Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **201619008**
Release Date: 5/6/2016

CC:ITA:B02
POSTF-136164-15

UILC: 162.21-21

date: January 29, 2016

to:

Large Business & International CC:LB&I:

from: Thomas D. Moffitt
Chief, Branch 2
Office of Associate Chief Counsel
(Income Tax and Accounting) CC:ITA:2

---

subject: Section 162(f) and Disgorgement to the SEC

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

LEGEND

Taxpayer =

Subsidiary =

Disregarded Entity =

Products =

Country =

Items =

Year 1 =
Year 2 =

Date 1 =
Date 2 =
Date 3 =
Date 4 =

$A =
$B =
$C =
$D =
$E =
$F =
$G =

ISSUE

Whether I.R.C. § 162(f) prohibits a deduction for an amount paid as disgorgement to the Securities and Exchange Commission for violating the U.S. Foreign Corrupt Practices Act.

CONCLUSION

Under the facts of this case, section 162(f) prohibits a deduction for such an amount.

FACTS

The Foreign Corrupt Practices Act

In 1977, the U.S. Foreign Corrupt Practices Act (as amended, 15 U.S.C. §§ 78dd-1, et seq.) (FCPA), was enacted in response to revelations of widespread bribery of foreign officials by U.S. companies. The FCPA contains both anti-bribery and accounting provisions. The anti-bribery provisions prohibit U.S. persons and businesses (domestic concerns), certain U.S. and foreign public companies (issuers), and certain foreign persons and businesses acting while in the territory of the United States (territorial jurisdiction) from making corrupt payments to foreign officials to obtain or retain business. The accounting provisions require issuers to make and keep accurate books and records and to devise and maintain an adequate system of internal accounting controls. The accounting provisions also prohibit individuals and businesses from knowingly falsifying books and records or knowingly circumventing or failing to implement a system of internal controls. The Department of Justice (DOJ) and the Securities and Exchange Commission (SEC) share FCPA enforcement authority. See generally A Resource Guide to the U.S. Foreign Corrupt Practices Act, by the Criminal Division of the U.S. Department of Justice and the Enforcement Division of the U.S.

Securities and Exchange Commission (2012), available at http://www.justice.gov/sites/default/files/criminal-fraud/legacy/2015/01/16/guide.pdf.

Taxpayer's Violations of the FCPA

Taxpayer is incorporated and headquartered in the United States. Taxpayer is a provider of Products. Taxpayer directly owns all the shares of Subsidiary. Subsidiary owns all the shares of Disregarded Entity. For federal income tax purposes, Subsidiary is treated as a corporation and Disregarded Entity is disregarded as an entity separate from its owner. Disregarded Entity manufactured and sold Products in Country. Disregarded Entity's books and records were consolidated into Taxpayer's books and records and reported by Taxpayer in its financial statements.

From Year 1 to Year 2, some of Disregarded Entity's executives and employees intentionally falsified Disregarded Entity's books and records related to approximately $A of things of value given to government officials in Country. Taxpayer failed to implement adequate internal accounting and financial controls designed to detect and prevent, among other things, corruption-related violations, including FCPA violations.

The things of value included Items and were given to obtain business benefits for Disregarded Entity in Country.

Resolution of Taxpayer's FCPA Violations

On Date 1, Taxpayer entered into a Consent Agreement in which it consented to the entry of a final judgment in a civil proceeding to be brought against it by the SEC. Taxpayer agreed that it would be permanently restrained and enjoined from violating sections 13(b)(2)(A) and 13(b)(2)(B) of the Securities Exchange Act of 1934 (Exchange Act) [15 U.S.C. §§ 78m(b)(2)(A) and 78m(b)(2)(B)]. Also, Taxpayer agreed to pay disgorgement of $B, representing profits gained as a result of the conduct alleged in the

complaint, together with prejudgment interest in the amount of $C, for a total of $D. The agreement provided that Taxpayer waived any claim of Double Jeopardy based upon the settlement of the proceeding, including the imposition of any remedy or civil penalty. Additionally, the agreement provided that Taxpayer understood and agreed to comply with the terms of 17 C.F.R. § 202.5(e), which provides in part that it is the SEC's policy "not to permit a defendant or respondent to consent to a judgment or order that imposes a sanction while denying the allegations in the complaint or order for proceedings."

