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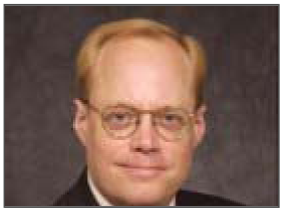

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THE TAX LAWYER

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Rajaratnam $92.8M Penalty Highlights Tax Deduction Rules

Image via hedgeco.net

Convicted hedge fund titan Raj Rajaratnam was ordered to pay a whopping $92.8 million penalty after his insider trading case. Judge Jed S. Rakoff came up with the figure by imposing the maximum penalty of three times Mr. Rajaratnam's illegal gains at Galleon Group. But however you get to the number, it's the largest ***ever*** assessed against a person in an SEC insider trading case.

In fact, when you add the fines and forfeitures ordered when Mr. Rajaratnam was sentenced to 11 years in prison, he will pay over $156 million. Many commentators were surprised that $92.8 million in civil penalties were heaped onto the already stiff criminal fines. But in the pantheon of big spenders, 1980s junk bond king Michael Milken still paid a lot more: $600 million in fines and restitution after he pled guilty to securities violations.

Much of that was restitution—paid back to the people who were injured—which can be different from fines when it comes to taxes. But it turns out fines can sometimes qualify for tax deductions too. And that can mean paying them, while painful, is not quite as painful after all.

Example: If you pay a $100 million fine you can deduct and are in a combined 40% state and federal tax bracket the fine only costs you $60 million after tax.

The general rule is that payments in a business context are deductible. That's even true with punitive damages you are ordered to pay. However, the tax code prohibits deducting "any fine or similar penalty paid to a government for the violation of any law." See IRC Section 162(f).

That includes criminal and civil penalties as well as sums paid to settle potential liability for a fine. Even so, many individuals and companies alike end up able to deduct settlements that are at least quasi-fine-like in character. And there are huge dollars at stake.

Example: Exxon's $1.1 billion Alaska oil spill settlement actually cost Exxon $524 million after tax. See BP, Oil, and Deducting Punitive Damages.

What's a nondeductible fine or penalty? Don't go by names alone. First, you only have to worry about payments to a governmental entity. Surprisingly, punitive damages paid to private parties are fully deductible. But even some fines or penalties paid to the government can be deductible.

If the fine or penalty is intended to be ***punitive***, then the payment is probably nondeductible. But if it is instead ***remedial*** in nature, then it may be deductible ***despite its "fine or penalty" name***. Environmental payments and a variety of payments to governments and quasi-governmental entities are routinely questioned in this way.

It is sometimes even possible to settle with a government agency and actually cover this issue in the settlement agreement, specifying that any "fine" is actually remedial rather than punitive in character. In light of these standards, how about Mr. Rajaratnam's $92.8 million? I don't know, but my guess would be that his penalty was meant to punish.

For more, see:

Rajaratnam Ordered to Pay $92.8 Million Penalty

Rajaratnam Ordered in SEC Case to Pay Record $92.8 Million Fine

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