Should the Securities Industry Settlement Be Deductible?

By Robert W. Wood

Lately, there has been a good deal of press over the supposed tax benefits to various securities houses arising out of the large settlements related to stock research abuses (see p. 36). I'd like to start with a brief overview of the complaints about the nature of the settlement, and tie this in to the landscape of what is and is not deductible under traditional analysis. That traditional analysis has focused on the difference between nondeductible fines or penalties on one hand and deductible remedial or compensatory payments (and even deductible punitive damages) on the other.

I'll start by saying that I find the great hue and cry over this issue to be a bit disingenuous, and perhaps a little naive.

The Complaints

As the securities industry reels in the wake of the approximately $1.5 billion global settlement to be paid by securities firms, *The Wall Street Journal* stated that it looks as if only about $450 million of the $1.5 billion total will likely be characterized as fines for penalties. See Zuckerman, "Pain of Wall Street Settlement to Be Eased by U.S. Taxpayers," *Wall Street Journal* (Feb. 13, 2003). The bulk of the settlement, more than $1 billion, was slated to go toward investor restitution, education, and the dissemination of independent research. These kinds of expenses, *The Journal* correctly noted, would normally be tax-deductible business expenses.

The $1.5 billion settlement, recall, was reached by 12 of the largest investment firms with state and federal regulators. Some commentators (and legislators) have criticized the $1.5 billion settlement as not enough to begin with. These criticisms become all the more vitriolic when the asserted tax benefits are taken into account. If the reports are correct that a $1.5 billion settlement becomes a $1.1 billion settlement on an after-tax basis, then there is concern that the securities industry is getting off lightly.

Hot on the heels of the public outrage over this topic, Senators Grassley, McCain, and Baucus wrote SEC Chairman William Donaldson on February 28, 2003 (see *Doc 2003-5497 (3 original pages)* or *2003 TNT 41-49*). The gist of the letter was that the settlements were being structured to maximize the amount of the payments that are tax-deductible, thereby forcing American taxpayers to "pick up much of the tab" for securities industry misdeeds. Must taxpayers first suffer with markets that were abused (taking money out of their pockets), and then have to sit as the same people who abused the markets try to structure the payments so that these brigands are not held accountable? Zounds!

The three senators note that the headlines stress the size of the settlement payments, but not the actual economic effect after taxes. The three senators go on to urge the SEC to take a more proactive stance when it comes to the tax treatment of the payments. "For the SEC to be oblivious to the tax treatment and the ultimate payor of a settlement is to have the SEC working contrary to other functions and goals of the U.S. government."

Senators Baucus, Grassley, and McCain then went to *The Wall Street Journal* on March 13, 2003, with a very public criticism entitled "A Second Betrayal." As the title of their piece suggests, the three senators argue that by structuring much of the settlement payment in a tax-deductible fashion, corporate America (and our whole system) has cheated taxpayers. The article asserts that by avoiding words like "fraud," benefits from insurance or tax deductions may be available. (I won't consider the insurance issues here.) As the senators flatly say, "To the extent that any portion of the settlement payments is paid by the firm's insurance policies or deducted from their taxable income, insurers, other insureds, and taxpayers will be left picking up the tab for corporate wrongdoing." *Id.*

Surveying the Landscape

What is all this about anyway? In contrast to the general rule that payments in a business context (either by way of settlement or judgment) will be deductible, the Internal Revenue Code states expressly that no deduction is allowed for "any fine or similar penalty paid to a government for the violation of any law." Section 162(f). This provision denies a deduction for both criminal and civil penalties, as well as for sums paid in settlement of potential liability for a fine. Reg. section 1.162-21(b). It is the latter element of the provision that often causes great controversy. It may (or may not) be clear that there is a likelihood of a fine being imposed when a "potential" liability is satisfied.

Whether a fine or penalty may be imposed in some cases depends on the intent of the perpetrator. However, the denial of the deduction does not require that the violation of law have been intentional. No deduction will be permitted for the payment of a fine even if the violation is inadvertent, or if the taxpayer must violate the law to operate profitably. *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958).