On Date 2, the SEC filed a complaint against Taxpayer. The complaint alleged that Taxpayer violated section 13(b)(2)(A) of the Exchange Act [15 U.S.C. § 78m(b)(2)(A)] by failing to make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflected the transactions and disposition of assets. The complaint also alleged that Taxpayer violated section 13(b)(2)(B) of the Exchange Act [15 U.S.C. § 78m(b)(2)(B)] because – by failing to ensure that it maintained adequate internal controls sufficient to record the nature and purpose of payments, or to prevent improper payments, to government officials – Taxpayer failed to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that its transactions and the disposition of its assets were recorded correctly, accurately, and in accordance with authorization of management. The prayer for relief requested that Taxpayer be permanently enjoined from violating sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act [15 U.S.C. §§ 78m(b)(2)(A) and 78m(b)(2)(B)]; Taxpayer be ordered to disgorge ill-gotten gains wrongfully obtained as a result of its illegal conduct, plus prejudgment interest thereon; and the court grant such other relief as it may deem just and appropriate.

On Date 2, Taxpayer entered into a with the United States of America, acting through the DOJ. In the , Taxpayer consented to the filing by the DOJ of a Criminal Information charging it with

The included provisions concerning implementation of a corporate compliance program and ensuring an adequate internal accounting controls system. Taxpayer agreed to pay a monetary penalty in the amount of $E to the United States Treasury within a specified time after the court's sentencing of Disregarded Entity for FCPA-related violations. In the , Taxpayer agreed "that no United States tax deduction may be sought in connection with the payment of any part of this $E penalty." The provided that the $E penalty would be reduced by any criminal penalties imposed by the court on Disregarded Entity in connection with its guilty plea to a Criminal Information charging it with

On Date 2, Disregarded Entity entered into a plea agreement with the United States of America, acting through the DOJ. Under the plea agreement, Disregarded Entity agreed to plead guilty to a Criminal Information charging it with Disregarded Entity agreed to pay a criminal fine of $F, subject to the sentencing court's acceptance of the guilty plea and entering of a final judgment consistent with the plea agreement. On Date 2, the court accepted Disregarded Entity's guilty plea and imposed a criminal penalty of $F.

On Date 3, Taxpayer paid by wire transfer to the United States Treasury the $F fine imposed by the court on Disregarded Entity. As a result of the imposition of that criminal penalty on Disregarded Entity, the penalty imposed on Taxpayer was reduced on a dollar-for-dollar basis to $G.

On Date 4, the district court entered the final judgment against Taxpayer in the civil proceeding brought against it by the SEC. Taxpayer paid $D to the SEC after the final judgment was entered. The SEC sent the funds to the United States Treasury.

LAW AND ANALYSIS

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[1] 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.

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.

[1] 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.

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). If a payment serves both a nondeductible purpose and a deductible purpose, it is necessary to determine which purpose the payment primarily serves. See Stephens, 905 F.2d at 673. Thus, a payment imposed primarily for purposes of deterrence and punishment is not deductible under section 162(f).

Taxpayer's First Argument[2]

Taxpayer argues that the disgorgement payment to the SEC was made to encourage prompt compliance with the securities laws. The exception Taxpayer asserts was described generally by the Tax Court as follows:

> [I]t was not intended that deductions be denied in the case of sanctions imposed to encourage prompt compliance with requirements of law. Thus, many jurisdictions impose "penalties" to encourage prompt compliance with filing or other requirements which are really more in the nature of late filing charges or interest charges than they are fines.

Southern Pacific Transp. Co., 75 T.C. at 652. Taxpayer does not explain the difference between "compliance" and "prompt compliance" under the FCPA, and cannot show that the payment was in the nature of a late filing charge or an interest charge.

Taxpayer's Second Argument

Taxpayer asserts that the disgorgement payment was intended "as a compensatory or remedial measure" and not to "penalize or punish" it. Taxpayer cites to Stephens for the proposition that "[c]ompensatory payments generally 'return the parties to the status quo ante.'" 905 F.2d at 673. Taxpayer then argues that the payment returned Taxpayer to the status quo ante and, therefore, should be deductible. Taxpayer also asserts that the intent of the parties in calculating the disgorgement clearly shows a desire to prevent unjust enrichment, not to punish Taxpayer.

Initially, 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.

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

[2] We have organized Taxpayer's arguments in the most logical order to address each of them.

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 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").

