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Loss Deduction for Forfeiture of Insider Trading Profits

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An individual convicted of engaging in unlawful activity is sometimes required to forfeit the profits from that activity as part of the sentence imposed on him. In such a case, the tax law's policy of taxing income, but only once, is in tension with considerations of public policy underlying the criminal law, under which allowing a tax deduction for payments made by court order upon conviction of a crime would reduce the "sting" of such payments and make the United States Treasury an unwilling, if indirect, contributor toward the malefactor's payment of the penalty. The provisions of the Internal Revenue Code (IRC) and related case law that govern this situation reflect that tension.

One major objective of the income tax laws is to measure a taxpayer's income accurately, by the allowance of appropriate deductions for costs of earning that income and expenses incurred in the course of profit-seeking activities. Disallowing a deduction in respect of a forfeiture of gains would be inconsistent with this objective, because it would cause the taxation of amounts that were not retained by the taxpayer.[1]

On the other hand, the tax law has long acknowledged that, as a matter of public policy, allowing a deduction for certain payments made in a punitive context may dilute those payments' appropriate deterrent (or retributive) function, and IRC section 162(f) accordingly disallows a deduction for "any fine or penalty paid to a government for the violation of any law," if that fine or penalty would otherwise qualify as a deductible "expense paid … in carrying on any trade or business." The tension between these objectives is reflected in the recent decision of the Court of Federal Claims relating to a court-ordered forfeiture by a corporate executive found to have engaged in illicit insider trading.[2]

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Facts in Nacchio

Qwest Communications International, Inc. (Qwest) issued options for the purchase of Qwest's stock to Joseph Nacchio (Nacchio), Qwest's Chief Executive Officer, in connection with his employment. In 2001, Nacchio exercised the options and then sold shares of the purchased stock, resulting in $45 million of net gain to him (computed as the gross proceeds from the sales of shares minus the cost to exercise the options). Nacchio reported the net gain on his tax return for 2001, and he paid $18 million of taxes on it.

In March 2005, the SEC initiated a civil action alleging that Nacchio and others had sought to defraud the public during 2001 by misrepresenting the financial performance and growth of Qwest. Nacchio was indicted by a federal grand jury later in the same year on multiple counts of insider trading relating to this conduct, and he was convicted in the Colorado District Court following a trial in 2007. The sentence imposed by the District Court included a prison term, a fine, and a forfeiture.

After an extended appeals process resulting in multiple decisions of the Court of Appeals for the Tenth Circuit, Nacchio was finally sentenced in 2010 by the District Court to a prison term of 70 months, the payment of a fine of $19 million, and forfeiture of the $45 million of net gain attributed to his insider trading. Nacchio paid the forfeiture amount to the Department of Justice during his 2007 taxable year.

The Department of Justice notified victims of the Qwest securities fraud that they were eligible to receive compensation from the amount forfeited by Nacchio, and substantial payments were made to the victims out of the proceeds of the forfeiture. Ultimately, according to a press release issued by the Department during 2012, the Department returned approximately $44 million to victims of the Qwest securities fraud.

Meanwhile, Nacchio had filed a tax return for 2007 that claimed a tax refund of $18 million by reason of the forfeiture in reliance on IRC section 1341, which relates to "Computation of Tax Where Taxpayer Restores Substantial Amount under Claim of Right". Although the precise manner in which the claimed refund was calculated is not made clear in the decision of the court discussed below, it appears that Nacchio contended that he was entitled to a deduction under

IRC section 165, relating to losses (including those incurred in a trade or business or a transaction entered into for profit), by reason of his payment of the forfeiture during 2007, but that the dollar amount of the refund should be computed under the special rules of section 1341. Assuming that section 1341 applied, Nacchio's refund for 2007 could be measured by the $18 million reduction in his tax for 2001 that would have resulted if the $45 million of gain had not been included in his income for that earlier year.[3]

The refund claim was denied by the IRS in 2009, and that denial was sustained by the IRS Appeals Office in 2010. The IRS noted that section 1341 cannot result in a refund unless a deduction is allowable under some other provision of the IRC, and asserted that no deduction at all was allowable in this case, under any IRC provision, because the forfeiture was a penalty and not remedial in nature. Nacchio then filed suit for refund in the Court of Federal Claims. Both Nacchio and the government then filed motions for partial summary judgment, and the bulk of the resulting decision of the court relates to whether a loss was allowable in respect of the forfeiture under IRC section 165.[4]

Analysis

The government did not dispute that Nacchio's forfeiture gave rise to a loss under section 165, but argued that the loss should not be deductible—notwithstanding the apparent absence of any statutory disallowance provision squarely on point—because allowance of a deduction "would contravene public policy against insider trading by 'reducing the sting' of the forfeiture penalty."

