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Memorandum

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to: Monica Garcia
Revenue Agent
([Office Name])

from: R. Scott Shieldes
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subject: Payment to Foreign Government

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

Can ("Taxpayer") deduct a $ payment ("Settlement Amount") to the ("Foreign Country") under I.R.C. § 162(a)?

CONCLUSION

No. The Settlement Amount payment is not deductible under I.R.C. § 162(a) because of the exception contained in I.R.C. § 162(f) and the regulations thereunder. No deduction is allowed under I.R.C. § 162(a) for any fine or similar penalty paid to the government of a foreign country. Treas. Reg. § 1.162-21(a)(2). A "fine or similar penalty" includes an amount paid in settlement of the taxpayer's actual or potential liability for a civil or criminal fine or penalty. Treas. Reg. § 1.162-21(b)(1)(iii).

FACTS

Taxpayer's former subsidiary, ("Subsidiary"), participated in a ("Entity") that in the Foreign Country. Entity was the subject of numerous investigations in various jurisdictions, including

Foreign Country. An official of the Foreign Country's government claimed that improper payments were made to other government officials of the Foreign Country in connection with the contracts awarded to Entity for specific projects in Foreign Country.

, the Foreign Country filed a indictment charging Entity, participants in Entity including Subsidiary, and various Foreign Country government officials with conspiracy to commit a felony in violation of laws of the Foreign Country. Specifically, the indictment charged that Subsidiary and Entity paid various Foreign Government officials in exchange for favorable contracts.

On , Taxpayer's General Counsel wrote a letter to the Foreign Country's Attorney General asking to meet to "achieve a satisfactory resolution of our differences." Taxpayer cited its continued activity in Foreign Country and the fact that it employed people in its operations there. On , the Attorney General responded to Taxpayer's General Counsel, stating that he was aware that Entity had been subject to corruption proceedings in other jurisdictions and that "the position and demand of the [Foreign Country] is that the same measure and amount of monies paid in other jurisdictions to settle the [Entity] matter be paid to the [Foreign Country]." The letter specifically stated that, going forward, Entity should "be subject to strict corporate governance transparency programmes."

On , the Foreign Country filed another indictment charging Taxpayer, Subsidiary, and high level executives of Taxpayer and Subsidiary with violations of the laws of Foreign Country. Specifically, the indictment charged that Taxpayer, Subsidiary, and the executives paid various Foreign Country government officials in exchange for a contract.

A trial was not held on the charges. Instead, on , Taxpayer and the government of the Foreign Country entered into a Settlement and Non-Prosecution Agreement ("the Agreement") resolving all matters relating to the criminal charges contained in the indictments. Per the Agreement, Taxpayer agreed to pay the government of the Foreign Country $, which amount included $ of Foreign Country's legal expenses. In exchange, the Foreign Country agreed to (1) terminate all criminal and civil proceedings and investigations involving the accused persons; (2) not file or seek additional charges against Taxpayer, Subsidiary, and the high level executives; (3) not bring any additional charges that would exclude, restrict, limit, disadvantage, or otherwise prevent the accused from actively executing their existing projects; and (4) waive all "potential civil and other claims arising under the laws of any jurisdiction arising from or relating to the [Entity], the on [Foreign Country], or any of the facts or allegations asserted in the Criminal Charges." The Agreement specifically states that Taxpayer was to make the payment "in consideration of the withdrawal of the Criminal Charges and the other promises" and that the parties put their disagreement with respect to the charges aside "to avoid the burden, inconvenience and expense of further protracted and costly litigation." Sections 5 & 7 of the Agreement.

LAW AND ANALYSIS

Taxpayers may deduct all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. I.R.C. § 162(a). I.R.C. § 162(f), however, prohibits a deduction under I.R.C. § 162(a) for any fine or similar penalty paid to a government for the violation of any law. Treas. Reg. § 1.162-21(a)(2) states that no deduction shall be allowed under I.R.C. § 162(a) for any fine or similar penalty paid to the government of a foreign country. A fine or similar penalty includes an amount paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal). Treas. Reg. § 1.162-21(b)(1)(iii). The amount of a fine or penalty 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. Treas. Reg. § 1.162-21(b)(2).

The Agreement is a settlement for purposes of the regulation. It is an agreement between Taxpayer and the government of a foreign country that resolves all issues associated with Taxpayer's purported criminal conduct in exchange for the payment of the Settlement Amount. The Settlement Amount payment is therefore a fine or similar penalty paid to a government for violation of law, and Taxpayer's deduction for that payment is prohibited by I.R.C. § 162(f).

Taxpayer asserts two claims to support its claimed deduction: (1) there is no evidence that it had any actual or potential liability because it was not a partner in the Entity, and (2) the primary motive for the payment was to preserve Taxpayer's business reputation, to protect Taxpayer's employees, and to ensure continued business operations in Foreign Country.

