Office of Chief Counsel
Internal Revenue Service
memorandum

Number: **20084301F**
Release Date: 10/24/2008

CC:LM:HMT:DET:CVDumas
PREF-123891-07
UIL: 162.21-01

date: September 25, 2008

to: (Revenue Agent)
HMT Group , ,

from: Eric R. Skinner
Associate Area Counsel (Detroit)
(Large & Mid-Size Business)

---

subject: Deductibility of Anti-trust settlement payments

Legend

Taxpayer =
$amount1 =
State X =
State Y =
State Z =
Product =
City =
State X Law1 =
State X Law2 =
State X Case1 =
State X Law3 =
State X Law4 =
State Y Law1 =
State Y Case1 =
State Y Law2 =
State Z Law1 =
State Z Law2 =
State Z Law3 =

Issue

Whether an $amount1 payment by Taxpayer to three states in settlement of an anti-trust suit under federal and state law is a non-deductible fine or penalty under I.R.C. §162(f).

Conclusion

The payment is a non-deductible penalty.

Facts

This memo relies on facts provided by the taxpayer and available in the public records. Taxpayer manufactures Product and is based in City, State X. States X, Y, and Z filed suit against Taxpayer in the federal court accusing it of fixing a minimum price for one of its more sought-after products. According to the complaint, Taxpayer engaged in anti-competitive practices in order to discourage price competition among retailers and keep prices higher than they otherwise would be. Taxpayer's alleged policy explicitly forbade retailers from advertising Product below a dictated price. If any retailer violated the price policy, they would lose access to Taxpayer's products for one year. This penalty was allegedly enforced against some retailers; however, Taxpayer often resumed its relationship with the retailers before the end of the one year embargo.

The states alleged that this was an anti-competitive practice, preventing customers from purchasing low-priced Products, and preventing vendors from setting prices that they wanted to set. The states sought an injunction against Taxpayer, as well as civil penalties.

After the anti-trust suit was filed, the parties filed a consent decree and final judgment. In it, Taxpayer agreed to an injunction against dictating the price of its Products to retailers. It also agreed to pay $amount1 to the states, to be used in each state by its attorney general for anti-trust enforcement, a consumer protection fund, or any other function allowable under state law.

Taxpayer had certain additional duties, such as maintenance of certain sale records. The district court retained jurisdiction to enforce the decree, and Taxpayer admitted no true liability, claiming that the consent judgment could not be used in any other proceeding to show its guilt.

Analysis of Relevant Statutes Underlying the Payment

I.R.C. § 162(a) allows a deduction for any ordinary and necessary business expenses paid during the course of a taxable year. However, section 162(f) provides that fines and penalties paid to any government for violation of the law are not a deductible expense. Courts generally differentiate between amounts paid as a fine and money paid as damages, with money paid as damages being deductible as an ordinary business expense. *See, e.g.*, *Schnadig Corp. v. Gaines Manufacturing Co.*, 620 F.2d 1166, 1169 n.7 (6th Cir. 1980); *see also* Treas. Reg. § 1.162-21, examples (1) and (3). Finally, the income tax regulations state that a fine or similar penalty includes any amount paid in settlement of the taxpayer's conduct or potential liability for a fine or penalty, whether civil or criminal. Treas. Reg. § 1.162-21(b)(1).

When a civil settlement payment is at issue, it is first necessary to determine whether the payment constitutes a fine or penalty, or some other type of damages. If the payment does constitute a fine or penalty, then the purpose of the payment must be analyzed to determine whether it is punitive or remedial in nature, because only punitive fines fall within the scope of section 162(f):

> [t]he Congress, by use of the word "similar," [as in "fine or other similar penalty"] was not intending to distinguish between criminal and civil sanctions, but rather was intending to make a distinction between different types of civil penalties. 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 section 162(f).

S. Pac. Transp. Co. v. Commissioner, 75 T.C. 497, 652 (1980).

Thus, under the punitive vs. remedial test, a payment imposed for purposes of enforcing the law or as punishment for its violation is not deductible, while a payment imposed as a remedial measure to compensate the government or another party is deductible, even if it is labeled as a fine or penalty. *See, e.g., Talley Indus., Inc. v. Commissioner*, 116 F.3d 382, 385-86 (9th Cir. 1997). In order to determine the purpose of a payment under the punitive vs. remedial test, courts first look to legislative intent, including the language of the statute or ordinance in question, its legislative history, and other court decisions construing the statute or ordinance. *Mason and Dixon Lines, Inc. v. United States*, 708 F.2d 1043, 1047 (6th Cir. 1983).

