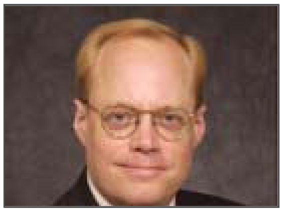

Robert W. Wood
THE TAX LAWYER

TAXES | 8/26/2013

SAC Indictment Could Have Silver Lining

Steven Cohen, founder of SAC Capital

Since the Department of Justice filed a criminal indictment against SAC Capital, the hedge fund led by Steven Cohen, many investors will probably flee in spite of past returns. Founded by Cohen in 1992, SAC Capital has delivered average annual net returns of some 30% over the last two decades. The charges include one count of wire fraud and four counts of securities fraud. See DOJ'S Case Against SAC Capital Is Built On Three Prongs.

While Cohen himself may be untouchable, eight former SAC Capital employees are mentioned in the indictment, and six have pled guilty to insider trading. The other two, Michael Steinberg and Mathew Martoma, are set for trial in November. Cohen himself was the ultimate heavyweight the government was after.

The indictment claims that SAC Capital's top management ignored "indications that trading recommendations were based on Inside Information." And all the chips are not yet on the table, with new allegations that Mr. Martoma was tipped by another so-far unnamed doctor. See New Martoma indictment describes second doctor as insider source.

The government claims that this criminal enterprise was soup to nuts, from hiring to compliance. SAC Capital's compliance department is alleged to have weak document retention policies and more. See The Government Is Moving To Destroy Legendary Hedge Fund Firm SAC Capital. Although Cohen has long denied any wrongdoing, SAC agreed to pay $616 million, the largest insider trading settlement ever to resolve a related SEC action. See Steve Cohen's Hedge Fund To Pay Over $600M To Settle Insider Trading Charges.

That settlement was a win for the SEC, but a win for Cohen too. He and his funds admitted no wrongdoing and settled, and that probably means a cool tax deduction. The SEC charged CR Intrinsic with insider trading in November 2012. See SEC Complaint and Summaries of SEC Enforcement Actions Against Insider Trading.

In that sense, even the indictment of SAC has a tarnished silver lining. Cohen himself eluded charges, no small feat considering the government's pursuit. Plus, the indictment means SAC is fighting for its survival and should be able to deduct all its lawyers and advisers fees. That may sound like a silly point, but it isn't.

Convicted hedge fund titan Raj Rajaratnam was ordered to pay a $92.8 million penalty, but that involved a conviction and forfeitures related to Galleon Group. Mr. Rajaratnam was sentenced to 11 years in prison plus $156 million. Recall that 1980s junk bond king Michael Milken paid $600 million in fines and restitution after he pled guilty to securities violations. Much of that was restitution—paid back to injured parties.

Restitution can be different from fines when it comes to taxes. But even fines can sometimes qualify for tax deductions. Even punitive damages are deductible. The tax code prohibits deducting "any fine or similar penalty paid to a government for the violation of any law," including criminal and civil penalties plus sums paid to settle potential liability for fines. See IRC Section 162(f).

Even so, many companies and individuals can deduct settlements even if they are quasi-fine-like in character. Huge dollars are at stake, such as Exxon's $1.1 billion Alaska oil spill settlement. It cost Exxon $524 million after tax. More recently, BP's Gulf spill raised similar issues. See BP, Oil, and Deducting Punitive Damages.

In determining what's a nondeductible fine or penalty, don't go by names alone. You only have to worry about payments to a governmental entity. And even some fines or penalties paid to the government are deductible. 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. Environmental payments are routinely examined in this way. It is sometimes even possible 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.

SAC probably has bigger issues on its collective mind than taxes. Still, assuming it survives it seems likely that it can expense most if not all of this unsavory episode.

You can reach me at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.