Taxpayer's first argument goes to the merits of the criminal complaint. This argument ignores, however, that Taxpayer was a named party in the criminal indictment and that Taxpayer voluntarily entered into the Agreement to resolve the charges asserted against it in that indictment. These two facts establish that there was potential criminal liability for Taxpayer. See McGraw-Edison Co. v. United States, 300 F.2d 453, 456 (Ct. Cl. 1962) ("We have no way of knowing whether and to what extent plaintiff in fact violated the Act, and trial of that issue would obviously defeat the very purpose of the compromise."). In addition, there is nothing to indicate that the payment was compensatory rather than punitive. The Agreement clearly states that the payment is in exchange for the dismissal of the criminal charges and resolves all matters relating to the charges.

Taxpayer cites Mathiasen v. Commissioner, T.C. Memo. 1961-325 (citing American Envelope Co. v. Commissioner, 29 T.C. 307, 312 (1957) and cases therein), which states: "When payments are made in settlement of a lawsuit the test of their deductibility, either as an ordinary and necessary business expense or nonbusiness expense, is the character of the transaction which gave rise to the payment." We need not determine whether Taxpayer's payment was an ordinary and necessary business expense because I.R.C. § 162(f) specifically excludes ordinary and necessary business expenses that would otherwise be deductible if the payment is a fine or similar penalty made to a government. The "origin of the claim" doctrine is, however, used to determine whether the payment is a fine or similar penalty.

In this case, the transaction giving rise to the payment is the settlement of the Taxpayer's actual or potential liability for a fine or similar penalty. Under the Treasury regulations, Taxpayer's criminal liability need not be determined and Taxpayer's contention that it was not in fact liable does not detract from the fact that Taxpayer was indicted and the payment at issue was to settle the potential criminal liability resulting from the indictment.

In Commissioner v. Longhorn Portland Cement Co., 148 F.2d 276 (5th Cir. 1945), the Fifth Circuit disallowed a business deduction for settlement payments made by a cement company accused of anti-trust violations. The Fifth Circuit looked at the "origin of the claim" doctrine, yet still denied the deductions as attributable to a non-deductible penalty:

> [T]he ultimate determinative inquiry upon this appeal is whether the deduction claimed was paid as a penalty. This is illustrated by cases where, due to a compromise settlement, the question of guilt or innocence was not established, yet the deduction claimed was disallowed to the extent that it represented a payment made to extinguish a cause of action to impose a penalty.

Id. at 277-78.

Similarly, in Adolf Meller Company v. United States, 600 F.2d 1360 (Ct. Cl. 1979), a taxpayer was faced with substantial postal fees and penalties assessed for violations of the Tariff Act of 1930. The taxpayer disputed the claims. After negotiations, the taxpayer agreed to pay the postal fees and a reduced amount "in compromise for" the penalties. The Court of Claims denied a deduction for the compromise amount stating that "it is not the fact of compromise agreement that controls but that allowance of sums paid for violation blunts the sting of the penalty." Id. at 1364 (citing McGraw-Edison Co. v. United States, 300 F.2d 453 at 456 (Ct. Cl. 1962)).

Taxpayer's guilt is not at issue in the determination of whether the payment of the Settlement Amount to the Foreign Country is deductible. The payment was made to avoid any potential liability (regardless of the validity of the charges) and, accordingly, is not deductible under I.R.C. § 162(a).

In support of its business reputation argument, Taxpayer cites Jenkins v. Commissioner, T.C. Memo 1983-667 (1983). Jenkins is distinguishable from this case in several ways. First, Jenkins involved the reimbursement of private investors for their losses in a failed business venture that bore the petitioner's name. This case, by contrast, involves criminal fines or penalties payable to a government. The business losses experienced in Jenkins were deductible under I.R.C. § 162(a). Fines and penalties, such as those paid by Taxpayer to the Foreign Country, are not. Secondly, unlike the petitioner in Jenkins, Taxpayer was named in the criminal indictment. Taxpayer, and many of its high level executives, had actual or potential liability for criminal fines or penalties. Taxpayer did not merely pay the fines of Subsidiary to protect its business reputation—Taxpayer and its high level executives were potentially liable themselves. In contrast, the petitioner in Jenkins had no actual or potential obligation to the investors, but instead sought to protect his business name "Conway Twitty" by paying investors in his Conway Twitty Restaurants. Taxpayer misplaces reliance on Lutz v. Commissioner, 282 F.2d 614 (5th Cir. 1960) for the same reasons that Jenkins is distinguishable.

Taxpayer's claim that the settlement payments were made to protect its income may be true but is, nevertheless, irrelevant. The issue of protecting Taxpayer's reputation or its continued business is incidental to the fact that the settlement resolved criminal charges filed against it and its high level executives for alleged violations of Foreign Country's law. Taxpayer's claims do not change the character of the transaction from a non-deductible fine or penalty to a potentially deductible business expense.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Please call 281-721-7301 if you have any further questions.

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