-----Original Message-----

From: Koch Kimberly L
Sent: Friday, December 21, 2001 11:18 AM
To: Fritz Matthew J
Cc: Koch Kimberly L
Subject: POSTF-167774-01

I have reviewed your memo and I agree with your arguments and your conclusion. In addition, I think there are two other arguments you could add. First, before the recurring item exception can even be considered, the taxpayer must meet the all-events test. It doesn't look like the taxpayer in this case has a fixed liability until [redacted]. In order to use the recurring item exception, the taxpayer would need to meet the all-events test in [redacted] and have economic performance occur by 8 1/2 months into [redacted]. The taxpayer doesn't meet the all-events test in [redacted] as far as I can tell because its liability in [redacted] is still contingent, not fixed. That would be the taxpayer's first hurdle (I would insert this argument on page 5 of your memo before you introduce the recurring item exception discussion). I think your recurring item discussion is fine. As a final argument, and an alternative to your argument that the liability is a tort, breach of contract, or violation of law, you could argue that, even if the liability does not fall into one of those categories, it would be an "other" liability under § 1.461-4(g)(7), which also does not qualify for the recurring item exception. See § 1.461-5(c). I hope these comments are helpful. If you have any questions, please let me know.

Kim Koch
Assistant to the Branch Chief
CC:ITA:1
(202) 622-4800

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:HMT:CIN:2:POSTF-167774-01
MJFritz

date: 12/19/02

to: Team Manager, LMSB Financial Services Team 1186, Louisville
Attn: Ronda Hensley, Team Coordinator

from: Associate Area Counsel (LMSB)
Cincinnati, Ohio CC:LM:HMT:CIN:2

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subject: [redacted]
[redacted] **Examination**

By Memorandum dated December 13, 2001, you asked us to give assistance regarding the taxpayer's $[redacted] deduction related to its settlement of controversies with the United States Department of Justice and the United States Department of Health and Human Services. Based on the information you provided, I agree with your proposed position that none of the $[redacted] is deductible until paid in [redacted].

ISSUE

When may liabilities incurred by the taxpayer in connection with a settlement made with the Government be deducted: in [redacted], when the settlement was tentatively agreed to, or in [redacted], when the settlement was finalized and the liabilities were paid?

CONCLUSION

No part of the settlement may be deducted for income tax purposes until [redacted], when it was paid.

FACTS

The taxpayer is an accrual basis taxpayer.

The taxpayer is a [redacted] company that provided [redacted]. The Department of Justice ("DJ") [redacted]. In [redacted], a tentative settlement of these

charges was reached.[1] In [redacted], officers of and attorneys for the taxpayer signed a written settlement agreement. On [redacted], an Assistant United States Attorney, another DJ attorney, and the [redacted] signed the agreement on behalf of the Government. The Agreement called for payment by the taxpayer to the Government of $[redacted]. This amount was paid on [redacted].

The Agreement includes the following pertinent provisions:

II. PREAMBLE

...

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

III. TERMS AND CONDITIONS

. . .

[redacted]

...

[redacted]

On its [redacted] Federal income tax return, the taxpayer deducted the amount it had paid for the settlement.[3] You accept the taxpayer's position that the amount of the settlement does not constitute a nondeductible "fine or similar penalty" under I.R.C. § 162(f), and would agree that the amount is deductible in [redacted], when "economic performance" occurred.[4] However, you maintain that none of the amount is deductible in [redacted].[5]

DISCUSSION

You maintain that no portion of the settlement payment is deductible in [redacted]. I agree.

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[3] Uncovering the fact of that the taxpayer deducted the settlement in [redacted] was no small chore for the examining agent. Upon first request, the taxpayer presented a summary schedule, referring to the amount as a nondeductible penalty and including the amount among items not deducted. A separate Schedule M penalty workpaper later presented by the taxpayer did not include the amount. Only upon further inquiry did the taxpayer take the position that the amount was not a penalty, but admit that it had been deducted as part of the "medical claims" amount.

[4] I.R.C. § 461(h).

[5] The taxpayer has attempted to reach agreement on the issue by positing that the settlement payment for the "[redacted]" is not deductible until [redacted], while the settlement payment for the "[redacted]" would be deductible in [redacted]. I agree with you that such a resolution would be improper.

Treas. Reg. § 461-1(a)(2) provides that, under an accrual method of accounting, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all events have occurred that establish the fact of the liability, in which the amount of the liability can be determined with reasonable accuracy, and in which economic performance has occurred with respect to the liability. An accrual basis taxpayer may claim deductions for liabilities which it is contesting no earlier than payment, settlement, or an adverse court ruling. I.R.C. § 461(f); Treas. Reg. § 1.461-2.

In this case, the agreement under which the payments were made was not finalized until [redacted], and no payment was made until [redacted]. Thus, under the rules just cited, no deduction is allowed until [redacted].

