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In this article, Brauweiler and Gerachis refute the conclusion in ILM 201619008 that a payment to the SEC under the U.S. Foreign Corrupt Practices Act to disgorge profits is nondeductible under section 162(f). They argue that the IRS's conclusion flies in the face of well-settled law that the disgorgement of profits under that act is generally non-punitive in nature.

Section 162(f) disallows a tax deduction for any fine or similar penalty paid to a government for the violation of any law. Civil fines and penalties may or may not be subject to disallowance under section 162(f).[1] As a general rule, to decide whether section 162(f) applies, a court must first decide if the statute imposing the fine is an enforcement tool that is punitive in nature or instead is non-punitive in nature. In each case, an inquiry must be made into the purpose of the underlying remedy represented by the settlement payment. Courts will often look beyond the label of the remedy (for example, fine or penalty) to determine whether the payment is intended to be punitive.

In a recent legal memorandum (ILM 201619008),[2] the IRS concluded that section 162(f) prohibits a deduction for a payment representing the disgorgement of profits made under a consent agreement between the SEC and the taxpayer for civil violations of the U.S. Foreign Corrupt Practices Act (FCPA).[3] That conclusion flies in the face of well-settled law that the disgorgement of profits under the FCPA is generally non-punitive in nature. Disgorgement is a remedy in equity, designed to prevent unjust enrichment, not to punish.[4] The memorandum distorts the standard for section 162(f) and disregards the relevant FCPA case law. As discussed below, under the proper legal standard and on-point authority, section 162(f) presents no barrier to deductibility for the taxpayer in ILM 201619008.

Background

The FCPA makes it unlawful for some classes of persons and entities to act corruptly in furtherance of an offer, promise, authorization, or payment of money or anything of value to a foreign government official to secure an improper advantage or assist in obtaining or retaining business for any person (the anti-bribery provisions). The FCPA also requires issuers of securities to maintain both accurate records and a system of internal controls to prevent those actions (the accounting provisions).[5]

The taxpayer in ILM 201619008 was incorporated and headquartered in the United States. Its second-tier subsidiary, a disregarded entity (DE), manufactured and sold products in a foreign country. DE's books and records were consolidated into the taxpayer's books and records and were reported in the taxpayer's financial statements.

The SEC alleged that in the years at issue, some of DE's employees and executives intentionally falsified DE's books and records concerning items

[1] *Southern Pacific Transportation Co. v. Commissioner*, 75 T.C. 497 (1980) (If a civil penalty is imposed for purposes of enforcing the law and as punishment for the violation thereof, its purpose is the same as a fine exacted under a criminal statute, and it is ''similar'' to a fine).

[2] An internal legal memorandum simply reflects the opinion of its author and is not to be relied on as precedent or as the official position of the IRS.

[3] 15 U.S.C. section 78dd-1, et seq.

[4] *See SEC v. Contorinis*, 743 F.3d 296 (2d Cir. 2014).

[5] *See* 15 U.S.C. section 78m(b)(2).

of value that had been given to the foreign country's officials to obtain business benefits in that country. The SEC also claimed that the taxpayer failed to implement adequate internal accounting and financial controls to detect and prevent corruption-related violations under the FCPA, including improper payments to foreign officials.

The SEC filed a civil complaint against the taxpayer alleging specific violations of the FCPA's anti-bribery and accounting provisions. The prayer for relief requested injunctive relief and asked that the taxpayer be required to "disgorge ill-gotten gains wrongfully obtained as a result of its illegal conduct plus prejudgment interest thereon." A district court entered final judgment against the taxpayer in the SEC civil proceeding,[6] and the taxpayer paid the disgorgement amount due to the SEC, consistent with the terms of a previously executed consent agreement with the commission.

IRS Applies Wrong Standard

The memorandum incorrectly concludes that the disgorgement payment is nondeductible. It does so by applying the wrong standard and failing to follow the controlling FCPA case law. In rejecting the taxpayer's arguments, the IRS develops a false standard based on a misreading of *Stephens*,[7] which did not even involve section 162(f). The analysis portion of the memorandum says that the focus is whether the payment is "primarily compensatory" or "primarily punitive." It then mistakenly argues that a disgorgement payment is deductible only if it compensates an injured party. Contrary to the IRS's position in the memorandum, the cases indicate that the category of non-punitive payments is broader than payments that are compensatory in nature.

In this regard, the memorandum misreads the Second Circuit's opinion in *Stephens*. Jon Stephens made restitution in settlement of a civil suit filed by the embezzled party to recover the funds. At issue was whether the public policy exception to allowable losses under section 165 applies when an individual has repaid embezzled funds. To the extent the court addressed section 162(f), it did so only to draw on public policy considerations relevant to section 165. The court held that section 162(f) did not apply because the taxpayer paid the embezzled party, not a government.

