Originally published in the:
New York Law Journal *June 15, 2023*

When an Expense is Considered to be Paid: *Gage v. Commissioner*

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The deductibility of payments made in settlement of claims is often contested by the Internal Revenue Service. In *Gage v Commissioner* (TC Memo 2023-47), the taxpayers wished to deduct an amount payable to the federal government to resolve claims attributable to their guarantee of obligations collateral to a loan insured by the Department of Housing and Urban Development (HUD). The Commissioner argued that the taxpayers could not deduct the amount as a business loss in the year before the court because "payment" was not made in that year. The Commissioner also argued that the payment was in settlement of a statutory claim for punitive damages and therefore a nondeductible "fine or similar penalty" under Internal Revenue Code section 162(f).

The court held for the Commissioner on the time of payment issue, but concluded that the position of the taxpayers in claiming a deduction for the payment, and as to the inapplicability of section 162(f), was reasonable and taken in good faith. Therefore, the taxpayers prevailed in their challenge to the substantial understatement of tax penalty that had been asserted by the Commissioner under Code section 6662.

Facts in *Gage*

Edwin and Elaine Gage (the Gages) jointly owned 30% of the stock of a corporation (RMG) that managed a nursing home in Oklahoma owned by a corporate subsidiary of RMG (Heartland).

In 1997, Heartland borrowed approximately $5 million, secured by a nonrecourse mortgage insured by HUD. To obtain the financing, RMG and Heartland entered into regulatory agreements with HUD that restricted the transfer of assets, and use of income, of the nursing home, except as contemplated by the agreements or with the consent of HUD. The agreements identified the Gages as owners and made them personally responsible for actions violating the regulatory agreements.

Heartland defaulted on the HUD-insured loan in 2003. Later that year, the lender assigned the mortgage to HUD, which in turn foreclosed on the nursing home in 2004; the property was sold for approximately $600,000. The assignment, foreclosure, and sale resulted in a loss to HUD of approximately $4 million.

Thereafter the government brought suit in federal district court against RMG's owners, including the Gages. The government asserted that the owners had used the assets and income of the nursing home in a manner that violated the regulatory agreements with HUD, and that under federal statutes the government was entitled to recover from the owners twice the government's actual damages, plus costs and fees. The suit included a claim under federal common law on the basis of unjust enrichment.

By August 2012, a settlement was negotiated under which the Gages and the other owners of the corporations would pay $1.75 million to the government. The settlement was contingent upon final acceptance and approval by the Department of Justice. That approval was believed to be likely, and the district court entered an administrative closing order which terminated the government suit without prejudice.

On December 27, 2012, the Gages purchased a cashier's check for $875,000 (their agreed-upon share of the settlement) and delivered it to their lawyer, who in turn sent an e-mail to the U.S. attorney representing the government that the check would soon be delivered. The U.S. attorney responded, however, that the check should not be delivered to the government before final approval of the settlement by the DOJ, and the Gages' attorney held the check until the following year.

The DOJ approved the settlement in March 2013, and the check was delivered in the same month. The settlement agreement recited the government's allegations that the owners had used nursing home income and assets in violation of the regulatory agreements, and the owners' denial of any wrongdoing; and the agreement included a statement to the effect that the government was not making any representation concerning the characterization of the settlement payment for tax purposes.

The Gages reported a business loss of more than $900,000 on their tax return for 2012 by reason of the settlement payment and associated legal fees. Following an audit, the IRS asserted a tax deficiency on the basis that the loss was not deductible in 2012.

In ensuing proceedings in the Tax Court, the Gages maintained that the settlement payment was made by them in 2012, and that the payment and related legal fees were deductible as business expenses in that year under Code section 162. The Commissioner conceded the deductibility of the legal fees, but maintained that the payment of $875,000 was not allowable as a deduction for 2012 for two reasons, the first being that the cashier's check was not delivered to the government until 2013. The Commissioner further asserted that Code section 162(f) precluded the deduction, because the claims made by the government against the Gages included a statutory claim for double damages, thus causing the settlement payment to be punitive in nature and therefore a nondeductible "fine or similar penalty" under that provision.

Discussion

The Gages used the cash method of accounting. Therefore, the court reasoned (on the basis of Treasury regulations and cases briefly discussed in the opinion), they could claim a deduction for a cash expenditure only when "payment" was made. Where payment is made by check, the tax law generally treats the payment as being made when the check is delivered to the payee. In this case, the check was not delivered to the federal government until after the end of the year for which the deduction was claimed.

The Gages argued that, under Oklahoma law, a payment is considered to be made when payment is tendered. The court concluded, however, that it need not consider Oklahoma law. In a context where the agreements underlying the claims were entered into federal law, between the federal government and the defendants in the lawsuit, and where the claims were made under federal statutes and federal common law, and in light of the need for uniformity in administration of such claims and settlements across the country, the court concluded that the time payment was made should be determined under federal law.

The Gages also challenged the substantial understatement penalty asserted under Code section 6662. Under Code section 6664 and related regulations, the penalty does not apply in respect of an underpayment of tax if it is shown that there was reasonable cause for the underpayment and the taxpayer acted in good faith.

The court observed that the Gages were skilled business people, but not learned in the tax law, and found it more likely than not that the Gages purchased the cashier's check and gave it to their lawyer with the intention of effectuating the settlement, and that they viewed themselves as having spent the amount of the check when they completed these actions. The court concluded that the Gages' position that the payment had been made in 2012 was reasonable and taken in good faith.

In respect of the application of section 162(f), the court noted that this provision (as in effect in 2012) states 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." Under regulations, a "fine or similar penalty" includes an amount paid as a civil penalty imposed by law or in settlement of a taxpayer's potential liability for a penalty (civil or criminal), but not compensatory damages paid to a government (Reg. § 1.162-21(b)).

After brief discussion of cases decided under this provision, the court observed that it was unclear whether the recovery of double damages, as provided for under the federal statutes relied upon by the government in bringing claims against the Gages, was intended to punish. The statutes do not compel the government to seek double damages, and the court concluded that the provisions may serve "both to compensate the government and to punish."

The court further observed that in this case, where the amount accepted by the government in settlement was far less than its loss from the loan, the magnitude of the recovery made it reasonable for the Gages to believe that the settlement payment was compensatory in nature, such that section 162(f) should not apply. The court therefore concluded that the Gages' return position in claiming the deduction was reasonable.

Observations

The conclusion of the court that the purchase and delivery of the cashier's check to the Gages' attorney in 2012 was not sufficient to constitute payment in that year for purposes of claiming a deduction is not at all surprising.

The further conclusion that the Gages' position in respect of the inapplicability of section 162(f) was sufficiently reasonable to avoid imposition of a penalty is not surprising either. It should be kept in mind, however, that section 162(f) as amended after the year at issue (by P.L. 115-97) may now require explicit identification of a payment as in the nature of restitution in a court order or settlement agreement, to avoid the denial of a deduction for a payment otherwise within the scope of section 162(f).

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