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Business 1 =  
Court 1 =  
Date 1 =  
Date 2 =  
Entity 1 =

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Subsidiary 1=  
Subsidiary 2 =  
Taxpayer =  
Year 1 =

ISSUES

(1) Whether certain language in the settlement agreement at issue is controlling for purposes of characterizing the settlement payments as deductible under section 162(a) of the Internal Revenue Code or nondeductible under section 162(f) for federal income tax purposes; and

(2) Whether a disgorgement payment to settle proceedings initiated by

is deductible under section 162(a)

or nondeductible under section 162(f).

CONCLUSIONS

(1) The provisions in the settlement agreement at issue are not controlling for purposes of characterizing the settlement payments as deductible or not deductible for federal tax purposes.

(2) Additional factual development is necessary to determine whether the disgorgement payment to \_\_\_\_\_ is deductible under section 162(a) or nondeductible under section 162(f).

FACTS

In Year 1, Subsidiary 2 made payments to settle lawsuits brought by \_\_\_\_\_ . The complaints in the lawsuits brought by the \_\_\_\_\_ alleged \_\_\_\_\_ and violations of \_\_\_\_\_ statutes in connection with \_\_\_\_\_ Subsidiary 1 and Subsidiary 2 of, for example,

(the Lawsuits).

For its Year 1 taxable year, Taxpayer seeks to deduct under section 162(a) a total of Amount paid to settle the Lawsuits brought against Subsidiary 1 and Subsidiary 2 by the \_\_\_\_\_. The Lawsuits involved losses incurred by the \_\_\_\_\_ themselves, \_\_\_\_\_, in connection with Subsidiary 1 and Subsidiary 2 of \_\_\_\_\_. In addition, Taxpayer seeks to deduct \_\_\_\_\_ in disgorgement paid to \_\_\_\_\_.

1. The Lawsuits

On Date 1 \_\_\_\_\_ filed a complaint in Court 1 against Subsidiaries 1 and 2, pursuant to the \_\_\_\_\_

\_\_\_\_\_, in connection with Subsidiary 1 and Business 1 for \_\_\_\_\_. In addition, the \_\_\_\_\_

The \_\_\_\_\_ statutes on which the \_\_\_\_\_ based the Lawsuits include various \_\_\_\_\_

\_\_\_\_\_ statutes that generally provide both punitive and compensatory remedies. For example, in their prayers for relief, most of the complaints in the Lawsuits asserted claims for civil penalties; most of the asserted claims for injunctive relief, attorneys' fees and costs of litigation, an accounting, and disgorgement; \_\_\_\_\_ of the \_\_\_\_\_ asserted claims

for restitution; of the asserted claims for pre-judgment and post-judgment interest; and of the requested treble damages.

On Date 2, Subsidiaries 1 and 2 entered into a settlement agreement with and the in order to settle the Lawsuit and all claims alleged in the complaints in the Lawsuits (the Settlement Agreement). The Settlement Agreement contains no admissions of violations of any law by Subsidiary 1 or Subsidiary 2.

Under the terms of the Settlement Agreement, Subsidiary 1 and Subsidiary 2 agreed to pay a total of , consisting of an payment to and an additional to among the .<sup>1</sup>

The Settlement Agreement specifically characterizes the payment to as a recovered pursuant to the . Taxpayer has not deducted this amount for federal income tax purposes.

With respect to the payable to the , however,

In addition , of the received by , is under law. The remaining of the payment will be used for

However, that

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1

The Settlement Agreement also sets forth the specific portions of the  
 paid to . Each received , except  
 the following : ( ; and .

The Settlement Agreement also describes the purposes for which some of the  
 would use share of the settlement payment, as set forth in  
 greater detail in your request. Funds would be used for purposes such as

. Some indicated that the amounts  
 would be deposited in or used at the discretion of the  
 . The Settlement Agreement indicates that for  
 and , part of the settlement proceeds would  
 be used to reimburse for in  
 Subsidiary 1 and Subsidiary 2- . Regarding the share of the settlement  
 proceeds that was designated for , the Settlement Agreement  
 provides that a portion would be deposited in

Some of the by the shortly after the  
 execution of the settlement agreement describe the purposes for which the settlement  
 proceeds would be used. For example:

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for which the use of the settlement proceeds were described in both the Settlement Agreement and included:

2. Disgorgement Payment

brought an against Business 1, a business unit of Subsidiary 1. In an provisions of the determined that Business 1 violated certain in

connection with Business 1's

also determined that Business 1 received approximately in compensation from the

at issue. As a result of these violations ordered Business 1 to make the following payments: (1) a civil monetary penalty in the amount (2) in disgorgement; and (3) in pre-judgment interest. Taxpayer intends to claim a deduction for the disgorgement payment. Taxpayer did not deduct the civil monetary penalty.

## LAW AND ANALYSIS

### 1. Section 162(f)

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 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 paid to a government do not constitute a fine or penalty.

