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Record Settlement Payments, Record Tax Deductions?

—By Robert W. Wood, Wood LLP

Law360, New York (December 13, 2013, 12:31 PM ET) — At JPMorgan Chase & Co., you want record earnings and deals, not record settlement payments. But the nation's biggest bank with $2.4 trillion in assets just took the cake for the biggest and most painful settlement ever. The U.S. Justice Department concluded a settlement agreement with the bank in which JPMorgan Chase and its subsidiaries will dish out $13 billion to various government agencies and several states, the largest settlement payment to the government on record.

According to the Department of Justice release, $9 billion will settle various federal and state civil claims. The Justice Department will receive $2 billion to settle claims filed under the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), and $1.4 billion will go toward settling federal and state securities claims by the National Credit Union Administration (NCUA). In addition, the Federal Deposit Insurance Corporation will get $515.4 million to settle federal and state securities claims, and the bank is paying a massive $4 billion to settle federal and state claims by the Federal Housing Finance Agency (FHFA).

To these outsized numbers you can tack on claims from five different states. California, for instance will get $298.9 million, the state with the biggest payout after New York's whopping $613 million. The remaining $4 billion of the agreement are reserved for consumer relief.

This remediation category is to include money for loan modifications, principal forgiveness, targeted originations, and other actions meant to help consumers. JPMorgan has plenty of time to make good on its promises, all the way until Dec. 31, 2017. Significantly, the agreement does not absolve the bank or any of its executives from future criminal charges. That means there still could be related legal proceedings.

The tax treatment of this settlement shouldn't be controversial, and yet it's clear that these big figures and the nature of litigation settlements have sparked debate. Some are even angry about it. According to a statement made by JPMorgan's chief financial officer, $7 billion of the settlement are specifically for compensatory payments.

According to current tax law, that should mean the bank can claim a whopping $7 billion tax deduction. That arguably shifts around 35 percent of the bank's burden — $2.45 billion — onto the backs of taxpayers. In short, this is a business expense, not a fine or penalty, and that means a deduction.

Of course, Code Section 162(f) bars a deduction for any fine or similar penalty paid to a government for a violation of law. However, many payments have been ruled not to constitute fines for that purpose. Thus, a late filing fee, which is really designed to

encourage prompt compliance with the law, has not been treated as a fine. See Reg. §1.162-21(b)(2).

Another exception to the nondeductibility of fines relates to so-called compensatory fines. If a fee is imposed only to compensate a government entity for harm it has suffered, as distinguished from a fine having a punitive motivation, a deduction should be available. In determining what is a nondeductible fine or penalty, though, names alone are not controlling.

If the fine or penalty is intended to be punitive, then the payment is probably nondeductible. But if it is remedial, it may be deductible despite a "fine or penalty" label.

It is sometimes possible for a corporation to settle with a government agency and explicitly address taxes in the settlement agreement, specifying that any "fine" is actually remedial rather than punitive in character.

It can work the other way around, too. The U.S. Public Interest Research Group argued that precluding JPMorgan Chase from claiming tax deductions should be explicit to safeguard taxpayers. However, no such clause made it into the final version of the settlement.

Thus, the fines in JPMorgan's settlement that are essentially reimbursements to the government for losses should be tax deductible. Tax language in settlement agreements doesn't bind the IRS, but it goes a long way toward avoiding tax disputes.

In any case, these sorts of tax benefits resulting from settlements are not unusual. In mid-2013, Citigroup agreed to pay $968 million to Fannie Mae to resolve claims that it breached representations and warranties on 3.7 million residential mortgages. Citi said the sum is covered by its existing reserves for mortgage repurchases.

Presumably Citigroup should be able to deduct the payment. Of course, some mortgage purchases have to be capitalized so cannot be immediately written off. Thus, when Bank of America agreed to pay Fannie Mae $3.6 billion, the bank also repurchased nearly $7 billion in mortgages.

In short, Citigroup's deal after taxes could be a lot less than $968M. That is normally the case, and not just with compensatory damages. Punitive damages paid to private parties are tax deductible too. Only government fines or penalties are not deductible, and even for those, some are allowed if they are remedial.

Some find this troubling from a policy standpoint. Remember Exxon's $1.1 billion Alaska oil spill settlement? It reportedly cost Exxon $524 million after taxes. More than half of the $900 million in civil damages Exxon paid were also deductible.

There are many other examples of the public and the press noticing the discrepancy between the pre- and post-tax settlement costs. For example, when Marsh & McLennan reached an $850 million settlement in 2005 over bid-rigging and conflicts of interest, the press trumpeted the after-tax cost as hundreds of millions of dollars less. In 2006, Boeing held the spotlight with a $615 million settlement over contract improprieties, spawning ire that taxpayers were subsidizing settlements by wrongdoers.

In response to outrage over such deductions, a bill dubbed the Government Settlement Transparency & Reform Act (S. 1654, 113th Congress) was introduced on Nov. 5, 2013. Co-sponsored by long-time tax reform advocates Sen. Harry Reid, D-Nev., and Sen. Chuck Grassley, R-Iowa, the bill would "amend the Internal Revenue Code of 1986 to deny tax deductions for corporate regulatory violations." More specifically, it would make corporate settlement payments to the government for even remedial penalties nondeductible. I am very skeptical that such a bill will pass.

As a homeowner, investor and taxpayer, you may feel that you have already paid for the financial and housing crises in several ways. But looking at the tax deductions claimed by JPMorgan and others, perhaps your payments as a taxpayer aren't over just yet.

Robert Wood is a tax lawyer with a nationwide practice. The author of more than 30 books including "Taxation of Damage Awards & Settlement Payments" (4th Ed. 2009 with 2012 Supplement, www.TaxInstitute.com), he is also a tax columnist for Forbes.com and Tax Notes magazine, as well as the host of the Legal Broadcast Network's Tax Law Channel.

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