As mentioned above, Taxpayer cites to Stephens for the proposition that "[c]ompensatory payments generally 'return the parties to the status quo ante.'" 905 F.2d at 673. Stephens cites to Colt Industries, Inc. v. United States, 11 Cl. Ct. 140, 146 (1986), aff'd, 880 F.2d 1311 (Fed. Cir. 1989). The holding of that case clearly shows that the quoted language means that a compensatory payment must return an injured party – not the wrongdoer – to the status quo ante. In the instant case, as in Colt Industries, there is no allegation that the business or property of the United States Government was damaged by the violations.

Taxpayer also argues that "the deductibility of a payment does not turn on whether the payment goes to injured parties." As a general matter, 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). Thus, the fact that a civil penalty is permitted to be applied toward the settlement of the taxpayer's potential liabilities in a separate civil action by injured parties does not change the status of the payment as a civil penalty. Id. Taxpayer does not cite to any authority that holds that a payment was compensatory even though it never went to an injured party. Also, Taxpayer does not describe how, and cannot show, there was some party that was being compensated for its specific losses by the payment. Cf. Allied-Signal, Inc. v. Commissioner, T.C. Memo. 1992-204, aff'd without pub. op., 54 F.3d 767, 1995 U.S. App. LEXIS 41283 (3d Cir. 1995) (Endowment created by the taxpayer did not compensate aggrieved parties for the specific losses attributable to the taxpayer's misconduct.)

As a general matter, "disgorgement" is defined as "[t]he act of giving up something (such as profits illegally obtained) on demand or by legal compulsion." Black's Law Dictionary (10th ed. 2014). In the context of enforcement of the federal securities laws, the Second Circuit has recently stated the following:

> Disgorgement serves to remedy securities law violations by depriving violators of the fruits of their illegal conduct. See SEC v. Fischbach Corp., 133 F.3d 170, 175 (2d Cir. 1997); see also SEC v. Tome, 833 F.2d 1086, 1096 (2d Cir. 1987) ("The paramount purpose of enforcing the prohibition against insider trading by ordering disgorgement is to

> make sure that wrongdoers will not profit from their wrongdoing."). Disgorgement is an equitable remedy, imposed to "forc[e] a defendant to give up the amount by which he was unjustly enriched." FTC v. Bronson Partners, 654 F.3d 359, 372 (2d Cir. 2011), quoting SEC v. Commonwealth Chem. Secs., Inc., 574 F.2d 90, 102 (2d Cir. 1978). By forcing wrongdoers to give back the fruits of their illegal conduct, disgorgement also "has the effect of deterring subsequent fraud." SEC v. Cavanagh, 445 F.3d 105, 117 (2d Cir. 2006) ("Cavanagh II"). Because disgorgement does not serve a punitive function, the disgorgement amount may not exceed the amount obtained through the wrongdoing. Id. at 116 n.25. At the same time, however, as it operates to make the illicit action unprofitable for the wrongdoer, disgorgement need not serve to compensate the victims of the wrongdoing. Bronson, 654 F.3d at 374. Because disgorgement is not compensatory, it "forces a defendant to account for all profits reaped through his securities law violations and to transfer all such money to the court, even if it exceeds actual damages to the victim." Cavanagh II, 445 F.3d at 117. Because disgorgement's underlying purpose is to make lawbreaking unprofitable for the law-breaker, it satisfies its design when the lawbreaker returns the fruits of his misdeeds, regardless of any other ends it may or may not accomplish.

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

For purposes of the securities laws, as described in the preceding quote, disgorgement is not defined as being compensatory because it is not measured by the amount of damage to the victims. Therefore, the amount of disgorgement can exceed the amount necessary to return the injured parties to the status quo ante.

For purposes of section 162(f), however -- keeping in mind that the scope of the provision includes deterrent as well as retributive measures, and that disgorgement is a discretionary remedy that depends on the facts of a case -- we think disgorgement in federal securities law cases can be primarily compensatory or primarily punitive for federal tax law purposes depending on the facts and circumstances of a particular case.

