Tax Treatment of Global Settlement Payments Far From Settled

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Timed to coincide with completion of the landmark settlement with the Wall Street securities firms, the Senate Finance Committee's top taxwriters last week proposed legislation that would greatly reduce the deductibility of the $1.4 billion payments.

On April 28, the Securities and Exchange Commission, the New York State Attorney General, and various federal and state securities regulators, announced that they had settled enforcement actions against 10 investment banking and securities firms under investigation for stock research abuses. Under the global settlement, the firms agreed to pay $487.5 million in penalties, $387.5 million in disgorgement, $432.5 million to fund independent research, and $80 million to promote investor education.

Also on April 28, Finance Committee Chair Charles E. Grassley, R-Iowa, and ranking minority member Max Baucus, D-Mont., introduced S. 936, the Government Settlement Transparency Act of 2003. Based on a legislative proposal introduced last fall in the post-Enron period, the draft bill would curtail the firms' ability to deduct large portions of the payments made under the global settlement.

Background

Under the general rule of section 162(a), a deduction is allowed for all ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business. Section 162(f), however, states that no deduction is allowed "for any fine or similar penalty paid to a government for the violation of any law." The regulations provide that a fine or similar penalty would include amounts paid in settlement of potential liability for a fine, but not compensatory damages paid to a government. In the civil context, even if labeled a penalty, a payment may be deducted if it is imposed as a remedial measure to compensate the government or another party.

There is a large body of case law exploring the gray area between nondeductible fines or penalties and deductible remedial or compensatory payments. There does not appear to be much uniformity of thought on the deductibility of the portion of a settlement payment that, although labeled restitution, is more than compensatory and less than punitive. (See Robert W. Wood, "Should the Securities Industry Settlement Be De-

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ductible?," *Tax Notes*, Apr. 7, 2003, p. 101; Burgess J.W. Raby and William L. Raby, "Tax Consequences of Settlements With Government Agencies," *Tax Notes*, Apr. 22, 2002, p. 565; Philip Manns, "When Does the Payment of Damages Punish the Payor?" *Tax Notes*, Jan. 9, 1995, p. 276.)

Getting Global

The Grassley-Baucus bill would expand "fines or similar penalties" under section 162(f) to include "other amounts," and would cover amounts paid to quasi-governmental agencies. The proposal would exclude from the new broader definition of nondeductible payments only restitution, which would be fairly narrowly defined.

The new section 162(f) would generally make nondeductible any amount paid to or incurred at the direction of a government or regulatory agency to settle the issue of liability for violation of any law or the investigation or inquiry into the potential violation of any law, unless the payment is for restitution.

Any change to the rules should have been done at the beginning of the negotiations, according to Wood.

The draft bill language defines restitution as an amount that the taxpayer can prove constitutes restitution for damage or harm caused. The Joint Committee on Taxation's description of the proposal, however, provides a narrower interpretation: "It is intended that a payment will be treated as restitution only if the payment is required to be paid to the specific persons, or in relation to the specific property, actually harmed by the conduct of the taxpayer that resulted in the payment."

The proposed legislation was drafted with the intention to reach charitable contributions made as part of settlements with governmental and regulatory agencies, according to sources familiar with the drafting. Although not explicitly linked to the charitable contribution statute, which requires donative intent, there is case law that payments made to third parties in lieu of a fine or penalty in an action brought by the government are not deductible, one source explained. It is not clear whether language addressing this point will be added to the official JCT description.

The bill's proposed effective date has been carefully selected to reach the firms involved in the global settlement, according to several sources familiar with the matter. The new section 162(f) would apply to amounts paid or incurred after April 27, 2003, but not to amounts paid or incurred under any binding order or agreement entered into on or before that date. The exception would not apply to an order or agreement requiring court approval unless the approval was obtained on or before April 27, 2003, according to the draft language. This latter language appears to be written to cover the two securities firms that are still negotiating their settlements with the SEC and various regulatory agencies.

