

UNITED STATES TAX COURT  
WASHINGTON, DC 20217

EDWIN L. GAGE &	)	
ELAINE R. GAGE,	)	
	)	<b>CZ</b>
Petitioners,	)	
	)	
v.	)	Docket No. 23874-17.
	)	
COMMISSIONER OF INTERNAL	)	
REVENUE,	)	
	)	
Respondent.	)	

**ORDER**

Pending in this case seeking a redetermination of a deficiency in petitioner’s federal income tax for 2012 are: (1) petitioners’ Motion for Summary Judgment, filed April 10, 2018, pursuant to Rule 121,<sup>1</sup> and (2) respondent’s Cross-Motion for Partial Summary Judgment, filed May 31, 2018. In their motion petitioners seek judgment in their favor that they are entitled to deduct under section 162(a) an \$875,000 payment which they made to the U.S. government under a settlement agreement between petitioners and the government. In his cross-motion respondent seeks judgment in his favor that \$875,000 payment is a nondeductible fine or penalty under section 162(f).

Background

The record reflects and/or the parties do not dispute the following:

In February 1995, RM&G, Inc. (RM&G), was incorporated. Petitioners and four other individuals owned RM&G. In June 1995 RM&G and its owners bought Heartland Health Care Center of Bethany (the Center), a nursing home in Bethany, Oklahoma, and the leases to 9 other nursing homes in Oklahoma for \$7.25 million. Of the \$7.25 million purchase price, \$5.1 million was allocated to the acquisition of the Center. RM&G and its owners obtained a loan to finance RM&G’s purchase of the Center and the nursing home leases. RM&G’s owners personally guaranteed payment of that purchase loan.

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<sup>1</sup>All Rule references are to the Tax Court Rules of Practice and Procedure. Unless otherwise indicated, all section references are to the Internal Revenue Code, as amended.

As of July 1996, the Center had not been profitable. As a result, RM&G's owners sought HUD-insured refinancing of the purchase debt for the Center, as to which debt they were personally liable. In late July 1996, Heartland of Bethany, a wholly-owned subsidiary of RM&G, was incorporated for the purpose of obtaining the HUD-insured refinancing of the Center. RM&G transferred to Heartland of Bethany ownership of the Center, which RM&G continued to manage.

In February of 1997, HUD insured a \$4.901 million non-recourse mortgage on the Center. As part of the transaction, Heartland of Bethany entered into a Regulatory Agreement with HUD which provided that Heartland of Bethany would not, absent HUD's prior written approval, transfer or encumber the mortgaged property, transfer any personal property or pay out any funds except surplus cash, except for reasonable operating expenses and necessary repairs, and generally make or receive and retain any distribution of assets or income except surplus cash. The Regulatory Agreement also provided that officers and owners of Heartland of Bethany could be personally responsible for retaining funds or for otherwise acting in violation of the Regulatory Agreement.

In 2010, the United States government filed a complaint in the U.S. District Court for the Western District of Oklahoma against RM&G's owners to recover double damages under the National Housing Act, 12 U.S.C. secs. 1701-1750, and Section 421 of the Housing and Community Development Act of 1987, 12 U.S.C. sec. 1715z-4a, for the recovery of Center assets and income that were used in violation of the Regulatory Agreement, as well as damages under federal common law for wrongful use of the project assets and income. The government alleged that defendants impermissibly transferred income and assets to RM&G and did not account for the income and assets, impermissibly paid income to other nursing homes, impermissibly paid income to other entities without supporting documentation, and used income and assets in a way that constituted unjust enrichment to the defendants.

Subsequently, defendants and the government entered into a settlement agreement, whereby petitioners and another couple agreed to pay the government \$1.75 million, in exchange for the government's releasing defendants from any civil monetary claims relating to the suit. The settlement agreement also contained a provision that nothing in the agreement constituted a representation or agreement by the government concerning the characterization of the settlement amount for purposes of the Internal Revenue Code. Petitioners and the other couple then each paid \$875,000 to the government under the settlement agreement.

