Taxwriters Question Tax Treatment Of Securities Settlements

By Sheryl Stratton — sstratto@tax.org

As regulators' efforts to crack down on corporate wrongdoing come to fruition, congressional taxwriters are questioning whether government agencies are doing enough to protect the fisc.

When it comes to the settlements being negotiated by the Securities and Exchange Commission and other agencies, the issue is whether public policy considerations — that is, the sting of a tax result — should be part of the equation, or whether deductibility should be taken care of as a result of adjusting the size of the payments.

The State of the Law

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."

Not all penalties, however, are nondeductible. The regs provide that a fine includes an amount paid as a civil penalty imposed by federal law. While a civil penalty that is punitive is not deductible under section 162(f), a civil penalty that is remedial is deductible.

In rulings, the IRS has held that the determination of whether a litigation or settlement expense is deductible under section 162(a) depends on the "origin and character of the claim" regarding which the expense was incurred, rather than the potential consequences to the taxpayer's assets. Regarding civil penalties that will be waived by a federal agency in exchange for directing the money elsewhere, the IRS has relied on the origin of claim doctrine. See Rev. Rul. 79-148, 1979-1 C.B. 93, in which the IRS ruled that an amount paid by a taxpayer to a charitable organization as a condition of probation by a federal district court was not deductible under section 162(a) because the amount paid was a fine for purposes of section 162(f).

There is historical authority that if the nature of the fine or penalty is more remedial than punitive, the payment is deductible, according to attorney Robert Wood, author of *Taxation of Damage Awards and Settlement Payments*. Anyone negotiating a settlement wants to have the payment not viewed as a slap on the wrist but as a contribution to a fund, for example, he said. As a practical matter, any taxpayer is going to try to characterize a payment obligation as something that is remedial in nature, he said. But there are not a lot of clear rules, he admitted.

Less clear is the nondeductibility of the portion of a settlement payment labeled restitution but that is more than compensatory and less than punitive. The courts' applications of section 162(f) to settlements with government agencies are not easily summarized or categorized. (See Robert W. Wood, "Should the Securities Industry Settlement Be Deductible?" p. 101 of this issue; 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.)

Settlements, Settlements

The news is filled with investigations by the Securities and Exchange Commission into accounting improprieties, including misuse of special purpose entities, as well as securities law violations. The disgorgement payments and fines are accumulating. The following are a few highlights pulled from the SEC's press releases over the past 15 months.

In January 2002, the SEC announced that Credit Suisse First Boston Corporation, the New York-based broker-dealer and investment bank, had agreed to settle charges filed by the SEC for abusive practices relating to the allocation of stock in "hot" initial public offerings. Credit Suisse agreed to pay disgorgement totaling $70 million, and civil penalties and fines totaling $30 million to resolve the charges and a related action by NASD Regulation. A year later, another brokerage and investment firm, Robertson Stephens Inc., agreed to pay disgorgement, including prejudgment interest, of $885,000 and a penalty of $4,115,000, for a total of $5 million, to settle similar charges.

In April 2002, Xerox agreed to settle an SEC complaint by consenting to the entry of an injunction for violations of the antifraud, reporting, and recordkeeping provisions of the federal securities laws; paying a $10 million penalty; and restating its financials for years 1997 to 2000.

In June 2002, Ernst & Young's Dutch accounting firm consented to a $400,000 civil penalty for an alleged auditor independence violation. In a separate SEC enforcement action for violations of auditor independence rules, PricewaterhouseCoopers and its broker-dealer affiliate agreed to pay a total of $5 million.

In August 2002, Michael J. Kopper, a former high-ranking Enron official, agreed to disgorge approximately $12 million for violating the antifraud provisions of the federal securities laws.

In September 2002, three former senior executives of Homestore Inc. agreed to repay $4.6 million in illegal trading profits gained by overstating advertising revenues by $46 million.

Also in September 2002, Dynegy Inc., the Houston-based energy production, distribution, and trading company, agreed to pay a $3 million penalty to settle charges relating to accounting improprieties and misleading statements.

In December 2002, Frank E. Walsh Jr., a former Tyco International Ltd. director, agreed to pay restitution of $20 million to settle charges that he violated the federal securities laws by signing a Tyco registration statement that he knew contained material misrepresentations.

In December 2002, five broker-dealers consented to pay fines totaling $8.25 million to the SEC, the New York Stock Exchange, and NASD for violations of record-keeping requirements concerning e-mail communications.

In January 2003, former day-traders agreed to pay more than $70 million in penalties and disgorgement to settle charges of securities fraud and violations of the SEC broker-dealer books and records and reporting provisions.

