What Does the New IRS Position Paper on Disgorgement Mean for FCPA Settlements?

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On May 6, 2016, the IRS announced in Chief Counsel Advice Memorandum 2016-19-008[1] (CCA) that certain disgorgement payments made to the Securities and Exchange Commission for a violation of the FCPA were not deductible expenses under Internal Revenue Code (IRC) Section 162(f). The IRS did, however, leave open the possibility that in some other factual scenarios, FCPA disgorgement penalties could serve purposes that would allow them to qualify for deductibility.

Legal Precedent on Deductions of Disgorgement

IRC Section 162(a) provides that taxpayers should be allowed a deduction for the “ordinary and necessary expenses paid or incurred” in carrying on a trade or business. However, Section 162(f) prohibits deductions under Section 162(a) for any fine or similar penalty paid to a government for the violation of any law. Treasury Regulations provide that a fine or similar penalty include amounts paid (i) pursuant to a criminal conviction or plea of guilty or nolo contendere for a crime, (ii) as a civil penalty imposed by federal, state or local law, (iii) in settlement of the taxpayer’s actual or potential liability for a fine or penalty, or (iv) forfeited as collateral in connection with a proceeding that could result in a fine or penalty.[2] The Regulations continue to provide that compensatory damages paid to a government do not constitute a fine or penalty, nor do amounts incurred for legal fees and related expenses in the defense of prosecution arising from a violation of the law that imposes the fine or penalty.

Case law interpreting Section 162(f) has at times taken a more expansive approach. Section 162(f) prohibits deductions for civil penalties “imposed for purposes of enforcing the law and as punishment for the violation thereof.”[3] But in Waldman v. Commissioner,[4] the court held that some payments, “although labeled ‘[civil] penalties,’” remain deductible if “imposed to encourage prompt compliance with a requirement of the law or as a remedial measure to compensate another party.” Another court has implemented a “primary purpose” test where a payment serves both a non-deductible and deductible purpose.[5] If the payment is imposed primarily for remedial measures, the expense is deductible, whereas if it is to deter and punish, it remains non-deductible.

The Facts Underlying CCA 2016-19-008

The taxpayer at issue in the CCA, a corporation headquartered in the United States, possessed a wholly owned subsidiary that in turn owned all of the shares of a disregarded entity. The books and records of the disregarded entity were consolidated into the parent taxpayer’s books and reported in
its financial statements. For two years, executives and employees of the disregarded entity “intentionally falsified” the entity’s “books and records related to approximately $[omitted] of things of value given to government officials” in a foreign country. Moreover, the taxpayer failed to detect and prevent the disregarded entity’s violations through an “adequate internal accounting and financial controls” system.

To resolve its violations of the FCPA, the taxpayer consented to an entry of final judgment against it in a suit by the SEC. As part of the consent agreement, the taxpayer agreed to pay a disgorgement penalty that represented the profits that the disregarded entity had gained as a result of the alleged misconduct. Thereafter, the taxpayer entered into a settlement with the DOJ in which the taxpayer agreed to implement a compliance program with adequate internal controls. The taxpayer also paid a penalty in this arrangement, agreeing to the terms of the settlement dictating that “no United States tax deduction may be sought in connection with the payment” of this second penalty.

IRS Analysis

After paying the FCPA disgorgement penalty, the taxpayer contended that the amount was a deductible expense under Section 162(a). The taxpayer argued that the disgorgement payment did not fall into Section 162(f)’s prohibition on deductibility for civil penalties because (i) the payment was made to encourage prompt compliance with the law, (ii) the payment was compensatory and remedial rather than for punishment or deterrence, and (iii) the consent agreement from the SEC case did not contain language prohibiting deductibility.

Taxpayer’s First Argument: Prompt Compliance

Citing Southern Pacific Transp. Co., the taxpayer argued that the disgorgement payment it made to the SEC was to encourage “prompt compliance” with the securities laws, and was thus deductible. [6] The IRS rejected this interpretation. It noted that in making this argument, the taxpayer does not explain the difference between “compliance” and “prompt compliance.” In Southern Pacific Transp. Co., the court indicated that penalties that are for the purpose of “prompt compliance” are those that encourage “timely filing or other requirements” that are more like “late filing charges or interest charges than they are fines.” Because the taxpayer could not demonstrate a similarity between the FCPA disgorgement penalty and these late filing charges, the IRS found the taxpayer’s argument to be insufficient.

Taxpayer’s Second Argument: Compensatory or Remedial

Second, the taxpayer contended that the disgorgement payment was a compensatory or remedial measure, and not for the purpose of punishment. In Stephens v. Commissioner, the Second Circuit found that deductible compensatory payments were generally designed to “return the parties to the status quo ante.”[7] Thus, they were not designed to harm the offending party, but rather to make the injured party whole. The taxpayer argued that in paying the FCPA disgorgement penalty, it was then returned to the status quo ante, warranting a deduction. It also contended that the disgorgement was based on a desire to prevent unjust enrichment, and not to punish the taxpayer.

The IRS found that the taxpayer was using incorrect analysis in its Stephens-based remedial payment argument. Particularly, the IRS opined the correct analysis is whether the party’s payment was remedial to compensate another party, and not just remedial or compensatory in general. The IRS also noted that whether or not a payment is “remedial” is not dispositive for tax purposes...
because *Stephens* requires a balancing. In short, “the tax treatment depends on whether the payment is more punitive or compensatory.” Furthermore, the CCA clarifies that “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.” Accordingly, the scope can include deterring future violations, and thus a fine under Section 162(f) is one that either punishes or deters.

