Hawronsky v. Commissioner, 105 T. C. 94 (1995)

Treble damages paid for breaching a scholarship obligation to serve in the Indian Health Service are non-deductible penalties under IRC section 162(f).

Summary

John Hawronsky received a tax-exempt scholarship from the Indian Health Services Scholarship Program, requiring him to serve four years with the Indian Health Service. After completing less than two years, he joined a private clinic and paid treble damages for breaching his obligation. Hawronsky attempted to deduct this payment as a business expense. The Tax Court held that the treble damages were a civil penalty, not a deductible business expense, under IRC section 162(f), which disallows deductions for fines or penalties paid to the government for violating laws.

Facts

John Hawronsky received a scholarship from the Indian Health Services Scholarship Program (IHSSP) to attend medical school. The scholarship required him to sign a contract with the National Health Services Corp. (NHSC), obligating him to serve four years in the Indian Health Service. After completing about one year and eight months of service, Hawronsky left to join a private medical practice, the Dakota Clinic, Ltd. , in May 1989. As a result, he was required to pay treble damages to the Department of Health and Human Services (HHS) under 42 U. S. C. sec. 254o(b)(1)(A). Hawronsky paid $275,326. 86 to HHS and attempted to deduct $233,194 of this amount on his 1989 tax return as a business expense related to his new employment.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Hawronsky's 1989 federal income tax and disallowed the deduction for the treble damages payment. Hawronsky and his wife petitioned the United States Tax Court, which held that the payment was a non-deductible penalty under IRC section 162(f).

Issue(s)

1. Whether the treble damages paid by Hawronsky to HHS for breaching his NHSC service obligation are deductible as an ordinary and necessary business expense under IRC section 162(a).

Holding

1. No, because the treble damages are a civil penalty under IRC section 162(f), which prohibits deductions for fines or similar penalties paid to a government for the violation of any law.

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Court’s Reasoning

The Tax Court applied IRC section 162(f), which disallows deductions for fines or penalties paid to a government for violating any law. The court determined that the treble damages imposed on Hawronsky were a civil penalty, punitive in nature, designed to deter violations of the NHSC service obligation. The court distinguished these damages from liquidated damages, noting that the amount bore no relation to the government’s actual damages from the loss of Hawronsky’s services. The court cited cases from the U. S. Courts of Appeals, which established that an NHSC scholarship recipient’s obligations are governed by statute, not contract principles, and that Congress intended the treble damages to be a punitive measure. The court emphasized that allowing a deduction for such payments would frustrate the public policy goal of correcting the geographic maldistribution of health professionals.

Practical Implications

This decision clarifies that treble damages paid for breaching obligations under government scholarship programs are non-deductible penalties under IRC section 162(f). Legal practitioners should advise clients that such payments cannot be claimed as business expenses, even if they are incurred in connection with starting a new job. This ruling underscores the importance of fulfilling service obligations under government-funded scholarship programs and the potential tax consequences of breaching them. Subsequent cases involving similar scholarship programs have relied on this precedent to deny deductions for damages paid for non-compliance with service obligations.

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