The significance of the rule that fines and penalties are nondeductible — and the considerable incentives that taxpayers have to avoid this rule — are well illustrated by the experience of Exxon regarding its liability in the Exxon Valdez oil spill litigation. According to news reports, the U.S. government's $1.1 billion Alaska oil spill settlement with Exxon actually cost Exxon a maximum of $524 million when Exxon's tax deductions for the payments were taken into account. These findings were made by the Congressional Research Service and announced by former Representative Gerry E. Studds, Democrat from Massachusetts.

The study by the Congressional Research Service determined that more than half of the civil damages totaling $900 million could be deducted on Exxon's federal income tax returns. The study also indicated that because the civil penalties would be paid out over 10 years, the real return to the government will be

significantly eroded by inflation. See "Tax Deductions Will Help Exxon Slip Away From Much of Its Oil Spill Liability Says CRS," *H&D,* Mar. 21, 1991, p. 2853.

One of the more important articles to define the line between nondeductible fines or penalties and deductible compensatory damage payments is Raby, "When Will Public Policy Bar Tax Deductions for Payments to Government?" *Tax Notes*, Mar. 27, 1995, p. 1995. See also Manns, "Internal Revenue Code Section 162(f): When Does the Payment of Damages to a Government Punish the Payor?" 13(2) *Virginia Tax Review* 271 (Fall 1993).

There seems to be more and more litigation over the question of what constitutes a fine or penalty. For example, in *S. Clark Jenkins, et ux. v. Commissioner*, T.C. Memo. 1996-539, *Doc 96-32146 (16 pages), 96 TNT 242-12*, the Tax Court held that a shareholder of a fertilizer manufacturer was entitled to deduct, through his S corporation, amounts he paid to two states as "penalties" for deficiencies in the fertilizer produced by his company. The IRS had disallowed the deduction (passed through from his S corporation), arguing that the payments represented nondeductible penalties. The Tax Court, however, looked to the purpose of the state legislation, finding that it was to compensate the consumer, not to punish the manufacturer.

Indeed, the Tax Court noted that the penalty was calculated by determining the value of the deficient ingredient that the consumer paid for but never received, plus an additional amount that was to compensate for additional crop yield. In this case, the Tax Court found for the taxpayer because it was a remedial statute, not a punitive one. *Jenkins* demonstrates that it is important to look beyond the mere "fine or penalty" language to discover the *purpose* of the statute pursuant to which the fine or penalty is levied. For additional discussion, see Schnee, "Some Fines and Penalties Can Be Deducted," 58(1) *Tax'n for Accountants* 20 (January 1997).

Merely concluding that a penalty is civil rather than criminal, of course, does not get the taxpayer out of the woods. For example, in *Hawronsky v. Commissioner*, 105 T.C. 94, *Doc 95-7783 (12 pages), 95 TNT 155-9* (1995), the Tax Court held that section 162(f) prohibits a man from deducting the treble damages he was required to pay when he breached a scholarship program contract, because the damages constituted a statutorily prescribed penalty. See also Raby, "When Will Public Policy Bar Tax Deductions for Payments to Government?" *Tax Notes*, Mar. 27, 1995, p. 1995.

Restitution

The deductibility of restitution payments has been discussed in a number of cases. For example, in *Jess Kraft, et ux. v. U.S.*, 991 F.2d 292, *Doc 93-4425, 93 TNT 79-15* (6th Cir. 1993); *cert. denied* 510 U.S. 976 (1993), the Sixth Circuit held that payments of restitution to Blue Cross/Blue Shield arising out of a criminal action for fraud were nondeductible. Although the restitution was paid to a private party and not to the government, the court held the payments nondeductible. Although traditionally the IRS has analogized these restitution payments to penalties, a number of courts have disagreed and found restitution payments to be deductible. See *Jon T. Stephens v. Commissioner*, 93 T.C. 108, *rev'd* 905 F.2d 667 (2d Cir. 1990). For a helpful collection of such cases, see Raby and Raby, "Restitution Payments May Produce a Tax Deduction," *Tax Notes*, Oct. 21, 1996, p. 335. See also Schnee, "Some Fines and Penalties Can Be Deducted," 58(1) *Tax'n for Accountants* 20 (January 1997); and Raby, "Deductibility of Restitution Payments," *Tax Notes*, May 31, 1993, p. 1221.

Public Policy Restrictions?