Having made these findings, the IRS rejected the taxpayer’s argument that the disgorgement was for a remedial purpose. With respect to the taxpayer’s contention that the fine was compensatory because it returned the taxpayer to the *status quo ante*, the IRS stated that *Stephens* “clearly” indicates that the effect of the payment should be to return the *injured party* to the *status quo ante*. Here, the taxpayer was the violating party, and there was no evidence offered that the recipient of the disgorgement payment – the U.S. government – had suffered any damages as a result of the taxpayer’s FCPA violations.

The taxpayer did, however, argue that “the deductibility of a payment does not turn on whether the payment goes to injured parties.” The IRS accepted the premise of the argument, finding that the characterization of the payment for Section 162(f) purposes stems from the origin of the liability and not the use of the funds.[8] The CCA analogized to a civil penalty that is to be used for the settlement of a taxpayer’s potential liabilities in a separate suit brought by injured parties. Though the money is ultimately used to compensate aggrieved parties, the penalty would be non-deductible given its origin. The IRS rejected the taxpayer argument on this count, though, because the taxpayer cited to no authority that would deem a payment compensatory where it never went to an injured party.

The CCA continued by analyzing the purpose of the disgorgement payments made pursuant to the securities laws in determining their categorization. In *SEC v. Contorinis*,[9] the Second Circuit found that the purpose of the disgorgement was to deprive the violators of the “fruits of their illegal conduct.” And although payments may be used to compensate victims of the payor’s wrongdoing, they need not be used for that purpose. In fact, because the payments are designed to prevent unjust enrichment, the disgorgement penalty may exceed the amount of damages suffered by any victims. With respect to the securities laws, disgorgement then would not be considered a compensatory payment. However, as it applies to Section 162(f), the CCA keeps open the possibility that in certain factual scenarios, disgorgement can be either primarily compensatory or primarily punitive. Instances when a payment may be more compensatory than punitive include when the amount of the wrongdoer’s profit equals the victims’ losses or when the SEC uses disgorgement as a way for harmed investors to receive remuneration through a fund.

The CCA also notes, consistent with the result of this memorandum, that disgorgement can be primarily punitive when it is primarily to strip violators of their profit from illegal conduct and to deter future violations. Because courts can consider the amount of disgorgement before imposing a similar penalty (*i.e.*, they may reduce the penalty where there is substantial disgorgement), disgorgement may be a “direct substitute” for a penalty “when it reduces the amount of the penalty that would otherwise be imposed.” The IRS also compared disgorgement to cases in which forfeiture is required by statute, noting that forfeiture is not deductible, even if used by the government to compensate injured parties.

Because nothing indicated that the disgorgement was used to compensate the federal government or any other party for losses suffered as a result of the taxpayer’s FCPA violation, the IRS determined the penalty was primarily punitive. As such, the amount paid was not eligible for a
deduction as required by Section 162(f).

**Taxpayer’s Third Argument**

The taxpayer also asserted that because the consent agreement that contained the disgorgement did not include language that prohibited deducting the expenses, it could thus do so. The taxpayer’s settlement with the DOJ contained the prohibitive language, but the consent agreement with the SEC did not. The IRS, however, found that an agreement lacking the provision that prohibits a deduction “does not create a negative implication.”

**Applying the CCA to Future Settlements**

Companies will need to carefully structure FCPA settlements given the position that the IRS has taken in the CCA. First, a taxpayer in an FCPA settlement should obviously try to avoid a provision that prohibits deducting the amount of their settlement payment. In some instances, the company might consider offering to pay a larger amount to settle the FCPA claim if the government in exchange were willing to remove the provisions precluding deductibility. If the value of the tax deduction were to exceed the additional settlement payment amount, absent other considerations, it would be economically beneficial to the company to do so.

Of the arguments that the taxpayer raised and the IRS rejected in the CCA, the second, which distinguishes payments based on a punitive or compensatory characterization, offers companies the best chance of negotiating a deductible settlement. A company should urge that the settlement payment – or at least a part of the settlement – be described as compensatory in nature. Factors short of such an outright label could still bolster a compensatory characterization. For instance, if third parties are harmed by the taxpayer’s FCPA violations, the company should consider a settlement that represents those parties’ damages or goes to a fund that is set aside to reimburse the injured parties as opposed to one that would be nondeductible. Because the CCA argued that the ultimate use of the funds for compensatory purposes may not change the penalty’s characterization if it originated as punitive, it is important for companies to have those amounts properly classified as early as possible.

**Conclusion**

Although limited by the facts and circumstances of this particular advice memorandum, the IRS determined that disgorgement payments stemming from FCPA violations are non-deductible under Section 162(f). The CCA rejects the taxpayer’s arguments that the payments are deductible because (i) the taxpayer did not explain the distinction between “compliance” and “prompt compliance” and why its payments fell into the latter category, (ii) the payments were primarily for punitive purposes, and (iii) the lack of a provision prohibiting a deduction does not then allow it. Despite the IRS’ conclusion in this CCA, companies may still be able to preserve the deductibility of disgorgement payments with a carefully structured settlement.

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Treas. Reg. § 1.162-21(b).


75 T.C. at 652.

905 F.2d at 673.

Bailey v. Commissioner, 756 F.2d 44, 47 (6th Cir. 1985).

743 F.3d 296, 301 (2d Cir. 2014); cert. dismissed, 136 S. Ct. 531 (2015).