A smaller scale settlement in February 2003 involved a $1 million civil penalty for violations of the antifraud provisions of the federal securities laws by New York money managers, Rhino Advisors Inc. and its president, Thomas Badian, who directed a series of manipulative short sales of Sedona Corp. stock that contributed to the decline in price of Sedona's stock.

This past March, Merrill Lynch announced that it had agreed with the SEC regarding an investigation into two 1999 transactions the firm did with Enron. The firm pledged to pay $80 million in disgorgement, penalties, and interest which will be paid into a court account under the Fair Fund provisions of the Sarbanes-Oxley Act of 2002 for ultimate distribution to victims of the fraud.

Also in March, Samuel Waksal, the former CEO of ImClone Systems Inc., agreed to a partial resolution of the SEC's insider trading case against him by consenting to pay more than $800,000 from the unlawful sales, including prejudgment interest.

In almost all the settlement announcements, the fines and penalties are clearly labeled, and the settling party states that it does not admit or deny allegations of wrongdoing.

Obviously there are more corporate wrongdoing settlements to come. In the past year, the SEC charged WorldCom and HealthSouth for accounting fraud for overstating earnings by $9 billion and $1.4 billion, respectively. Other pending SEC actions involve the likes of Household International, Microsoft, KPMG, Adelphi, PNC Financial Services Group, and former officials of Qwest, Waste Management, and Rite Aid, to name a few.

Called to the Carpet

It was media coverage of the announcement of the global settlement of stock research abuses that prompted the taxwriters to demand an explanation from the government agencies. At the end of last year, then-SEC Chair Harvey L. Pitt, New York Attorney General Eliot Spitzer, several securities associations, the New York Stock Exchange, and state securities regulators announced a "historic settlement" with the nation's top investment firms to resolve issues of conflict of interest at brokerage firms. Ten investment and brokerage firms have agreed to pay $1.4 billion in penalties, restitution, and monies to be used for investor education and independent research. (For the full text of the press release, see http://www.sec.gov/news/press/2002-179.htm.) The SEC has not yet approved the settlement.

Even before settlement was reached, a report questioning the potential tax treatment ran in *The Wall Street Journal.* J. McKinnon, "Firms Accused of Chicanery Could Get Windfall From IRS," Sept. 3, 2002. *The Wall Street Journal* in February 2003 ran a report by Gregory Zuckerman, "Pain of Wall Street Settlement To Be Eased by U.S. Taxpayers," pointing out that large portions of the global settlement were going to be tax-deductible or covered by insurance. In the February 13, 2003 article, SEC spokesperson Christi Harlan is reported as saying that the SEC looks at violations of securities law, and doesn't take other factors into account.

The news reports and the defensive statement made by the SEC's director of public affairs provoked an angry letter to newly seated SEC Chair William H. Donaldson by Senate Finance Committee Chair Charles E. Grassley, R-Iowa, Finance Committee ranking minority member Max Baucus, D-Mont., and Senate Commerce Committee Chair John McCain, R-Ariz. In the February 28 letter, the senators question the SEC's approval of settlement agreements structured to maximize deductibility and insurance coverage.

The senators called Harlan's statements "galling," and deemed announcements highlighting settlements without mentioning tax or insurance consequences "disingenuous." They instructed the SEC to cure its "apparent apathy" about the tax treatment and insurance coverage of settlements by having the commissioners review a general analysis of the tax treatment of the settlements.

The senators acknowledge that payments of restitution are deductible, and state that the tax code should not penalize efforts of direct restitution. But they remain concerned that payments presented as restitution for tax and other purposes may not translate into relief for those harmed. The senators ask the SEC to consider what portion of the settlement will be deductible and what deductibility will mean generally for the firm in regard to tax savings as well as in terms of potential loss of revenue to the Treasury.

Congress, the SEC, and "the American taxpayer need to know how much each firm will pay that will not be deductible and will not be paid by an insurer or other third party," the senators wrote. "[A]rtfully crafted settlements of corporate wrongdoing that have the taxpayers subsidize this wrongdoing or have the costs paid for by somebody else" send the message that the need for reform at the SEC and in corporate America has been a matter of words rather than action, the senators conclude.

Even as members of Congress begin to question the tax treatment of settlements, the securities firms are calling attention to the payments by minimizing the amounts paid as fines. (See Suzanne Craig and Charles Gasparino, "Morgan Stanley Puts Settlement Over Research on a 'Spin' Cycle," *The Wall Street Journal*, Mar. 31, 2003.) In addition to emphasizing that it paid the smallest fine, one securities firm characterized as fines the amounts other firms paid for investor education.