On their 2012 income tax return petitioners claimed an \$875,000 business loss deduction for their above \$875,000 settlement agreement payment. In the notice of deficiency upon which this case is based, respondent disallowed that business loss deduction. On November 15, 2017, the petition in this case was filed. In their amendment to petition, filed August 16, 2018, petitioners alternatively assert that they are entitled to deduct that settlement agreement payment under section 162(a).

On April 10, 2018, petitioners filed their Motion for Summary Judgment. On May 31, 2018, respondent filed his Response to petitioners' motion.

On May 31, 2018, respondent filed his Cross-Motion for Partial Summary Judgment. On July 5, 2018, petitioners filed their Response to respondent's motion. On September 19, 2018, respondent filed his Reply to Petitioners' Response.

### Applicable Law

Section 162(a) generally provides that a taxpayer is allowed a deduction for all ordinary and necessary expenses paid or incurred in carrying on a business. Section 162(f), however, proscribes a deduction under section 162(a) for any fine or similar penalty paid to a government for the violation of any law. Section 1.162-21(b)(1)(iii), Income Tax Regs., defines fine or similar penalty to include an amount paid in settlement of the taxpayer's actual or potential liability for a civil or criminal fine or penalty. Section 1.162-21(b)(2) of the regulations, on the other hand, provides that compensatory damages paid to a government do not constitute a fine or penalty.

Although 12 U.S.C. section 1715z-4a permits the recovery of double damages, the decision to award double damages is a matter within the trial court's discretion. United States v. Cofield, 215 F.3d 164, 170, (1st Cir. 2000); United States v. Coleman, 200 F.Supp.2d 561, 573 (E.D. N.C. 2002). In addition, a claim for unjust enrichment is a claim for restitution or compensation. S.S. Silberblatt, Inc. v. East Harlem Pilot Block -Building I, 608 F.2d 28, 37 (2d Cir. 1979).

### Discussion

This Court may grant summary judgment only if there are no genuine disputes or issues of material fact and the moving party is entitled to judgment as a matter of law. See Rule 121(b); Naftel v. Commissioner, 85 T.C. 527, 528-529 (1985).

Among other things, upon reviewing the motion papers and materials offered in the instant case by petitioners and respondent, the Court concludes that genuine issues of material fact exist, including as to: (1) the characterization and purpose of the \$875,000 settlement payment made by petitioners to the government; (2) whether that \$875,000 payment represented compensation to the government or double damages; and (3) if that \$875,000 payment represents double damages, whether the parties to the settlement agreement intended the payment to compensate the government for its losses or to deter and punish defendants for their conduct. See, for e.g., Talley Industries, Inc. v. Commissioner, 116 F.3d 382, 386 (9th Cir. 1997), rev'g T.C. Memo. 1994-608, on remand, T.C. Memo. 1999-200, aff'd 18 Fed. App'x 661 (9th Cir. 2001); see also, Frensius Medical Care Holdings, Inc. v. United States, 763 F.3d 64, 69-70 (1st Cir. 2014) (rejecting government's argument that tax characterization agreement is precondition to deductibility of settlement payment; if the parties left the question open, a court has to look objectively to the economic reality of the transaction to determine whether there was a compensatory purpose).

Neither party has shown there are no material issues of fact in dispute, accordingly neither party is entitled to judgment as a matter of law. Summary judgment is not appropriate under these circumstances. Accordingly, the Court will deny both petitioners' summary judgment motion and respondent's cross-motion for partial summary judgment.

Premises considered, it is

ORDERED that petitioners' Motion for Summary Judgment, filed April 10, 2018, is denied. It is further

ORDERED that respondent's Cross-Motion for Partial Summary Judgment, filed May 31, 2018, is denied.

**(Signed) Peter J. Panuthos**  
**Special Trial Judge**

Dated: Washington, D.C.  
November 5, 2018