Stephens was convicted of criminal conspiracy and fraud in connection with a scheme to defraud Raytheon Co. The trial judge sentenced him to five years in prison and monetary fines for each count on which he was convicted. The judge agreed to suspend Stephens's prison sentence and place him on probation on the condition that he make restitution to Raytheon of the embezzled funds, plus interest. Raytheon also filed two civil suits against Stephens. Stephens settled with Raytheon and attempted to deduct the restitution payment under section 165(c)(2) as an uncompensated loss in a transaction entered into for profit.

The issue in the tax case was whether allowing the deduction under section 165 would "frustrate a sharply defined public policy." The government argued that the restitution was paid in lieu of a penalty, but the Second Circuit disagreed, holding that the sentencing judge had ordered the restitution "in addition to" the explicit criminal fines (which were nondeductible and not at issue). The Second Circuit found that the payment was not punitive in nature but instead was remedial. The court did not purport to make any distinctions between types of deductible payments under section 162(f), because that provision did not apply.

The IRS in ILM 201619008 also takes the position that to be deductible, a settlement payment under the securities laws must make the injured party whole as opposed to serving some other remedial purpose. Focusing on an illusory injured party rather than the wrongdoer, the IRS contends that there were no facts indicating that the purpose of the taxpayer's disgorgement was to compensate an injured party. In support, it relies on *Allied-Signal*.[8]

However, *Allied-Signal* did not turn on whether the taxpayer's payment compensated an injured party. To the contrary, both the Tax Court and the Third Circuit found that the clear purpose of the payment in that case was to satisfy a criminal fine imposed by the sentencing judge.

In 1976 the predecessor of Allied-Signal Inc. was indicted under the Refuse Act of 1899 for environmental contamination in Virginia caused by Kepone, a highly toxic chemical Allied had sold as an insecticide. Allied entered a plea of *nolo contendere* and agreed to pay court-ordered fines of $13.24 million. At the suggestion of the sentencing judge, who had no legal power to order Allied to pay the fines to the state rather than the federal government, Allied created a charitable endowment fund dedicated to repairing Kepone damage in Virginia. It contributed $8 million to the fund in 1977, which the judge credited dollar-for-dollar against the fine.

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[6]There was also a parallel criminal investigation and settlement. The criminal payment is nondeductible and was not at issue in ILM 201619008.

[7]*Stephens v. Commissioner*, 905 F.2d 667 (2d Cir. 1990).

[8]*Allied-Signal Inc. v. Commissioner*, T.C. Memo. 1992-204, *aff'd*, 54 F.3d 767 (3d Cir. 1995).

Allied deducted the $8 million on its 1977 tax return as an ordinary and necessary business expense under section 162(a). The Tax Court rejected the company's argument that the $8 million payment was voluntary. It held that the amount was paid as the quid pro quo for reduction of the criminal fine imposed by the sentencing judge. The Tax Court further held that the judge clearly intended the fine to punish Allied and deter similar conduct in the future. Finally, the court dismissed Allied's argument that the $8 million was not paid ''to a government,'' as required by section 162(f). The Third Circuit affirmed on all three points, holding that the $8 million was paid to the endowment at the direction of the sentencing judge in lieu of the criminal fine.

Civil Disgorgement Is Remedial, Not Punitive

The law is well settled that the remedy of civil disgorgement under the securities laws merely returns the wrongdoer to the status quo before any wrongdoing had occurred. It is remedial in nature.[9] Case law has uniformly permitted deductions for payments to disgorge ill-gotten gains. Disgorgement merely dispossesses a wrongdoer of the profits earned from proscribed conduct.[10]

Remarkably, ILM 201619008 cites several cases, such as *Cavanagh*,[11] for the proposition that ''disgorgement does not serve a punitive function.'' Yet the memorandum concludes that disgorgement under the securities laws is ''not compensatory.'' Based on that conclusion, the IRS mistakenly contends that a payment to disgorge ill-gotten gains must be primarily punitive and therefore is not deductible under section 162(f).

However, the standard of requiring proof that the injured party was made whole is an incorrect reading of section 162(f). In determining if the amount paid is a fine or penalty, the focus when deciding whether section 162(f) applies must be on whether the purpose of the statute is to punish the wrongdoer or deter objectionable conduct.

In the memorandum, the IRS maintains that disgorgement in securities cases can be primarily punitive in some situations for tax purposes ''where it serves primarily to prevent wrongdoers from profiting from their illegal conduct and deters subsequent conduct.'' But there is no support in the case law for that assertion.

