

**Office of Chief Counsel  
Internal Revenue Service  
memorandum**

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subject: Section 162(f) and Disgorgement for Violating a Federal Securities Law

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

Previously, and prior to the opinion in Kokesh v. SEC, 137 S. Ct. 1635 (2017), this office provided written advice on the above-referenced subject. (See CCA 201619008.) Recently, we provided oral advice addressing the effect of the holding in Kokesh, and, as you requested, we are providing a written analysis in this Chief Counsel Advice.

ISSUE

Whether section 162(f) of the Internal Revenue Code prohibits a deduction under section 162(a) for an amount paid as disgorgement for violating a federal securities law.

CONCLUSION

Section 162(f) prohibits a deduction under section 162(a) for an amount paid as disgorgement for violating a federal securities law.

LAW AND ANALYSIS

Section 162(f) of the Code provides that no deduction shall be allowed under section 162(a) for any fine or similar penalty paid to a government for the violation of any law. Section 1.162-21(b)(1) of the Income Tax Regulations provides that a fine or similar penalty includes<sup>1</sup> an amount (i) paid pursuant to conviction or a plea of guilty or nolo contendere for a crime (felony or misdemeanor) in a criminal proceeding; (ii) paid as a civil penalty imposed by federal, state, or local law; (iii) paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal); or (iv) forfeited as collateral posted in connection with a proceeding that could result in imposition of such a fine or penalty. Section 1.162-21(b)(2) provides, in part, that compensatory damages (including damages under section 4A of the Clayton Act (15 U.S.C. § 15a), as amended) paid to a government do not constitute a fine or penalty.

The characterization of a payment for purposes of section 162(f) depends on the origin of the liability giving rise to it, not the ultimate use of the funds. Bailey v. Commissioner, 756 F.2d 44, 47 (6th Cir 1985); Nacchio v. United States, 824 F.3d 1370, 1380-1381 (Fed. Cir. 2016), cert. denied, 582 U.S. \_\_\_\_ (2017). Courts have held that section 162(f) prohibits a deduction for civil penalties "imposed for purposes of enforcing the law and as punishment for the violation thereof," and courts have also held that some payments, although labeled as "civil penalties," are deductible if "imposed to encourage prompt compliance with a requirement of the law or as a remedial measure to compensate another party." Waldman v. Commissioner, 88 T.C. 1384, 1387 (1987), aff'd without opinion, 850 F.2d 611 (9th Cir. 1988); Stephens v. Commissioner, 905 F.2d 667, 672-673 (2d Cir. 1990); see also Southern Pacific Transp. Co. v. Commissioner, 75 T.C. 497, 646-654 (1980). It is important to clarify that the correct analysis involves whether the payment was "a remedial measure to compensate another party," not whether the payment was "a compensatory or remedial measure." See Stephens, 905 F.2d at 673. The word "remedial" is not in the statute or the regulations. The fact that a payment is "remedial" does not by itself determine the tax treatment; the tax treatment depends on whether the payment is more punitive or compensatory. If a payment serves both a nondeductible purpose and a deductible purpose, it is necessary to determine which purpose the payment primarily serves. See id. at 673.

It is also important to clarify that, although the issue under section 162(f) is often referred to as whether a payment is punitive or compensatory, the scope of section 162(f) is not restricted to payments that are "punitive" in the narrow sense that they are imposed solely as retribution for *past* wrongdoing. The scope of "punitive" in this context includes the purpose of enforcing the law by deterring the proscribed conduct *in the future*: "Thus, it is clear that, if the deduction of a civil fine (or similar penalty) is to

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<sup>1</sup> We note that section 7701(c) provides that the terms "includes" and "including" when used in a definition shall not be deemed to exclude other things otherwise within the meaning of the term defined. See also § 301.7701-16 of the Procedure and Administration Regulations.

fall within the proscription of section 162(f), the fine must be one which *punishes and/or deters.*” Middle Atlantic Distributors, Inc. v. Commissioner, 72 T.C. 1136, 1143 (1979) (emphasis added); see also True v. United States, 894 F.2d 1197, 1205 (10th Cir. 1990) (amounts paid for violating the Federal Water Pollution Control Act were not deductible because they served "a deterrent and retributive function similar to a criminal fine"). Therefore, a payment imposed primarily for purposes of deterrence and punishment is not deductible under section 162(f).

In Kokesh v. SEC, 137 S. Ct. 1635 (2017), the United States Supreme Court held that disgorgement imposed as a sanction for violating a federal securities law was a penalty for purposes of the 5-year statute of limitations in 28 U.S.C. § 2462 (applicable to an action for the enforcement of any civil fine, penalty, or forfeiture). In its analysis, the Supreme Court stated that “SEC disgorgement . . . bears all the hallmarks of a penalty: It is imposed as a consequence of violating a public law and it is intended to deter, not to compensate.” Kokesh, 137 S. Ct. at 1644. The Court also stated that “courts have consistently held that “[t]he primary purpose of disgorgement orders is to deter violations of the securities laws by depriving violators of their ill-gotten gains.” Id. at 1643 (citing SEC v. Fischbach Corp., 133 F.3d 170, 175 (2d Cir. 1997)). Because, as the Supreme Court held, disgorgement payments are penalties and are not compensatory, section 162(f) prohibits a deduction under section 162(a) for an amount paid as disgorgement for violating a federal securities law.

Please coordinate any litigation on this section 162(f) issue with our office. Please call Christopher Wrobel at (202) 317-7011 if you have any questions.