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Tax Deductibility And Statutory Damages — A Waiting Trap

By **Peter Robbins**

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Peter Robbins

Statutory damages, as the name implies, are damages awarded in civil law, in which the amount of compensation is stipulated by law, usually without regard to the actual harm suffered by a plaintiff.[1] Generally, statutory damages are provided when it is impractical to calculate the value of the loss suffered by a plaintiff.

Statutory damages reduce administrative costs and clarify the consequences of violation of the law. While statutory damages offer plaintiffs a procedural advantage, they have become a multiplier of liability for defendants, with settlements often becoming oppressive.[2]

In class actions, small individual claims of multiple persons are aggregated to make one suit. As statutory damages guarantee a minimum recovery in each individual case where a violation may cause only nominal damage, a class action may bring the aggregate amount of these claims to massive levels. Class actions serve as an incentive to sue or uncover wrongdoing that would not exist if moved individually.[3]

Tax Treatment of Class Action Settlements

Generally, tax consequences of damages paid in a lawsuit are the same whether it was settled or litigated to judgment. When class action settlements are finalized or damages are paid after a class action judgment, it is important to comply with the taxation of these payments and the related IRS information reporting requirements which are triggered by these payments. Businesses or persons engaged in trade are generally required to file Form 1099-MISC to report payments above $600 per calendar year to the IRS and to the payee, including reporting of settlement payments and damage awards.[4]

In class action settlements, to determine whether payments to class members are tax deductible, the parties to the settlement must consider the implications of IRC §162(c)(2), which prohibits deductions for illegal payments under United States law (or any law of a state), and IRC § 162(f), which prohibits deductions for any fine or similar penalty paid to a government for the violation of any law.

The Third Circuit Court applied IRC § 162(f) in Allied-Signal Inc. v. Commissioner of Internal Revenue Service,[5] affirming the Tax Court, and holding that a statutory penalty is disallowed and not tax deductible though the government does not receive the penalty.

In this case, the company was not allowed to deduct an $8 million contribution to an environmental fund because that payment reduced the criminal fine, which would have otherwise been assessed for the underlying conduct. The IRS ruled that the payment was punitive in nature and since it was made per the direction of a district judge, it was deemed to have been "paid to a government."

Similarly, in Technical Advice Memorandum 200502041, the IRS held that while the portion of a lump sum payment representing compensatory damages was deductible, the portion intended to pay a fine or penalty was nondeductible. In the TAM, the IRS applied IRC §162(f) holding that the penalty portion of the payment was punitive in nature and consequently nondeductible.

To determine the proper tax treatment of the settlement costs, it is necessary to examine all facts and circumstances of a case. In a class action lawsuit, there is a probability that the settlement could relate to both ordinary business transactions and capital transactions, as well as have a punitive component.

The deductibility of a class action settlement depends upon the origin of claims asserted, the source of the litigation, the origin and character of the claim and, ultimately, the nature of the payment. Thus, all class action settlements may not result in tax deductible payments to class members, and settlement payouts should be divided into deductible and non-deductible tax portions.

The IRS held that instead of medical monitoring benefits, the reimbursements of medical monitoring expenses and cash are not taxable to class members in a class action suit.[6] If the class action lawsuit arises from an ordinary conduct of the taxpayer's business, then tax deduction is necessary. However, in case of fine or statutory penalty, the settlements and payment are not tax deductible.

Why Statutory Damages Are Not Tax Deductible

Both federal and state statutory schemes, including, but not limited to, the Telephone Consumer Protection Act (TCPA), the Video Privacy Protection Act, the Fair Debt Collection Act and the Fair and Accurate Credit Transactions Act, provide statutory or punitive damages for violations. Since under these laws, companies can face class actions, many courts have declined coverage of insurance for the underlying conduct.