All 10 firms participating in the global settlement have agreed that the $487.5 million in penalties are not tax-deductible, according to the terms of the settlement agreements. The consent agreements and final judgments entered April 28 against each of the firms also provide that none of the payments for independent research ($432.5 million) or investor education ($80 million) will be considered disgorgement or restitution, or be used for compensatory purposes. (For the full text of the agreements, see http://www.sec.gov/litigation/litreleases.shtml.) So none of these amounts would be exempted from nondeductibility under the new section 162(f).

Finally, even the funds in the $387 million disgorgement pot, which are generally described as restitution, are not necessarily going to specifically identified victims of the wrongdoing. It has been widely reported that Virginia may use some of the money to reopen recently shuttered Department of Motor Vehicles offices. So the deductibility of any amounts distributed by states to people not actually harmed by the firms' conduct would be in question if the proposed legislation becomes law.

Dirty Pool

Because the proposed legislation covers the securities settlement payments negotiated in 2002, some of those involved in the global settlement claim it effectively has a retroactive effective date.

It is not like the securities industry is playing "dirty pool" with the tax treatment of settlement payments, said Robert Wood, author of *Taxation of Damage Awards and Settlement Payments*. Under existing rules, businesses are allowed to deduct things that are not clearly penalties or fines, he said. The securities firms didn't make the rules, he added.

Any change to the rules should have been done at the beginning of the negotiations, according to Wood. Characterizing a portion of the payment as nondeductible affects the amount of the total settlement, he said. It looks like the senators are saying that the global settlement amount wasn't big enough because it really isn't $1.4 billion after tax, he noted. Because they can't change the number and make it bigger, they will change the law to make the payment more painful, he concluded.

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The legislative maneuvering should come as no surprise, responds one Hill staffer, because it was proposed last year. Baucus introduced it in September 2002 in the Small Business and Farm Economic Recovery Act. Grassley and Baucus, along with Senate Commerce Committee Chair John McCain, R-Ariz., began questioning the SEC and the IRS over the tax aspects of the proposed global settlement earlier this year. (For prior coverage, see *Tax Notes*, Apr. 7, 2003, p. 36.)

"They were negotiating with their eyes wide open," said one Hill source.

Relocating the Gray Area

In the press release describing the proposal, Grassley refers to the confusion about what settlement payments are tax-deductible. The legislation is designed to clear up the confusion and "end all imprecision," according to Grassley.

The tax treatment of settlement payments is a big mess, agreed several practitioners, but none endorsed the proposal as a practicable fix. Preliminary reaction from the tax bar indicates that, as drafted, the proposal merely moves the gray area over on the continuum from deductibility to nondeductibility.

The intent is to tighten up the definition of remedial payments, Wood observed. So instead of arguing about whether a payment is compensatory or penal in nature, he noted, the question will be whether it is restitutional in effect. But the JCT description of restitution as bearing a "substantial quantitative relationship to the harm caused" isn't all that clear, he pointed out. His comments were echoed by several other practitioners.

There is some need for clarification, observed Rick Grafmeyer, formerly with the Joint Committee on Taxation. The proposal may be overly broad because, "I don't think they fully comprehend all the factual situations that arise when making settlements."

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In determining what is deductible restitution, Grafmeyer said, the proposed provision could create a whipsaw effect. Citing what he called a common situation, Grafmeyer posed the hypothetical of a government suing a company asking for $100 million in restitution for damages caused. After negotiations, the company agrees to pay $2 million to settle the case. How can the government say that any part of the settlement payment is not restitution? he wondered. It would effectively give the government two bites of the apple, in terms of characterizing damages and penalties, Grafmeyer concluded.

Future Impact

The proposed legislation will have a chilling effect on settlements, several practitioners said.

Without deductibility, what is the incentive to settle? asked former IRS Commissioner Sheldon S. Cohen, now with Morgan, Lewis & Bockius.

The narrow JCT description of restitution will force negotiating parties to identify all harmed people before coming up with a deductible dollar figure, pointed out one practitioner. At a minimum, it will drag things out, the practitioner said.

Taxpayers facing government or regulatory enforcement actions are not going to go to trial because of this provision, insisted one person familiar with the proposal's drafting. They don't want the bad publicity or the cost of trial, he said. While they may pay less money, he acknowledged, the settlements will be structured to go to those harmed. And the proposal does not diminish the amount that the government gets "one iota," he said.