SEC Response

In his March 10 response, Donaldson said that he shared the senators' view that settlements should not be structured to provide wrongdoers with tax or insurance benefits. Firms participating in the stock research settlement were afforded no special treatment, he insisted.

Donaldson enclosed a memo prepared by SEC staff denying that the global analyst research settlement was structured "to facilitate tax deductibility and / or insurability of the firms' settlement payments."

The settlement was designed to achieve maximum benefits for investors, which is the mandate of federal securities laws, the staff memo explained. In bringing enforcement actions, the SEC seeks to deter future violations of securities laws, compensate harmed investors, protect future investors, and maintain the integrity of the capital markets.

The proposed settlement includes $400 million in disgorgement, $400 million in penalties, $450 million for independent research to future investors, and $85 million for investor education. A footnote explains it is the SEC's general practice in litigation and settlements to impose a penalty equal to the amount of disgorgement, defined under securities law as the gross amount of pecuniary gain to the wrongdoer.

Disgorgement is intended to deny the wrongdoers the ill-gotten gains of their violations, and whenever possible, compensate their victims. Monetary penalties, on the other hand, are designed to punish wrongdoers, the SEC staff said. The $400 million in penalties are among the largest ever obtained in civil enforcement actions under securities law, according to the memo.

Under a brief section addressing the tax treatment of settlements, the SEC staff said that disgorgement payments are deductible, while penalties or fines paid to the government are not. Application of section 162(f) to a payment — even one not denominated as a fine or penalty — is not simple or straightforward, the SEC observes. Even a penalty can be deductible if imposed to encourage compliance or as a remedial measure to compensate another party, the memo points out by citing a Tax Court case.

"The complexity of the federal tax law and its application to amounts paid in settlement, whether designated as disgorgement, penalties, or something else, make it difficult for the staff to predict the tax treatment of the global settlement payments with any certainty," the memo states.

While the staff is not blind to the possible tax consequences of obtaining disgorgement in any given case, the SEC should not forgo compensating harmed investors solely because of the consequences, the staff memo provides. Moreover, the staff points out, in enacting the Fair Fund provision of the Sarbanes-Oxley Act, which allows penalties to be added to a disgorgement fund for victims, Congress has also expressed a strong preference for returning illegally obtained profits to harmed investors.

The staff reiterated that it did not afford special treatment to the investment firms in structuring the settlement. As in all settlements, the staff maintained, while mindful of the tax and insurance consequences of settlement payments, the primary focus is on designing a settlement proposal that best achieves the SEC's goals of deterring securities violations, protecting investors, and compensating victims.

The SEC staff is consulting with Treasury to ensure that the SEC does not inadvertently do something to facilitate different tax treatment in this settlement than otherwise would be afforded penalties, disgorgement, and other penalties.

As an aside, on April 1, the SEC announced that Harlan, a former *Wall Street Journal* reporter, is ending her 15-month stint as the SEC's public affairs director to join the Public Company Accounting Oversight Board.

Senators Scorned

Unhappy with the SEC's response, Baucus, Grassley, and McCain wrote an editorial, "A Second Betrayal," that appeared in *The Wall Street Journal's* commentary section on March 13. "The SEC has suggested that matters such as the tax treatment of settlement payments fall outside its purview," the senators said. This is an overly narrow reading of the laws, they countered. The proper view is that the SEC has a duty to protect investors and punish corporate wrongdoers, the editorial provides.

With a brief nod to the SEC's assertions that it did not structure the settlements to be tax deductible or insurable, the senators state that to the extent any portion of the settlement payments are deductible or insured, it leaves taxpayers "picking up the tab for corporate wrongdoing."

The deterrent effect and punitive value of the settlement is eviscerated, and the agreement could instead "reaffirm cynicism among investors about the market's integrity," the senators insist.

Questioning the IRS

Two weeks before firing off the letter to the SEC, Grassley and Baucus wrote IRS Chief Counsel B. John Williams.

In a January 30 letter, the two taxwriters noted that for administrability reasons, some states have said that funds received from the global settlement will be committed to other uses. For example, Virginia plans to use the funds to reopen some of its Department of Motor Vehicle offices. It appears that no investor in Virginia will be compensated for market losses, the senators point out.

The letter briefly summarizes the statutory and regulatory framework for section 162(f), and asks for the "benefit of [the Chief Counsel's] thinking." The senators make clear that they are not asking for an opinion on the appropriate tax treatment of the global settlement, but instead ask the IRS to respond to 12 questions on the state of the law under section 162(f).