The Fourth Circuit Court has held that as a matter of public policy the statutory damages sought under TCPA cannot be covered by a prospective insurance policy which excluded intentional, criminal and/or penal acts. Standard Mutual Ins. Co. v. Lay.[7] For the same reasons, companies are prohibited from taking a tax deduction for the payments of statutory damages to class members for its penal nature under the origin of the claim.[8]

Whether the Insurance Premium for Class Action Settlement Insurance Coverage Is Tax Deductible

Under IRC § 162, ordinary and necessary business expenses are tax deductible. Payments made in settlement of legal claims including the procurement of insurance, legal fees and administrative costs constitute tax deductible ordinary and necessary expenses.

Currently, in the market, companies have two options to achieve a retroactive risk transfer of the known liability arising out of the statutory damage cases: litigation buyout or class action settlement insurance. Using retroactive insurance like litigation buyout or class action settlement insurance, the company achieves two significant objectives.

First, the insurance policy caps the company's exposure and provides full balance sheet risk transfer of the settlement liability. This has clear business, accounting and GAAP advantages.[9] Second, the company now has a tax deductible business expense rather than a nondeductible obligation to pay class members.[10]

In most cases, this would reduce the cost of settlement by an assumed corporate tax rate of 35 percent. In cases which often settle for millions of dollars, the use of insurance is a prudent consideration which meets the legitimate business objective of risk transfer and has the ancillary benefit of substantial tax efficiency.

Tax Treatment for Fines and Penalties

IRC § 162(f), which relates to fines and penalties, provides that "[n]o deduction shall be allowed under subsection (a) for any fine or similar penalty paid to a government for the violation of any law." This includes criminal and civil penalties, and payments in settlement of potential liability for a fine.

However, compensatory fines are an exception to the nondeductibility of fines. Thus, if a fine is compensatory in nature it can be deducted.[11] In S&B Restaurant Inc. v. Commissioner,[12] a payment to avoid prosecution for water pollution was held as deductible. If the payment is of compensatory character, then even fines that appear to be punitive may be held to be deductible.

The imposition of statutory "liquidated damages" for violation of truck weight limitations was held to be deductible in Mason Dixon Lines Inc. v. U.S.[13] In this case, the theory was that the state was compensated via statutory liquated damages for the damage to the highways caused by the overweight vehicles.

The policy under IRC § 162(f) is that those who pay fines and penalties for the violation of a law should not be permitted to receive, in essence, a taxpayer funded discount. Further, a fine is nondeductible regardless of whether the violation is voluntary or involuntary. However, as discussed above, if the nature of the payments is remedial or compensatory, it is deductible.

In Colt Indus. Inc.,[14] the consent decree labeled the payment as a civil penalty. As part of the decree, the taxpayer paid and deducted the $1.6 million it paid to the Pennsylvania Clean Air and Clean Water funds. The taxpayer alleged that the penalty was deductible because it was not punitive.

However, the Federal Circuit held that the payment was nondeductible. The court stated that under IRC § 162(f), there is no distinction between punitive and remedial penalties. Therefore, all civil fines and penalties are nondeductible, irrespective as to whether the fine was punitive or remedial in character.[15]

Deductibility of the Settlement Payment

Obviously the deductibility of settlement payments is often confusing and must be considered carefully. There is a two-step approach to classify settlements by the IRS Office of Chief Counsel: first, analyze the underlying statute. If it is punitive, then it is a penalty. But if it is remedial, then the settlement does not fall under Section 162(f). Secondly, if the statute has both punitive and remedial aspects, the settlement agreement must be examined to determine the origin of the settlement.

In short, any ambiguity may require a court to review the payment under the two-step process, then to accept the agreement as determinative.[16]

Tax Deduction: The Peril to Companies

Generally, in litigation, the main focus is solely on the amount of damages awarded. The tax treatment of these damages is often overlooked, though it is an essential feature that should be prominent in resolving the litigation and determining how much a party ultimately owes, as well as the payment structure.

For certain causes of action, plaintiffs may only seek statutorily defined damages. These statutory damages, when combined with class action, create a risk of staggeringly large awards, often mostly for a mere technical violation. This threat often places defendants' companies under intense pressure to settle in class actions.