15 U.S.C. § 1, a part of the Sherman Anti-trust act, allows a fine of up to $10,000,000 for any corporation found to be restraining trade in violation of federal law. 15 U.S.C. § 15 allows a plaintiff in an anti-trust action to recover not just damages, but also three times the damages sustained, plus interest and attorneys' fees. Under 15 U.S.C. § 15c, the attorney general of a state may bring a civil action in the name of the people of that state injured by an illegal restraint of trade. The state may pursue treble damages, attorneys' fees, and interest, but may not pursue recovery that would duplicate recovery already granted in a prior suit. Under 15 U.S.C. § 15e, the monetary relief that an attorney general recovers from a federal anti-trust suit may either be distributed at the court's discretion, or deemed a civil penalty and distributed at the attorney general's discretion.

State X Law1 outlaws any contract to restrain trade. State X's statute is understood by the courts to bar most price-fixing activities. *See, e.g., State X Case1*. State X Law2 allows the state attorney general to bring suit for violations of the State X anti-trust act. The statute allows for recovery of up to $50,000 for each act of restraint of trade, as well as injunctive relief. State X Law3 allows a penalty of up to $1,000,000 for violating the act. State X Law4 clarifies that the penalties in the act are cumulative.

State Y Law1 outlaws and voids any contract which interferes in the free exercise of business activity by restraining competition. As with State Y and Federal law, the courts understand that State Y anti-trust law bars price-fixing. *See, e.g., State Y Case1*. State Y Law2 allows the state Attorney General to bring an action against corporations that have entered into arrangements that violate the state anti-trust act. The statute allows for a penalty of up to $20,000 beyond damages awarded.

State Z Law1 outlaws contracts that unreasonably restrain trade. The comments from the State Z Bar on this law state that it prohibits vertical price fixing agreements; however, they also state that a court must examine the purposes and consequences of an agreement before concluding that it has the effect of restraining trade. State Z Law2 empowers the state attorney general to bring action against companies and individuals found to be in violation of the act, and to seek damages, attorney fees, and treble damages if the restraint of trade is found to be willful. This statute also allows the State Z Attorney General to sue based on federal anti-trust law.

State Z law has a provision that explicitly bans price fixing (State Z Law3), but this is meant as a ban on non-competition, horizontal price fixing, not vertical price fixing. State Z law also has a provision that allows the state attorney general to seek up to $1,000,000 in fines, but not on a charge of vertical restraint of trade agreements.

Discussion

The question is whether the $amount1 that Taxpayer paid to the three plaintiff states should be considered an ordinary business expense or a non-deductible penalty. The answer to this question turns on whether the payment was meant to cover the actual damages that the plaintiff states allegedly incurred through the defendant's conduct, or if the payment is meant to be a punitive measure to discourage future anti-competitive behavior.

The settlement document does not explicitly allocate the money into one category or the other. However, the Federal statute as well as the State X statute that the suit invoked speak only of fines, not of damages. Additionally, the amount that Taxpayer paid was below the maximum that either act allows for a penalty. Presumably, then, all settlement money that flowed to State X is non-deductible, all of it having been paid as penalty. State Y and State Z law are less clear about whether an anti-trust monetary judgment is a penalty or simple damages. However, the fact that those states also filed their complaint under federal anti-trust statutes, and the amount that Taxpayer paid was well within the penalty limits of that law, means that the payment can reasonably be treated as a penalty.

Furthermore, the plaintiffs' complaint specifically requests civil penalties, at paragraph 51, while it does not specifically request compensatory damages anywhere. It would be inconsistent with the relief requested to assume that the Taxpayer's $amount1 payment constituted deductible damages.

Taxpayer may argue that the payment was compensation for damages in the three states, or that it was an amount paid outside of anti-trust law to settle the suit. It may point to the fact that the settlement does not admit any wrongdoing on the company's part. The admission of wrongdoing is not necessary for IRC 162(f) to apply; all that is necessary is that the payment be most properly characterized as a penalty. Here, Taxpayer paid $amount1 to settle anti-trust allegations, and had Taxpayer been found liable for these allegations, it would have been subject to a fine of up to $10 million.

Conclusion

Taxpayer's $amount1 payment in settlement of the anti-trust claims of States X, Y, and Z was the payment of a penalty, and is thus not a deductible business expense under IRC 162(f).

Please call us at   if you have any questions concerning this matter.

ERIC R. SKINNER
Associate Area Counsel (Detroit)
(Large & Mid-Size Business)

By: /s/ Charles V. Dumas
Charles V. Dumas
Attorney (Detroit)
(Large & Mid-Size Business)