy
 - Commissioner v. Heininger, 360 U.S. 467 (1943)
 - If allowance of a deduction would frustrate a sharply defined state or national public policy, the deduction will be disallowed.



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- For a contra position
 - See Hossbach v. Comr., TC Memo 1981-291 the tax court allowed a casualty loss as a result of manufacturing speed.

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- Enactment of IRC §162(f)
 - Represents a codification of the general court position. S. Rep. No. 552, 91st Cong., 1st Sess. (1969)
 - Section 162(f), enacted in 1969, was intended to codify the public policy grounds previously used by courts to deny deductions for fines or penalties if allowing the deduction would frustrate a sharply defined national or state policy. Joint Committee on Internal Revenue Taxation, "General Explanation of the Tax Reform Act of 1969," at 234, JCS-16-70 (December 3, 1970).

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- 162(f) – No deduction shall be allowed under 162(a) for any fine or similar penalty paid to a government for the violation of any law.

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- Tax Reform Act of 1969 - §162(f) is to apply in any case in which the taxpayer is required to pay a fine due to a conviction of a crime (felony or misdemeanor) in a full criminal proceeding in an appropriate court.
- Revenue Act of 1971 – More clearly explain the that the definition of "fines and penalties" applied to penalties which are imposed under civil statutes but which in general terms serve the same purpose as fine exacted under a criminal statute.

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- Treas. Reg. §1.162-21 – Provides further explanation of the scope of 162(f).

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- Fine or Similar Penalty
- Includes any one of the below conditions:
 - Paid pursuant to a conviction, a plea of guilty, or a plea of nolo contendere (whether civil or criminal).
 - Civil penalty imposed by federal, state or local law.
 - Paid in settlement of the taxpayer's actual or potential liability for a civil or criminal penalty

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- Definition of a “fine or similar penalty.” 1.162-21(b)
 - Paid pursuant to conviction or a plea of guilty or nolo contendere for a crime (felony or misdemeanor) in a criminal proceeding; or
 - Paid as a civil penalty imposed by Federal, State, or local law, including additions to tax;
 - Paid in settlement of the taxpayer's actual or potential liability for a fine or penalty; or
 - Forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty.

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- Definition of Government 1.162-21(a).
 - The government of the United States, a State, a territory or possession of the United States, the District of Columbia, or the Commonwealth of Puerto Rico;
 - The government of a foreign country, or
 - A political subdivision of, or corporation or other entity serving as an agency or instrumentality of, any of the above.

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- Pursuant to 1.162-21(b)(2) a fine or similar penalty does ***not*** include
 - Legal fees and related expenses incurred in defense of prosecution or civil action arising from a violation of the law imposing the fine or penalty.
 - Nor compensatory damages paid to a government.

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- Punitive v. Compensatory
 - Factors
 - Legislative Intent
 - Nature of Payment
 - Facts and Circumstances
 - Intent/Method of calculating payment
 - Label Not Determinative

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- Restitution (Split of Authorities)
 - Restitution paid to a victim is a fine or similar penalty because it is compensatory
 - Waldman v. Comr., 88 T.C. 1384 (9th Cir. 1988)
 - Restitution paid to a victim is not a fine or similar penalty because it is compensatory
 - Stephens v. Comr., 905 F.2d 667 (2nd Cir. 1990)

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- FSA 200210011
 - IRS Chief Counsel's Office advised that 162(f) did not apply to a corporation that pled guilty to Sherman Antitrust Act.
 - Corporation paid actual damages to the to government

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- Rev. Rul. 88-46
 - IRS ruled that a nonconformance penalty assessed by EPA involving a truck manufacturer was to eliminate a competitive advantage not to punish.



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- Southern Pacific Transportation v. Comr., 75 T.C. 497 (1980) interpreted the “similar penalty” provision of 162(f).
 - If a civil penalty is imposed for purposes of enforcing the law and as punishment for the violation thereof, its purpose is the same as a fine exacted under a criminal statute and it is “similar” to a fine. However, if the civil penalty is imposed to encourage prompt compliance with a requirement of the law, or as a remedial measure to compensate another party for expenses incurred as a result of the violation, it does not serve the same purpose as a criminal fine and is not “similar” to a fine within the meaning of 162(f).



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- TRUE, JR. v. U.S., 65 AFTR 2d 90-547
 - Penalty served primarily a deterrent and retributive function rather than compensatory or remedial function even though penalty employed strict liability standard and proceeds were used to pay for oil spill cleanup. Amount of penalty depended on degree of fault of violator, not amount of damage done, and other provisions existed for recouping cleanup costs.



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- Allied Signal, Inc. v. Comr., T.C. Memo 1992-204 held that a payment in an endowment fund create by the taxpayer to receive a lesser sentence was a fine or similar penalty because the payment was not voluntary.



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- S. Clark Jenkins, et ux. v. Commissioner, TC Memo 1996-539
 - The method of calculation of the settlement payments were determinative.



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- Antidumping Act of 1921, 19 USC 160-173 (1982),
 - Such payments are deductible.
 - The intrinsic nature of the special dumping duty assessed under the 1921 Act is remedial, in that its purpose is to equalize competitive conditions between foreign exporters and U.S. industries by neutralizing the effects of dumping.



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- Environmental Remediation Costs
 - Restoration Principle
 - does not apply to situations in which the property is acquired by the taxpayer in a contaminated state. This rule applies even where the taxpayer was unaware of the contamination at the time of the acquisition, and the remediation "restores" the property to the value taxpayer believed it had at the time of acquisition. In such a case, taxpayer overpaid for the property. **United Dairy Farmers Inc v. U.S.**, (2000, DC OH) 85 AFTR 2d 2000-2235.



802 – Tax Implications

- Environmental Remediation Costs
 - Restoration Principle
 - If the taxpayer acquires property in clean condition, and contaminates the property in the course of its everyday business operations, restoring the property to its approximate condition at the time of acquisition does not result in a permanent improvement that increases the property's value. Thus, the restoration costs are deductible.