Public policy and taxes? Boy, that gets sticky. Occasionally, the IRS has objected to the deductibility of a payment where allowing the payment as a deduction raises public policy issues. The IRS as policy wonk? Again, that is disturbing.

No Internal Revenue Code provision specifically authorizes the IRS to disallow deductions based on this doctrine. Nevertheless, the government has occasionally raised the issue where a legal action involves penalties or punitive provisions, and the settlement or judgment payment could therefore be seen to acquire a similar taint. Fortunately, the Supreme Court determined that the IRS could not disallow deductions under a general public policy theory. *Commissioner v. Tellier*, 383 U.S. 687 (1966).

Indeed, the fact that a liability is based on the taxpayer's fraud, breach of fiduciary duty, or mismanagement is generally not enough to prevent the payment from being deductible, as long as the liability arose out of the taxpayer's trade or business. Examples of this rule in operation are illustrated below:

- Damages caused by a taxpayer's fraud in negotiating a lease were held deductible. *Helvering v. Hampton*, 79 F.2d 358 (9th Cir. 1935).

- Damages paid by a stockbroker for improperly churning a client's account were held deductible. *Ditmars v. Commissioner*, 302 F.2d 481 (2d Cir. 1962).

- Damages paid by a director for breach of fiduciary duty to a corporation were held deductible. *Graham v. Commissioner*, 326 F.2d 878 (4th Cir. 1964).

- Damages paid by an executive for mismanagement and misuse of corporate assets were held deductible. *Great Island Holding Corp.*, 5 T.C. 150, *acq.*, 1945 C.B. 3 (1945); *acq. sub nom.*, 1945 C.B. 7.

- Punitive damages paid by a corporation to a victim of a fraudulent scheme in settlement of a breach of contract and fraud action were held deductible. Rev. Rul. 80-211, 1980-2 C.B. 57 (1980).

There is a limit, however. If the payment itself is illegal under federal law, the deduction will be disallowed. Rev. Rul. 82-74, 1982-1 C.B. 110. Thus, where a taxpayer sought to deduct a payment made

to an arsonist to burn down his building (a taxpayer with considerable chutzpah) no deduction was allowed. *Id.*

Is there a common thread here? The question of when a payment may not be deductible based on public policy restrictions is closely tied to the restriction on the deductibility on fines or penalties. Indeed, it has been argued that the public policy doctrine and section 162(f) are interrelated. One article notes that the nondeductibility of fines or penalties under section 162(f) was designed to replace the old restriction on public policy grounds. See Raby, "When Will Public Policy Bar Tax Deductions for Payments to Government?" *Tax Notes*, Mar. 27, 1995, p. 1995.

After all, despite the enactment of section 162(f), it can be argued that when a payment is made to a private party that will definitely reduce the amount of a government-imposed fine, allowing a deduction for the payment could subvert the purposes of section 162(f). That was essentially the position taken in *Allied-Signal, Inc. v. Commissioner*, 54 F.3d 767, *Doc 95-2752 (23 pages), 95 TNT 47-8* (3rd Cir. 1995). The court in *Allied-Signal* denied the taxpayer any deduction for the $8 million it paid to a trust established to eradicate a highly toxic chemical pesticide from the environment. The court denied the deduction (affirming the Tax Court) because it found that the $8 million was paid with the virtual guarantee that the district court would reduce the criminal fine by at least that amount.

What is troubling about cases such as *Allied-Signal* is that it would seem difficult to control the circumstances in which the section 162(f) type of restriction would apply. The factual determinations that must be made, and that were made in the *Allied-Signal* case, are still important. Negotiated settlements for a variety of types of legal violations occur with great frequency. Surely Congress did not intend that all of these negotiated settlements would be brought within the ambit of section 162(f). Did it?

If one reviews some of the case law with this public policy view in mind, it is possible to discern disturbing trends even where the "public policy" moniker is not used. In *Oden v. Commissioner*, T.C. Memo. 1988-567, the Tax Court disallowed a sole proprietor's deduction of a judgment for compensatory damages obtained against her in a defamation suit brought by an ex-employee. Noting that there was malice in the defamation, the Tax Court found that there are some actions so extreme that a deduction should not be available. Given the elimination of the public policy grounds for denying a deduction (and the explicit limitation in section 162(f) to fines and penalties), this decision seems wrong. (Regarding the deduction of Michael Milken's settlement, see Lee Sheppard, "Milken's Deduction for His Settlement," *Tax Notes*, March 9, 1992, p. 1189.)