The taxpayer has argued to you, however, that it may claim a deduction on its [redacted] income tax return for the amounts paid on [redacted], under the "recurring item exception" of I.R.C. § 461(h)(3) and Treas. Reg. § 1.461-5. We share your doubts that the taxpayer has given complete consideration to the implications of this argument. According to Treas. Reg. § 1.461-5(a)(3), "[a] liability is recurring if it can generally be expected to be incurred from one taxable year to the next." There is a certain obvious incongruity between the taxpayer's positing of this argument, on the one hand, and its careful denial of the DJ and [redacted] contentions, as set forth in section II. q. of the Agreement, on the other. Further, because the "[redacted]" all occurred prior to [redacted], and the "[redacted]" all occurred prior to [redacted], and the taxpayer was placed under the [redacted] effective [redacted], I just cannot see a factual basis for expecting liability to the Government for such conduct to recur again in the year [redacted] and beyond.

In any event, a specific portion of the recurring item exception rule, Treas. Reg. § 1.461-5(c), brings us to the general rule which calls for disallowance of the claimed [redacted] deduction. This subsection tells us that the recurring item exception does not apply to any liability described in Treas. Reg. § 1.461-4(g)(2).

Treas. Reg. § 1.461-4(g)(2) is the primary authority for disallowing the claimed deduction.[6] It states

> (2) **Liabilities arising under a workers compensation act or out of any tort, breach of contract, or violation of law.** If the liability of a taxpayer requires a payment or series of payments to another person and arises out of any ... tort, breach of contract, or violation of law, economic performance occurs as payment is made to the person to which the liability is owed.

Resolution of this issue requires us to discern the nature of the taxpayer's liability to DJ and [redacted]. Although the taxpayer has attempted to make you focus on distinctions between "[redacted]" and "[redacted]," I think the more pertinent distinctions for analyzing the bases for the liability are those set forth in section [redacted]. of the written Agreement: (1) claims under the False Claims Act, (2) claims under other federal statutes, and/or (3) claims under common law doctrines.

It is readily apparent that claims under the False Claims Act would arise "out of ... [a] violation of law." Treas. Reg. § 1.461-4(g)(2).

It is equally apparent that claims arising from other federal statutes (several of which are mentioned in sections [redacted]. [redacted]. and [redacted] of the written Agreement, as set forth above) would arise "out of ... [a] violation of law." Treas. Reg. § 1.461-4(g)(2).

Most obviously, claims for breach of contract, one of the common law theories mentioned in the written Agreement (sections [redacted] and [redacted]) arise "out of ... breach of contract."

The remaining "claims under common law doctrines" require a bit more inquiry, but yield the same result. Those mentioned specifically in the written Agreement are : (1) payment by mistake, (2) unjust enrichment, and (3) fraud. (Sections [redacted]. and [redacted])

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[6] In a "hierarchy of legal authority" sense, I.R.C. § 461(h)(2)(C) and (D) could be said to be primary to the regulation. I use the word "primary" to denote the first place I would look, since the entire applicable rule can be found in the one place.

Fraud is a tort. Restatement (Second) of Torts § 525 (1965).[7]

Strictly speaking, "unjust enrichment" and "payment by mistake" are neither contract nor tort concepts. However, unjust enrichment gives rise to a *quasi contractual* right of restitution. Restatement of Restitution § 1 (1937). Further, "unjust enrichment" often is connected to the commission of tortious acts. Id. §§ 3, 8. "Payment by mistake" is closely related to "unjust enrichment." Interestingly, fraud is categorized as a type of mistake that might involve "payment by mistake."

There is no indication in I.R.C. § 461(h) or in Treas. Reg. § 1.461-4(g)(2) that these common law concepts, so closely related to contract law and tort law, are not to be included in the category of matters covered by section 1.461-4(g)(2). Section 1.461-4(g) is designed to cover several types of liabilities. Indeed, the drafters of the regulation obviously had in mind just the sort of case which you are now examining. In the preamble to the Treasury Decision announcing section 1.461-4(g)(2), they wrote:

> Section 1.461-4(g) ... identifies six types of liabilities, in addition to liabilities arising under a workers compensation act or out of any tort, for which payment constitutes economic performance. These liabilities are: (1) liabilities arising out of a breach of contract; (2) liabilities arising out of a violation of law ... .
>
> ...
>
> The Service and the Treasury Department have concluded that payment is the appropriate time for economic performance to occur for these "payment liabilities." The payment rule was chosen because of the nature of the liabilities and the difficulty in applying the statutory rules to these liabilities. For example, in the case of liabilities arising out of a breach of contract or violation of law, it is often difficult to distinguish among actions based on breach of contract, violation of law, and tort because many such actions are brought on alternative grounds and

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[7] A negligent misrepresentation, or even an innocent misrepresentation, may likewise give rise to tort liability. Id. §§ 552, 552C.

> settled without any objective determination of the prevailing theory.

T.D. 8408, 1992-1 C.B. 155, 159. Accord, id. at 162.

In [redacted]'s case, DJ and [redacted] raised allegations "brought on alternative grounds," which were "settled without any objective determination of the prevailing theory." Id. at 159. All of the alternative grounds fall within the parameters of section 1.461-4(g)(2).

SUMMARY

I agree with your conclusion that none of the taxpayers' liability to DJ and [redacted] as reflected in the Agreement, may be deducted until [redacted].

Please call me at (513) 263-4868 if you have any more questions.

MATTHEW J. FRITZ
Associate Area Counsel
(Large and Mid-Size Business)