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# Ruling Illustrates Treatment of Payments to Settle Litigation

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Litigation is an unfortunate reality in the business world, and businesses that are sued often make payments to settle the litigation brought against them. The tax treatment of such payments is a perennial source of controversy between taxpayers and the Internal Revenue Service. A recent decision of the Seventh Circuit Court of Appeals, affirming a memorandum decision of the Tax Court,[1] illustrates the range of possible tax outcomes – including immediate deduction, capitalization into the cost of a tangible or intangible asset, and, possibly, no tax benefit at all – and the method of analysis generally applied by the courts that determines the appropriate treatment of the making of settlement payments by reference to a characterization of the underlying claims with respect to which the payments are made.

### WellPoint, Inc. v. Commissioner

WellPoint, Inc. is a provider of health insurance on a for-profit basis through various subsidiaries including a number of licensees of the Blue Cross and Blue Shield Association ("Blue Cross companies"). The payments in issue before the Seventh Circuit were made by WellPoint in settlement of litigation that arose from the merger into WellPoint, during the period of 1993 to 1997, of three Blue Cross companies, one in each of Connecticut, Kentucky, and Ohio, that had previously provided health insurance on a not-for-profit basis.

After the acquisitions, the attorneys general of the three states brought lawsuits alleging that the acquisition and use of the assets of these Blue Cross companies in a profit-making activity violated restrictions on the use of the assets arising from the charitable status of the acquired companies.

These actions were characterized by the attorneys general who brought them primarily as "cy-pres" or charitable trust proceedings. Under the cy-pres doctrine, where property is held in trust for a particular charitable purpose, but that purpose is no longer capable of being carried out, an attorney general may intervene to cause the trust to be administered in furtherance of a charitable purpose that is as close as possible to the original charitable purpose.

The remedies sought in the lawsuits included divestiture by WellPoint of its ownership of the assets acquired by merger, or the imposition on such assets of a charitable trust under which WellPoint would not be allowed to retain profits from the assets. Certain of the attorneys general also asserted claims for unlawful conversion, unjust enrichment, and breaches of fiduciary duty.

During 1999, WellPoint agreed to make settlement payments aggregating $113,837,500 to resolve all pending claims and potential claims in the litigations. The funds were used to establish charitable organizations that would serve charitable purposes including the promotion of healthcare. WellPoint also incurred $827,595 of legal and professional fees in connection with the lawsuits.

The amounts paid in settlement and the litigation expenses were deducted by WellPoint on its tax returns for 1999 and 2000. Following an audit, the IRS disallowed the deductions for the settlement payments and related legal and professional fees, asserting that those costs had to be capitalized and included in the basis of the assets acquired in the mergers or, in the alternative, that those costs were neither capitalizable nor deductible.

### Tax Court Analysis

The Tax Court decision described the issue as whether the settlement payments and related legal fees were, as asserted by WellPoint, deductible as ordinary and necessary business expenses, or required to be capitalized as asserted by the government.[2] Both parties agreed that the answer to that question should be determined under the "origin of the claim test" by reference to the underlying claim or transaction that gave rise to the expenditures. The Tax Court observed that, as a general proposition, it is well established that the costs of litigating title to assets are capital expenditures, citing Treasury Reg. section 1.263(a)-2(c), but that case law has held that, while settlement payments and legal fees to resolve disputes over the ownership of property may be capital in

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nature, expenses incurred in defending the right to continue an ongoing business are generally deductible.

The Tax Court reviewed the documents relating to the underlying litigation, including the complaint in each action, the settlement documents, and the parties' own descriptions of the lawsuits (such as the characterization of the lawsuits in WellPoint's financial statements and annual reports as being "disputes over assets," rather than, say, regarding its business practices).

Based on that review and on its characterization of testimony by the taxpayer's witnesses that WellPoint could no longer do business if the attorneys general prevailed in the lawsuits as "self-serving" and "unconvincing," the Tax Court concluded that the core issues in dispute in the underlying litigation had been questions of either title to or equitable ownership of the acquired assets,[3] issues that normally gave rise to capitalized costs, rather than deductible expenses. Further undercutting WellPoint's argument for deductibility, the decision notes, was that none of the attorneys general demanded that there be a change in WellPoint's business behavior or that its business activities be terminated.

Thus, the Tax Court concluded that the settlement payments originated from suits to defend title, as opposed to business practices, and therefore could not be deducted. Similarly, the decision concluded that the legal and professional fees relating to the underlying litigation were capital expenditures.

The Tax Court decision does not state explicitly that the settlement payments would be subject to capitalization and includible in basis of some asset, but the rationale for the Tax Court's conclusion, including a statement that the future benefits accruing to WellPoint from the defense and settlement of the cy-pres claims were manifest, strongly implied that capitalization would be appropriate.