Some taxpayers have expressed concern whether exemplary or punitive damages will give rise to normal business expense deductions notwithstanding the fact that they may be incurred in the course of an activity that arguably violates public policy. For example, an employer may incur liability for exemplary damages under the Age Discrimination in Employment Act or the Fair Labor Standards Act. The Treasury regulations flatly state that an amount that is otherwise deductible under section 162 will not be made nondeductible by reason of the fact that allowing the deduction would frustrate public policy. Reg. section 1.162-1(a). See also Rev. Rul. 80-211, 1980-2 C.B. 57. But as with so many flat statements, even that does not obviate all of the line-drawing.

In a blow to the traditional notion that virtually any legal expense (of a noncapital and nonpersonal nature) is deductible, in *Daniel Frances Kelly, Jr. v. Commissioner*, T.C. Memo 1999-69, *Doc 1999-9190 (18 original pages), 1999 TNT 45-16*, the Tax Court held that the legal costs of defending against a sexual assault charge are nondeductible. The taxpayer had been charged with criminal sexual assault, and sought to deduct the legal fees as a business expense. The Tax Court found that the sexual harassment charges arose out of the individual's personal activities, and not out of any profit-seeking activities. The court distinguished *Clark v. Commissioner*, 30 T.C. 1330 (1958), because of the personal nature of this claim.

In *Clark*, the taxpayer had been wrongfully accused of assault with intent to rape during the course of his employment activities. In *Kelly*, on the other hand, the Tax Court found that Kelly was pursuing a purely personal desire. *Clark* seems inconsistent with *Kelly*, because the court in *Clark* found the expenses deductible. However, in that case there was a finding that Clark had been working within the course and scope of his employment, and he had not committed the rape. The Tax Court in *Kelly* stated that, unlike the *Clark* case, sexual assault activity was not within the course and scope of the defendant's employment, nor was it conducted for a legitimate business purpose.

Most tax advisers have assumed that sexual harassment, gender or race discrimination, wrongful termination, and a variety of other claims made against an officer of a company would be deductible by the company. The specific facts and the conclusion may turn on whether there is an express indemnity obligation either under law or in the employment contract or other governing documents (including bylaws). Reading *Kelly*, it may be disturbing to think that virtually all harassment or discrimination cases arguably arise out of some personal activity that could, at least under one reading of the facts, be considered outside the course and scope of employment. It remains to be seen exactly how far this particular notion will go.

Indeed, the kind of line-drawing done in *Kelly* reminds me a little bit of the origin-of-the-claim test. That, of course, is the overarching rule for determining the tax treatment of a settlement or judgment payment (to a payor or payee). Although I think it is possible to make sense of the origin-of-the-claim test, I find that it is also often possible to come out with quite different results depending on how one chooses to view the course of conduct that led up to

the litigation. Some of the seminal cases in this area, such as *U.S. v. Gilmore*, 372 U.S. 39 (1963), involve precisely this line-drawing. It is understandable that the authorities would seek to make sense of what may be perceived as tax advantages arising from abhorrent conduct. Nevertheless, there should probably be a more systematic and reasoned approach for this than there is.

Punitive Damages Confusion

I cannot leave this topic without at least mentioning punitive damages. Punitive damages paid to private parties are deductible. Nonetheless, there seems to be no end of confusion about this topic among business people and even tax practitioners. The IRS ruled that liquidated damages paid under the Fair Labor Standards Act are deductible as business expenses. Rev. Rul. 69-581, 1969-2 C.B. 25. The Tax Court held that liquidated damages paid under the Age Discrimination in Employment Act and the Fair Labor Standards Act are also deductible. See *Downey v. Commissioner*, 97 T.C. 150 (1991), *on reconsideration* 100 T.C. 634, *Doc 93-7379 (27 pages), 93 TNT 138-14* (1993), *rev'd and remanded* 33 F.3d 836, *Doc 94-8280, 94 TNT 176-8* (7th Cir. 1994), *cert. denied* 550 U.S. 1141. As long as punitive damages are paid or incurred by a taxpayer in the ordinary conduct of its business, they will be deductible. Rev. Rul. 80-211, 1980-2 C.B. 57.