Policy Call

What is the object of the game, asked Cohen, who participated in the policy discussions when section 162(f) was enacted in 1969 in the midst of antitrust settlements. There's a balance to be struck between punishing people and moving cases, he said.

The firms involved in the global settlement have already been punished, Cohen asserted. The firms have been ridiculed in public, analysts have been fired, and there are going to be all kinds of civil suits brought by individuals, he pointed out.

Others have expressed concern over the proposed approach as bad tax policy. The provision would apply to government settlements in all arenas, including environmental and healthcare issues. In every context, companies have made deductible payments to settle potential liabilities, they point out. Amounts paid in the course of business that are not labeled as fines or penalties are generally considered to be business expenses.

And the money paid out has already been included in the company's income, pointed out Grafmeyer. It is like imposing a double tax on that income if it is required to be paid without getting a deduction, he explained. That isn't good tax policy, he concluded.

Somehow it is a shock to the public conscience when someone does something wrong and gets to deduct the payment to make it go away, acknowledges Wood. "That is a policy issue." But there is an analog in the tax treatment of punitive damages paid to private parties, he pointed out. Apart from President Clinton's 1999 budget proposal to deny deductions for punitive damages paid to plaintiffs in civil lawsuits, which met with resounding defeat, Wood is not aware of any other suggestion that punitive damages should be nondeductible. "When a business incurs the wrath of punitive damages, it deducts them."

It is the difference between *mala in se* and *mala prohibita*, explained Cohen, "it's a public policy call." But one that should be made after careful consideration and hearings, he said. "I haven't seen that rational process here. This is emotional."

Transparency

Those familiar with the drafting of the proposal don't buy the double-tax argument. They point out that the government has been handing out a tax benefit in the course of negotiations without being fully cognizant of protecting the federal fisc. It is a bad situation when one party to the negotiations is tax-neutral while the other side is enormously tax-motivated, said one source.

> ***'It's a public policy call,' but one that should be made after careful consideration and hearings, Cohen said. 'I haven't seen that rational process here. This is emotional.'***

The proposal is about clarifying for all parties and the public what really is a fine or penalty, the Hill staffers explained. Congress never intended to create a gray area in which government settlement payments not going to people harmed by the payer's wrongdoing are considered deductible restitution, their logic goes.

What's the Score?

When scored by the JCT in September 2002, the prior version of the proposed legislation was expected to raise $97 million over 10 years. The Finance Committee staff has asked the JCT for a revised revenue estimate, which is expected back within the first few days of May.

The number is expected to go up, said sources familiar with the scoring. The last figure was based on the proposal's date of enactment effective date, which would have preceded the global settlement. At the time, the JCT also expected that future settlements would be made smaller to take into account the nondeductibility aspect. Further, the JCT believed that settlements would also be structured to come within the tightened definition of restitution to take advantage of the new provision. ■

Full Text Citations

- **Government Settlement Transparency Act**. *Doc 2003-10786 (3 original pages); 2003 TNT 83-23*
- **SEC release on settlement**. *Doc 2003-10734 (6 original pages); 2003 TNT 82-32*
- **Grassley statement on settlement**. *Doc 2003-10721 (1 original page); 2003 TNT 82-29*
- **Grassley-Baucus release on corporate settlement legislation**. *Doc 2003-10728 (4 original pages); 2003 TNT 82-30*
- **Grassley release on SEC settlement**. *Doc 2003-10513 (1 original page); 2003 TNT 80-24*
- **Grassley release on SEC response**. *Doc 2003-10162 (3 original pages); 2003 TNT 77-16*
- **Senators' second letter to SEC**. *Doc 2003-9453 (2 original pages); 2003 TNT 71-82*
- **IRS response**. *Doc 2003-8931 (12 original pages); 2003 TNT 68-20*
- **Senators' letter to IRS**. *Doc 2003-8498 (3 original pages); 2003 TNT 66-58*
- **SEC's response**. *Doc 2003-8500 (6 original pages); 2003 TNT 66-59*
- **Senators' first letter to SEC**. *Doc 2003-5497 (3 original pages); 2003 TNT 41-49*

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