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." Southern Pacific Transportation Co. v. Commissioner, 75 T.C. 497, 652 (1980). Courts also have held that some payments, although labeled as "civil penalties," are deductible if they are "imposed to encourage prompt compliance with a requirement of the law or as a remedial measure to compensate another party for expenses incurred as a result of the violation." Id. See also Stephens v. Commissioner, 905 F.2d 667, 672-73 (2d Cir. 1990); Waldman v. Commissioner, 88 T.C. 1384, 1387 (1987), aff'd without opinion, 850 F.2d 611 (9th Cir. 1988). Compensatory payments generally "return the parties to the status quo ante." Stephens, 905 F.2d at 673. In contrast, a payment imposed primarily for purposes of deterrence and punishment is not deductible under section 162(f). Middle Atlantic Distributors Inc. v. Commissioner, 72 T.C. 1136, 1150 (1979), acq., 1980-2 C.B. 2 (1980) ("if the deduction of a civil fine (or similar penalty) is to fall within the proscription of section 162(f), the fine must be one which punishes and/or deters"). See also Waldman, 88 T.C. at 1389. If a payment serves both a nondeductible purpose

and a deductible purpose, it is necessary to determine which purpose the payment primarily serves. Middle Atlantic Distributors Inc., 72 T.C. at 1145.

In general, 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) (holding that civil penalties that a court permitted a taxpayer to apply to the settlement of a class action suit against the taxpayer were not deductible under section 162(f) because the amount originally was characterized by the court as a civil penalty).

The taxpayer has the burden to show that the settlement payments were made to compensate the parties harmed by its conduct through, for example, examining whether the provisions of the statutes cited in the complaints on which the settlement payments were based had largely compensatory, as opposed to punitive, purposes, the language in the settlement agreement, and other evidence that demonstrates the parties' intent. Middle Atlantic Distributors Inc., 72 T.C. at 1150-53.

Taxpayer argues that the

indicates that the parties intended the settlement payments not to be a fine or similar penalty. However, Taxpayer ignores which provides that

. Because the language of is specific with respect to

is, therefore, not determinative of the character of the settlement payments for purposes of section 162(f).

” but Taxpayer did not elaborate regarding how the settlement payments further the compensatory and remedial goals of those statutes. The statutes on which the based the Lawsuits contain both punitive and compensatory forms of relief. In addition, the requested both punitive and compensatory relief complaints. For example, asked for restitution, which could be compensatory in nature; disgorgement, which could be either compensatory or punitive; and civil penalties, which could be punitive.

. The Settlement Agreement



does not apportion the settlement payments between compensatory and punitive remedies, yet Taxpayer argues that the settlement payments were not intended by the parties to be fines, penalties, or payments in lieu thereof. It is Taxpayer's burden to substantiate why it believes that the settlement payments it made to the are compensatory.

2. Disgorgement

For purposes of section 162(f), disgorgement in can be primarily compensatory or primarily punitive, depending on the facts and circumstances of a particular case. In some cases, there may be certain facts that weigh in favor of treating disgorgement as primarily compensatory for tax purposes. In some cases, for example, the amount of the wrongdoer's profit may equal the victims' losses. Furthermore may be using disgorgement as a means to obtain compensation who can receive distributions through a

Fund. See generally

Nevertheless, the fact that disgorgement goes to a fund does not always mean that it is primarily compensatory. Bailey, 756 F.2d at 47 (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). By comparison, when \_\_\_\_\_ adds civil penalties to a \_\_\_\_\_, those amounts are not deductible by the wrongdoer.

On the other hand, disgorgement can be primarily punitive for tax purposes in some cases, where it serves primarily to prevent wrongdoers from profiting from their illegal conduct and deters subsequent illegal conduct. Courts may consider the amount of the disgorgement ordered in determining the appropriate amount of a civil penalty to be imposed for violation of \_\_\_\_\_, and such penalty amount may be less when there is substantial disgorgement. See, e.g.,

Consequently, disgorgement can serve as a direct substitute for a civil penalty when it reduces the amount of the penalty that would otherwise be imposed. Additionally, some cases that impose disgorgement as a discretionary equitable remedy can have similarities to some cases that impose forfeiture as required by statute. Cf.

We note that forfeiture is not deductible even when it is used by the government to compensate victims. See Bailey, 756 F.2d at 47. Forfeiture and restitution to a victim serve different purposes, and a criminal defendant can be required to pay restitution and also forfeit an equal amount. United States v. Newman, 659 F.3d 1235, 1239-42 (9th Cir. 2011). Although it is not obligated to do so, the government has discretion to use forfeited assets to restore a victim whom the defendant has failed to compensate. See 28 U.S.C. § 2461(c) (cross-referencing 21 U.S.C. § 853); 21 U.S.C. § 853(i)(1) (authorizing the Attorney General to grant remission of criminal forfeitures to victims); 28 C.F.R. Part 9 (§§ 9.1-9.9) (providing procedures for remission).

Taxpayer argues generally that the disgorgement payment it made was meant to compensate a \_\_\_\_\_ who were purportedly harmed by Taxpayer's conduct. However, similar to its argument with respect to the settlement payments made to the \_\_\_\_\_, Taxpayer is required to provide specific reasons why it believes the disgorgement is compensatory rather than punitive.

#### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

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