Of course, a controversy raged for years about the tax treatment of punitive damages in the hands of the recipient. With *O'Gilvie v. U.S.*, 519 U.S. 79, *Doc 96-31894 (14 pages), 96 TNT 240-1* (1996), and the parallel changes in the 1996 tax legislation, it is now clear that punitive damages are always taxable to the recipient. Still, there remains a difficult determination of precisely when "punitive damages" have been paid, since neither the code nor the regulations define this term. Often, a liability that might be viewed as partially punitive in nature is settled on appeal or in some other consensual way.

I suspect the controversy about the treatment of punitive damages to the recipient has not helped the confusion over the treatment of punitive damages to the payor. Then, there was President Clinton's 1999 budget proposal to deny deductions on punitive damages paid to plaintiffs in civil lawsuits. The proposal would have denied a deduction to any party paying punitive damages. Furthermore, Clinton's proposal would have required a company with insurance for punitive damages to recognize income in the amount that the insurance company actually paid for the punitives. The proposal did not meet with approval from the business community, which was hardly a surprise. See Schlesinger and Hitt, "Clinton Wants to Tax Civil Damages," *The Wall Street Journal*, Feb. 1, 1999, p. A3.

A Rose by Any Other Name?

Tax lawyers get used to semantics, and the importance of form. Still, consistency is important too, and it may be surprising that some in the securities industry are calling some of the payments here "fines" for one purpose, but decidedly not admitting that they are fines for purposes of tax law. Indeed, *The Wall Street Journal* recently noted that some of the firms are calling some of the remediation payments here "fines," ostensibly because it affects how the respective firms are perceived vis-à-vis the other securities firms. See Craig and Gasparino, "Morgan Stanley Puts Settlement Over Research on a 'Spin' Cycle," *Wall Street Journal,* Mar. 31, 2003.

I suppose the IRS might take the position that disclosures in the press, in annual reports, and the like don't change the fundamental character of a payment. If it is remedial in nature, after all, presumably that is how it should be treated for tax purposes. However, the tax literature is full of circumstances in which inconsistencies haunt taxpayers. And bear in mind that the intent of a payor in making a payment is always relevant to the tax characterization of a payment. It will be important whether there is a remedial purpose evident for a payment. But what the payor thinks it is paying will be important too.

Exactly how the securities industry players will deal with these seeming inconsistencies isn't yet clear, nor is it certain that it will be as bothersome to the IRS as it is to me. Yet, the stakes are certainly high. As but one example, Goldman Sachs is to pay $110 million to regulators, a $50 million fine, $50 million for independent stock research, and $10 million for investor education. When you add up all the firms, there ought to be someone looking at these issues.

So *Should* the Settlement Be Deductible?

I suppose this is the question that the SEC and other concerned parties should be raising. Much of it comes down to expectations, although I fear that the popular press tends to gloss over the landscape of these rules. The headlines have suggested that something nefarious is afoot, with the powers that be giving "tax breaks" to the securities industries, so that their $1.5 billion settlement is winnowed down to a more reasonable size.

Whether that's appropriate or not, I frankly don't know. It certainly doesn't surprise me that those negotiating on behalf of the various securities firms would attempt in settlement documents to characterize as much as possible as remedial in nature. Characterization is one thing, of course, but reality can sometimes be another. From what little I know about this settlement (only what I've read), a good deal of the money is actually being set aside for education, research, etc. — the very things that one would think of as remedial in nature.

Ultimately, it is understandable that legislators would want to point out the bad conduct that gave rise to this large securities industry settlement in the first place. It is also understandable that these legislators would want to suggest that the securities firms will get a tax benefit for part of the payments, although to me the recognition of these tax benefits seems both belated and unexceptional. Indeed, this whole issue strikes me as something that cuts to the very essence of our tax system. Every time one reads about a big business paying a huge settlement amount, it is deductible, unless it falls within what is

a fairly narrow exception (fine or penalty). There is probably some legislative line-drawing that can be done here, but I don't predict it will be easy.

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