Indeed, the IRS ignores abundant FCPA case law that recognizes that disgorgement does not result in any economic penalty or act as a deterrent to securities law violations. In considering disgorgement as a remedy to a common law fraud action between private parties, the Fifth Circuit in *Allstate*[12] relied on cases evaluating disgorgement in SEC actions. It held that ''disgorgement wrests ill-gotten gains from the hands of a wrongdoer. It is an equitable remedy meant to prevent the wrongdoer from enriching himself by his wrongs.''[13] The Fifth Circuit explained that ''because disgorgement is meant to be remedial and not punitive, it is limited to property causally related to the wrongdoing at issue.''[14]

Contrary to the relevant FCPA case law, the IRS in the memorandum merely *assumes* that a disgorgement can be punitive in nature, citing *Middle Atlantic*[15] and *True*.[16] However, those non-FCPA cases do not support the IRS's position. *Middle Atlantic* demonstrates that courts examine the underlying purpose of a statute to determine whether the remedy is punitive. The Tax Court in *Middle Atlantic* concluded that the federal customs law provision that triggered the taxpayer's payment could in some cases be used to punish and deter but could also be remedial in nature. Consequently, the court looked at whether the particular claim giving rise to the settlement payment was made for punitive or non-punitive purposes. Following the language of the settlement correspondence and agreement, the court held that the parties intended for the settlement payment to be liquidated damages, and, as such, the payment was not intended to punish or deter. Therefore, section 162(f) did not prohibit deductibility. The court added that if the government had intended the settlement to be penal in nature, it could have indicated that punitive intent in the settlement agreement.

Similarly, in *True*, the court examined the purpose of the Federal Water Pollution Control Act (FWPCA). After upholding the validity of reg. section 1.162-21, which defines the statutory language ''fine or similar penalty'' to include payments made ''as a civil penalty imposed by Federal, State, or local law,'' the court examined an example in that regulation concluding that a civil penalty under the exact FWPCA provision at issue was nondeductible under section 162(f). Holding that the FWPCA

[9]By contrast, fines and penalties alter the status quo.

[10]*See, e.g.*, *SEC v. Dibella*, 409 F. Supp.2d 122 (D. Conn. 2006) (disgorgement is a remedial measure and not a punitive one).

[11]*SEC v. Cavanagh*, 445 F.3d 105 (2d Cir. 2006).

[12]*Allstate Insurance Co. v. Receivable Finance Company LLC*, 501 F.3d 398 (5th Cir. 2007).

[13]*Id.* at 413 (quoting *SEC v. Huffman*, 996 F.2d 800, 802 (5th Cir. 1993)).

[14]*Id.* (citing *SEC v. First City Financial Corp.*, 890 F.2d 1215, 1231 (D.C. Cir. 1989)).

[15]*Middle Atlantic Distributors Inc. v. Commissioner*, 72 T.C. 1136 (1979).

[16]*True v. United States*, 894 F.2d 1197 (10th Cir. 1990).

provision was primarily punitive in nature, the court found the civil penalty to be nondeductible under section 162(f).

Applying a similar analysis to the FCPA cases discussed above, the conclusion is clear: The remedy of civil disgorgement is not punitive in nature.

Also unavailing is the IRS's attempt to draw an analogy between cases involving civil disgorgement and criminal forfeiture to support its application of section 162(f) to the taxpayer's settlement payment. As the Second Circuit held in *Contorinis*, "While both criminal forfeiture and civil disgorgement serve to deprive wrongdoers of their illicit gain, the two remedies reflect different characteristics and purposes — disgorgement is an equitable remedy that prevents unjust enrichment, whereas criminal forfeiture is a statutory legal penalty imposed as punishment."[17]

In the memorandum, the IRS disregards the same "disgorgement of ill-gotten profits" language used by the SEC in its prayer for relief against the taxpayer. The wording of the documents reflects the parties' intention that the disgorgement be remedial in nature, and no language even suggests that the disgorgement was intended as a fine or penalty.[18] Further, as referenced in the memorandum's recitation of facts, the consent agreement itself had no language prohibiting the taxpayer from seeking a tax deduction for its disgorgement payment. The amount the taxpayer was required to disgorge was measured by the excess profits from its prohibited transactions, returning the taxpayer to the position it occupied before the FCPA violations. As a matter of law, this reflects that the payment was not to punish the taxpayer but to prevent unjust enrichment.

Simply stated, the IRS got it wrong in ILM 201619008. The payment was remedial and not punitive in nature. Accordingly, section 162(f) is not a bar to the taxpayer's deduction. ■

[17] *SEC v. Contorinis*, 743 F.3d 296 (2d Cir. 2014). *See also Nacchio v. United States*, 824 F.3d 1370 (Fed. Cir. 2016) (income forfeited under criminal statutes by an individual convicted for insider trading was not deductible under either section 162(a) or section 165(c) because it was a "fine or similar penalty" under section 162(f) and reg. section 1.162-21(b)(1)).

[18] *See Middle Atlantic*, 72 T.C. 1136.