In a particular case, there may be certain facts that weigh in favor of treating disgorgement as primarily compensatory for tax purposes.[3] In some cases, for example, the amount of the wrongdoer's profit may equal the victims' losses. Furthermore, the SEC may be using disgorgement as a means to obtain compensation

[3] We note that the IRS permitted a taxpayer to deduct disgorgement under section 165(c)(2) in Wang v. Commissioner, T.C. Memo. 1998-389, aff'd, 35 Fed. Appx. 643 (9th Cir. 2002).

for harmed investors, who can receive distributions through a Fair Fund or Disgorgement Fund. See generally Investor Bulletin: How Harmed Investors May Recover Money, U.S. Securities and Exchange Commission (2014), available at http://www.sec.gov/oiea/investor-alerts-bulletins/ib_recovermoney.html; Rules of Practice and Rules on Fair Fund and Disgorgement Plans, U.S. Securities and Exchange Commission (2006), pp. 103-107, available at http://www.sec.gov/about/rulesprac2006.pdf. 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 the SEC adds civil penalties to a Fair Fund for the benefit of harmed investors, those amounts are not deductible by the wrongdoer.[4] We have seen cases where the SEC added civil penalties to a Fair Fund and the settlement agreement provided that in any related investor action the taxpayer would not benefit from any offset or reduction of any investor's claim by the amount of any Fair Fund distribution to such investor that is proportionately attributable to the civil penalty. Whether or not a SEC settlement agreement includes such a provision concerning disgorgement is another fact relevant to determining whether the disgorgement is primarily compensatory or primarily punitive for tax purposes. Additionally, if there has been any litigation by harmed investors relating to the same facts that justified disgorgement to the SEC, information concerning those allegations of harm and claimed damages is relevant.

On the other hand, we think 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 securities laws, and such penalty amount may be less when there is substantial disgorgement. See, e.g., SEC v. Gibraltar Global Sec., Inc., 2015 U.S. Dist. LEXIS 145380 (S.D.N.Y. 2015). 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, we think some cases that impose disgorgement as a discretionary equitable remedy can have similarities to some cases that impose forfeiture as required by statute. Cf. United States v. Contorinis, 692 F.3d 136, 146 (2d Cir. 2012); United States v. Dobruna, 2015 U.S. Dist. LEXIS 160476 (E.D.N.Y. 2015). 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, 1239-1242 (9th Cir. 2011). Although it is not bound to do so, the government has the discretion to

[4] Accordingly, the SEC provides in its standardized settlement language that such penalty amounts are to be treated as penalties for tax purposes. Tax Administration: Systematic Information Sharing Would Help IRS Determine the Deductibility of Civil Settlement Payments, pp. 9-11, 13-14 GAO-05-747 (September 2005), available at http://www.gao.gov/new.items/d05747.pdf.

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). For FCPA cases in particular, it is important to consider the sharply defined Congressional policy to deter and punish such violations, as shown in the overall statutory scheme of the FCPA as well as section 162(c)(1) of the Code.

In the instant case, we think the absence of certain facts is determinative. Here, there simply is nothing indicating that the purpose of the disgorgement payment was to compensate the United States Government or some non-governmental party for its specific losses caused by Taxpayer's violations of the FCPA.[5] Consequently, we think the disgorgement payment is not deductible pursuant to section 162(f) because the payment was primarily punitive. Similarly, a deduction for a loss under section 165 is prohibited. See generally Rev. Rul. 77-126, 1977-1 C.B. 47; Stephens, 905 F.2d 667.

Taxpayer's Third Argument

Finally, Taxpayer argues that the payment is deductible because the Consent Agreement and final judgment in the SEC case "do not contain language prohibiting deductibility, which the SEC commonly uses when it seeks to punish wrongdoers." However, the absence of a provision prohibiting a deduction for disgorgement does not create a negative implication. In 2003, the SEC adopted a policy of requiring settlement agreements with civil penalties to include language stating that the settling parties would not deduct civil penalties for tax purposes. Tax Administration: Systematic Information Sharing Would Help IRS Determine the Deductibility of Civil Settlement Payments, pp. 9-11, 13-14 GAO-05-747 (September 2005), available at http://www.gao.gov/new.items/d05747.pdf. The SEC does not negotiate with settling parties about whether settlement amounts are tax deductible. Id. Also, the SEC does not consider any aspects of taxes when calculating a proposed settlement amount. Id.

[5] Moreover, during , Taxpayer settled a

This fact was not included in Taxpayer's analysis or your request for advice. Consequently, we recommend that you develop the facts concerning what was paid by whom and how Taxpayer treated these amounts for tax purposes.

If the disgorgement payment to the SEC did not in any way reduce the , then that indicates the disgorgement was not compensatory for purposes of section 162(f).

Please call Robert Basso at (202) 317-7011 if you have any questions.