In cases of civil or criminal violations of the law, the federal government has become very aggressive in extracting substantial fines and penalties from corporations. Under the False Claims Act, the U.S. Department of Justice has secured $4.9 billion per year in settlements and judgments alleging fraud against the government. Much is at risk.

By illustration, Company X agrees to pay $75 million to end a class action for using automated dialers to call customers' cell phones without consent in violation of the TCPA. The TCPA provides a statutory penalty of $500 per violation and $1,500 for willful violation. Since the settlement payment is a statutory penalty under TCPA, it is nondeductible under IRC § 162(f).

Thus, if Company X attempts to deduct the settlement payment of $75 million, which is clearly nondeductible under IRC § 162(f), Company X may open itself to further lawsuits under the False Claims Act by the Department of Justice for fraud against the government, as well as further punitive action from the IRS. As a result, Company X would again be subject to fines and penalties, which would result in a staggeringly large award, potentially enough to destroy Company X. Company X needs to carefully consider its options.

Conclusion

Aggregated statutory damages present serious problems for defendants in class action lawsuits. Statutory damages guarantee a minimum recovery stipulated within the statute in each individual case where a violation may cause only nominal damage.

The combination of statutory damages and the class action procedure sometimes creates a risk of staggeringly large awards. Furthermore, payments to class members are normally not tax deductible. So a company settling a $75 million TCPA case will have a true cost of the full $75 million without any tax benefit.

Failing to treat these payments appropriately may subject the settling company to additional liability from tax whistleblower litigation and/or IRS penalties or fines, further exacerbating the financial damage. Using alternative strategies such as retrospective litigation buyout or class action settlement insurance can achieve the business objective of balance sheet risk transfer while having the added benefit of tax efficiency.

Peter Robbins is a CPA and a partner at Corbett & Robbins LLP.

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[1] Statutory Damages, available at https://en.wikipedia.org/wiki/Statutory_damages.

[2] Emerging Issues in Statutory Damages, available at http://www.jonesday.com/emerging_issues_in_statutory_damages/.

[3] Due Process Forgotten: The Problem of Statutory Damages and Class Actions, available at http://scholarship.law.missouri.edu/cgi/viewcontent.cgi?article=3812&context=mlr.

[4] IRS Reporting Requirements for Class Action Settlement Payments and Court Awarded Damages, available at https://www.classactionlawsuitdefense.com/2013/02/20/irs-reporting-requirements-for-class-action-settlement-payments-and-court-awarded-damages/.

[5] Allied-Signal Inc. v. Commissioner of Internal Revenue Service, 54 F.3d 767 (3rd Cir. 1995), 40 ERC 1660, 75 AFTR2d 95-1287, 95-1 USTC ¶ 50, 151, aff'ing (1992) TC Memo 1992-204, RIA TC Memo ¶92204, 63 CCH TCM 2672.

[6] http://www.philadelphiabar.org/WebObjects/PBAReadOnly.woa/Contents/WebServerResources/CMSResources/TaxAspectsofLitigation.pdf.

[7] Standard Mutual Ins. Co. v. Lay, 2012 IL App (4th) 110527.

[8] Class Action Settlements: Financial and Tax Reporting, available at http://www.thefederation.org/documents/14.Class%20Action-Financial.pdf.

[9] Id.

[10] Id.

[11] Robert W. Wood: Tax Deductions for Damage Payments: What, Me Worry?, available at http://www.woodllp.com/Publications/Articles/pdf/TN011606.pdf.

[12] S&B Restaurant Inc. v. Commissioner, 73 T.C. 1226 (1980).

[13] Mason Dixon Lines Inc. v. U.S., 708 F.2d 1043 (6th Cir. 1983).

[14] Colt Indus. Inc. v. United States, 880 F.2d 1311 (Fed. Cir. 1989), 30 ERC 1179, 64 AFTR.2d 89-5231, 58 USLAW 2175, 89-2 USTC P 9450.

[15] Violation of Public Policy and the Denial of Deductions, available at http://www.thetaxadviser.com/issues/2011/may/may2011-schnee.html#fnref_30.

[16] Id. All Content © 2003-2017, Portfolio Media, Inc.