**Decision on Appeal**

WellPoint appealed, arguing that the payments were an ordinary and necessary business expense. WellPoint contended that the authority requiring capitalization of expenditures incurred to defend title was not on point, because the attorneys general were not questioning the title of WellPoint to the assets but rather its right to use the assets for profit-making, rather than charitable, purposes.

The decision of the Court of Appeals observed that a key distinction between a capital expenditure and an ordinary and necessary business expense is the period for which the expenditure is expected to provide a benefit. In particular, case law was cited for the proposition that any expenditure is capital if its "utility . . . survives the accounting period" in which it is made; therefore, that an expenditure incurred to enhance the value of a capital asset must be capitalized and (in general) amortized over the asset's remaining useful life.[4] Accordingly, the Court of Appeals stated, expenditures "incurred to defend (or assert) the ownership of a capital asset, cannot be expensed."

Ultimately, the Court of Appeals concluded, consistent with the Tax Court's decision, that the amounts paid by WellPoint to settle the cases were not in the nature of damages for improper business practices, but had rather been paid in lieu of recovery by the attorneys general of the underlying assets. The expenditures therefore were required to preserve WellPoint's equitable ownership of the assets and had to be capitalized.

The Court of Appeals further observed, perhaps as an aside, that the characterization by the attorneys general of their claims as cy-pres claims tended to confuse the issue. In a typical cy-pres context, the specific charitable purpose for which a charity was established is no longer achievable, as in the case of the treatment of victims of a disease which has been eradicated. In this case, however, there was no reason to believe that the underlying charitable objectives of the Blue Cross companies were no longer attainable. Rather, the core of the argument by the attorneys general was that the assets acquired had been "unlawfully used to provide health insurance for profit; it's as if the assets had been stolen."

Before the Court of Appeals, the Government also made the argument, in the nature of a cross-appeal, that the Tax Court had reached the right result in denying any immediate deduction to WellPoint, but for the wrong reason. The Government contended that "the settlement with WellPoint was in effect a partial restoration of the acquired assets to their rightful owners and that like any other repayment of money it was not a capital expenditure and therefore should have no tax consequences at all."

This analysis would lead to the conclusion that the settlement costs should not be included in the bases of the acquired assets in a manner that would allow to the taxpayer the benefits of depreciation or amortization over time or of recoupment in full should the business be sold.

After discussing at some length whether as a procedural matter this argument was properly before the court (and deciding that it was), the Court of Appeals quickly concluded that the Government's analogy to a repayment of a loan did not provide any ground for denying capitalization. When funds are borrowed, the repayment of the principal does not result in any deduction – but that is because the obligation to repay the principal precludes the borrower from having to take the borrowed amount into income when the borrowed funds were received. Thus, the repayment of a fixed obligation arising from a loan does not separately result in a tax benefit because it is nothing more than the performance of an obligation that was taken into account for tax purposes when it arose.

By contrast, WellPoint presumably did not include any contingent liability to the states in its tax bases for the assets until the litigation was resolved in a manner that required WellPoint to make payments in order to retain the assets.

It is not clear from the decision what other arguments the Government may have made in support of its draconian view that WellPoint was entitled neither to a deduction nor to capitalization. It seems conceivable, however, that the Government might have been trying to bootstrap WellPoint's argument that the underlying litigation was not about defending its title to property and to argue that the settlement payments were in substance penalties imposed on WellPoint for improper conduct in impermissibly converting charitable property to a for-profit purpose.

Under this view, the underlying obligations settled with the attorneys general would perhaps have arisen from conduct outside the ordinary course of business activities to a degree that would support a conclusion that the payments ultimately made were not "ordinary and necessary expenses" deductible under Internal Revenue Code section 162(a).

**Observations**

Although the Tax Court and Court of Appeals decisions do not set forth all the facts that might potentially be relevant to evaluating the merits of

WellPoint's position, the claiming of immediate deductions for the settlement payments and costs of litigation appears to have been aggressive, and the courts' denial of such deductions is not surprising. It does seem noteworthy that, in opposing and ultimately squelching the taxpayer's claim of an immediate deduction, the Government adopted and (unsuccessfully) advocated a "hard line" position denying capitalization as well, a position which might well never have been raised had WellPoint taken a conservative approach and capitalized the payments in the first instance.

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1 *WellPoint, Inc. v. Commissioner*, No. 09-3163 (7th Cir., March 23, 2010), affirming TC Memo 2008-236 (2008).

2 The court ultimately concluded that it did not need not to address the Government's alternative argument (which, however, was briefly addressed on appeal) that the payments could be neither deducted nor capitalized.

3 *WellPoint, Inc. v. Commissioner*, TC Memo 2008-236, n. 6.

4 *Sears Oil Co. v. Commissioner*, 359 F.2d 191, 197 (2d Cir. 1966).