The questions cover every gray area of the law under the section, including several questions on the definition of "restitution," such as whether amounts designated as such can be for the benefit of a broader class than those actually harmed. The senators want to know how a settlement agreement should be structured to allow for deduction of restitution amounts.

The senators ask whether Treasury or IRS officials are consulted by government agencies negotiating settlements, and whether the appropriate tax treatment of these settlements should be set forth in the agreements. Are there other tax-related issues arising from settlement payments in lieu of a fine or penalty? What level of attention is the IRS devoting to enforcement of section 162(f), the senators want to know.

And finally, the senators ask whether the IRS intends to issue guidance regarding the appropriate tax treatment of payments made by taxpayers in lieu of a fine or penalty.

The Senate Finance Committee received a response from the IRS on April 2, but is not releasing it until the senators have had time to read and digest the letter, a staffer told Tax Analysts. It is expected to be made public soon.

Policy Clash

It is a classic case of confusing tax policy with social policy, observed one practitioner. Whenever a corporation enters into a large settlement, there is some sense of outrage that restitution or compensation payments made by the wrongdoer are deductible, said one practitioner. The voice questioning deductibility often comes from Congress. The response is typically that settlements structured without any consideration for tax benefits reap less money for the harmed class.

From a purist's tax policy perspective, the proper measurement of income involves deducting any expenses incurred in creating the income. The federal income tax is intended to be a tax on net income and not to act as a sanction against wrongdoing, offered the New York State Bar Association Tax Section in its report on the deductibility of punitive damages. (For the full text of the report, see *Tax Notes,* Nov. 26, 2001, p. 1209.) An accurate measurement of net income necessitates taking into account all expenses associated with the production of income, regardless of moral or legal considerations, the NYSBA report says.

Even fines or penalties can be considered a cost of doing business. The nondeductibility of penalties and fines paid to the government is the codification of the public policy exception embraced by Congress in 1969.

There is no particular coherence to the public policy exceptions under section 162, note the NYSBA report. For example, the NYSBA cited, deductions for certain antitrust damages are disallowed but deductions for damages under other regulatory regimes are allowed; penalties that are remedial in nature are allowed but those that are punitive are not; illegal bribes and kickbacks are not deductible, but only if the state law that prohibits them is enforced.

A proposed expansion of the public policy exception would exacerbate the incoherence in the use of tax penalty provisions and run counter to the neutrality principle of sound tax policy, concluded the NYSBA regarding the Clinton administration's proposal to disallow any deduction for punitive damages paid or incurred by a taxpayer.

As a practical matter, the government agency negotiating the settlement is deciding the level of taxes paid. But every day large corporations determine the level of taxes they pay, points out a tax lawyer. The question is whether the agency is adequately protecting the federal fisc, said another.

Since section 162(f) is a public-policy-driven provision, isn't it appropriate for the SEC, rather than the IRS, to decide how punitive the payment for alleged securities violations should be, offers another practitioner. That would seem to depend on how knowledgeable the SEC is on the tax impact of settlement.

The SEC has only so much flexibility in structuring settlements. If there is no violation, points out one lawyer, the payment cannot be labeled a penalty. If Congress does not like the fact that deductions may be permitted under the law, it would be forced to deal with legislation. For deductibility of settlement payments, the lines are already drawn in the statute, regs, and case law. If the senators don't like where the answer comes out, they will have to change the law.

While ultimately a tax question, the issue really is a public policy question that will be administered by tax people, said one tax professor.

Transparency

What are the taxwriters thinking? They are trying to get clarity on how the IRS views these matters now, explained a Senate Finance Committee staffer.

The issue isn't a matter of injecting public policy into the tax code, the staffer said. Rather, it is about transparency in the settlements, he insisted. The senators want to make sure that what would otherwise be nondeductible payments aren't being negotiated into remedial payments.

People are artfully crafting the agreements to get around the intent of section 162(f), the staffer said. The senators understand that certain things are deductible but would like clarification on where the line is drawn when it comes to fines and penalties. The interest is in openness and transparency about what portion of these payments are nondeductible fines and what portion is deductible reimbursement, he said.

The senators were surprised to discover that the federal government has been tax-neutral about these payments in which the paying parties have an enormous interest in structuring for tax purposes, he explained.

It is good tax policy for the federal government to be more informed about the tax consequences of these payments, the staffer argued.

So even if the situation does not warrant a legislative response, at least the SEC is now talking to Treasury. ■

Full Text Citations

- Senators' **letter to SEC**. *Doc 2003-5497 (3 original pages); 2003 TNT 41-49*
- SEC's **response**. *Doc 2003-8500 (6 original pages)*
- Senators' **letter to IRS**. *Doc 2003-8498 (3 original pages)*