

# Ransom Silver Lining? It's A Tax Deduction

By Robert W. Wood

In business, investments, or your personal life, every dollar spent is a little sweeter — or a little less painful — if you can write it off. Some expenses in business, investments and even personal matters are tax deductible. Less desirably, some must be saved up for later as part of your tax basis (say, improvements to your house). You can at least offset the latter against your gain on sale later, provided that you can prove you incurred them.

Some payments though are not deductible at all. The biggest category of these occurs in our personal lives, things that are not really business or investment-related, and that aren't personal tax breaks allowed by the tax code. By personal tax breaks I mean state and local taxes, mortgage interest, charitable contributions, etc.

When you are faced with an odd expense that you're not sure how to handle, do some googling, or ask your tax adviser. What if you pay ransom? Just this week, businesses across the globe were forced to pay ransom to hackers in order to regain access to their own data after becoming infected with ransomware known as Petya. Even governmental entities have been known to pay ransom. The IRS has been engaged in a legal battle to uncover the identities of bitcoin users, issuing summonses, etc.

Amidst that hunt, ironically, federal prosecutors revealed that government prosecutors in Pennsylvania paid a bitcoin ransom to protect the privacy of that office's information. The amount of the ransom was relatively small, only \$1,400. But it's still remarkable seeing a government entity paying ransom, and even more so in digital currency.

So, if you pay hackers ransom to keep your business operating, is it tax deductible? Whether personal or business, it probably is, although the type of deduction can vary. The IRS defines a theft as the taking and removing of money or property with the intent to deprive the owner of it.

The taking of property must be illegal under the laws of the state where it occurred and it must have been done with criminal intent. But to claim a deduction, you don't need to show a conviction for theft. Theft includes the taking of money or property by:

- Blackmail
- Burglary
- Embezzlement
- Extortion
- Kidnapping for ransom
- Larceny
- Robbery

The taking of money or property through fraud or misrepresentation is theft if it is illegal under state or local law. For businesses, paying ransom or blackmail is likely to fall into the wide category of business expenses. In fact, many taxpayers try to find a business connection to virtually any legal mess.

Most legal settlements in business are tax deductible, even ones that are unusual. There is limited tax authority on the tax deductibility of blackmail. But in the right circumstances, even paying blackmail can be tax deductible.

The same is usually true for legal fees, even though in some sense the size of the legal fees may be quite enormous. For example, remember Martha Stewart's brief run in with federal prosecutors over stock trades and obstruction of justice? She paid

huge legal fees on an obstruction of justice charge from the sale of Imclone stock.

To pay legal fees, she sold 75,000 shares of Martha Stewart Living stock (raising \$4.67 million). SEC filings revealed she sought reimbursement (as an officer and director) for \$3.7 million of fees for her successful defense on the charge that she tried to lift her own company's share price by declaring that she was innocent of insider trading. In the end, all of her vast legal expenses in the case were probably tax deductible.

Technically expenses must be ordinary, necessary and reasonable to be deductible, but those three terms are more malleable than you might think. An expense is "ordinary" even if it is once in a lifetime. Necessary is usually easy too. Even a payment in cash without a receipt can sometimes generate a tax deduction.

In fact, tax receipts are sometimes optional. And reasonableness is one of those fuzzy terms. Even huge legal bills can be reasonable when the parties are unrelated and dealing at arm's length.

Hush money — even blackmail — has probably been claimed on more tax returns than you might think. Bribes and illegal payments are nondeductible, but as Bill Clinton said, it can sometimes depend on what the meaning of the word "is" is. One barrier is for fines or penalties paid to the government.

Section 162(f) of the tax code prohibits deducting "any fine or similar penalty paid to a government for the violation of any law." That includes criminal and civil penalties as well as sums paid to settle potential liability for a fine. Another no-no is deducting bribes and illegal payments. This too is often debated, for taxpayers have a big incentive to try to deduct payments.

In *SEC v. Bilzerian*, 729 F. Supp. 2d 9 (D.D.C. 2010), Mr. Bilzerian paid off his stockbroker and tried to deduct it, even though Bilzerian was convicted of violating securities laws and conspiring to defraud the IRS. Bilzerian created entities to hide his ownership of stock, and when his broker lost money and found out, Bilzerian paid the broker \$125,000 to make up for the broker's loss. Bilzerian deducted it as a business expense.

Later, Bilzerian was convicted of violating securities laws, making false statements and criminal conspiracy. The IRS disallowed his tax deduction saying the related \$125,000 payment had to be illegal. The IRS claimed the payment was nondeductible regardless of whether the payment itself was legal since it was made in furtherance of an illegal activity.

The Tax Court ruled that only payments *illegal by themselves* were nondeductible. That can be a pretty forgiving standard. For example, former House Speaker Dennis Hastert faced criminal charges over his handling of his own cash to pay hush money. His repeated withdrawals of small amounts to avoid the \$10,000 IRS cash reports led to 'structuring' charges and an eventual guilty plea.

But his payment of blackmail itself could probably have been claimed as a tax deduction. So if you get stuck paying ransom — or any other unusual expense — at least think about the tax aspects.

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