



New Tax Bill Will Rewrite Rules for Deducting Disgorgement Payments to SEC

U.S. tax reform will mean new rules for deducting fines, penalties, and other amounts, including disgorgement, paid to the Securities and Exchange Commission ("SEC").

Currently, Internal Revenue Code section 162(f) prohibits businesses from deducting "any fine or similar penalty paid to a government for the violation of any law." I.R.C. § 162(f). Whether a payment constitutes a "fine or similar penalty" generally turns on whether the payment is punitive in light of all the relevant facts and circumstances. Disgorgement payments to the SEC, long thought of as purely equitable and compensatory, have generally been considered outside the scope of the section.

The tax reform bill that passed the House of Representatives and Senate on December 20, 2017, and that is expected to be signed into law by President Trump amends section 162(f). Under the amendment, taxpayers will not be able to deduct amounts paid to the government in settlement or as a result of court order. The amendment applies broadly to "any amount paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government or governmental entity in relation to the violation of any law or the investigation or inquiry ... into the potential violation of any law." The amendment will be effective upon enactment. It does not apply to existing binding orders or settlement agreements that have already been entered into and approved by courts, if necessary.

The amendment provides an exception to this new general rule for payments made in restitution (including remediation of property) or payments made to come into compliance with law. To be deductible, such payments will have to be, among other things, identified in the relevant court order or settlement agreement as serving one of these specific purposes. In addition, an appropriate government official must report to the IRS the total amount of the payment along with the amount that constitutes restitution or the amount paid to come into compliance with law. The amendment thereby gives the government significant influence over the tax treatment of any settlement payment, in essence inviting the SEC (or court) to sign off on its deductibility.

The SEC may have an incentive to do just that. A unanimous U.S Supreme Court recently held that disgorgement to the SEC is subject to a five-year statute of limitations because it operates as a penalty. *Kokesh v. SEC*, 137 S. Ct. 1635 (2017). The Court expressly noted that its holding was limited to the statute at issue and did not address whether disgorgement generally constitutes a penalty. Following *Kokesh*, the SEC has argued in district courts throughout the country that, outside the statute of limitations context, disgorgement is not a penalty but remains an equitable remedy.

The SEC has good reason to keep making that argument—while neither the SEC nor the federal courts generally have explicit statutory authority to impose disgorgement, district courts have consistently used their equitable powers to order disgorgement in SEC actions. If disgorgement constitutes a penalty, it begs a fundamental question: what is the source of the SEC's authority to impose disgorgement? Thus, to preserve its ability to recover disgorgement, the SEC may be willing to distinguish disgorgement payments from penalties by identifying them as restitution in settlement agreements.

The amendment to section 162(f) offers a significant issue to consider during settlement negotiations with the SEC, and defendants would be well advised to take into account the tax consequences of any settlement before it is finalized.

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