The court did not take issue with the government's position that a loss otherwise described in section 165 could, in some circumstances, be disallowed on public policy grounds such as those cited by the government here. Based on various cases cited in the opinion, however, the court concluded that the loss could not be denied on those grounds unless doing so would "frustrate sharply defined national or state policies proscribing particular forms of conduct."[5]

The opinion notes that Nacchio had been given stern punishment, including (apart from the forfeiture of the net gain) a jail sentence of more than 5 years and a fine of $19 million. Taking this into account, the court concluded that permitting a deduction of the forfeiture under section 165 would not "increase the odds in favor of insider trading or destroy the effectiveness of the securities laws" or otherwise frustrate a sharply defined public policy, and, therefore, that the deduction should not be disallowed on public policy grounds.

The court then turned to the government's further argument that the allowance of the deduction was precluded by section 162(f), which states that "[n]o 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 162(f) by its terms limits only the allowance of a deduction under section 162(a), which is presumably why the government led with its nonstatutory "public policy" argument discussed above. That argument having failed, the government argued that regulations under IRC sections 162 and 165 provide that a non-business expense otherwise described in section 162(f)—that is, an expense a deduction for which would be disallowed under subsection (f) if it *were* attributable to a business—should also not be allowed as deduction under section 165.

Without either endorsing or rejecting the government's position on whether the regulations were authorized to, and did, expand the applicability of the section 162(f) limitation to an amount otherwise deductible as a loss under section 165, the court acknowledged that public policy considerations embodied in section 162(f) are relevant to determining whether an amount was deductible under section 165. However, cases applying section 162(f) distinguish between a "fine or similar penalty" imposed to punish a defendant and a forfeiture that is intended to have a compensatory purpose, such as compensating victims of a crime.[6] Section 162(f) does not preclude the allowance of a forfeiture that has a substantial compensatory purpose. The court found ample evidence in the record that the amount forfeited by Nacchio was intended to be used and was in fact used for a compensatory purpose, and therefore was not within the scope of the "narrow prohibition" codified in section 162(f) against deduction as a business expense of a fine or similar penalty.

Claim of Right

If Nacchio did not otherwise have substantial income in the tax year of the forfeiture (apparently 2007), the allowance of a $45 million loss deduction in 2007 would not necessarily be of great benefit to him. Section 1341, however, in some circumstances authorizes a tax refund computed as if forfeited gain had been excluded from income in the year in which the gain was realized (2001 in this case), even if the year in which the gain was recognized was otherwise a closed year under relevant statutes of limitation. In order to claim the benefits of IRC section 1341, however, it is necessary to establish, among other things, that the taxpayer believed he had a "claim of right" to the (later forfeited) gain in the year of realization.

The government argued that Nacchio was barred under the doctrine of issue preclusion from litigating that "claim of right" issue here because a jury had convicted him of engaging in insider trading "willfully, knowingly and with the intent to defraud" and because an individual so acting would clearly have known that he was not entitled to the gain at any time.

The court responded that the necessary "claim of right" under section 1341 would be established if Nacchio subjectively believed that he had an unrestricted right to the gain in the year in which it was realized. Thus, had he pled guilty to the insider trading charges, he might not have later sustained a claim under section 1341.[7] Given that Nacchio had maintained his innocence during the criminal trial, the court did not have before it sufficient evidence to conclude whether or not he had a subjective belief in his entitlement to the gain, and concluded that this was a question of material fact that could not be resolved on motion for summary judgment.

Observations

The court's analysis of the section 165 issue, and also as to Nacchio's "claim of right" argument not being precluded by reason of his prior conviction for insider trading, seems sound. The case further serves as a reminder to counsel that, in representing defendants in situations similar to those of Nacchio, the defendant's positions and the details of any judgment against the defendant in the criminal proceedings may influence the tax treatment of any disgorgement of profits or other forfeiture resulting from those proceedings.

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1 See, e.g., *Stephens v. Commissioner*, 905 F.2d 667, 671 (2d Cir. 1990).

2 *Nacchio v. United States*, No. 1:12-cv-00020, 113 AFTR 2d 2014-1288 (Fed. Cl.).

3 See IRC § 1341(a)(5)(B). Nacchio, having long since ceased employment with Qwest and being preoccupied with defending himself against criminal charges, presumably did not have sufficient income during 2007 to take full advantage of the deduction in the "normal" manner by offsetting it against his income for that year.

4 The opinion dismisses in a footnote Nacchio's argument that the forfeiture was deductible under section 162 as a business expense relating to his trade or business as CEO of Qwest. The court reasoned that the forfeiture arose from the conviction of Nacchio for insider trading, which the court considered not part of Nacchio's business as CEO of Qwest.

5 *Commissioner v. Tellier*, 383 U.S. 687, 694 (1966), citing *Commissioner v. Heininger*, 320 U.S. 467 (1943).

6 See also Reg. § 1.162-21(c)(2), interpreting section 162(f), which provides in part: "Compensatory damages . . . paid to a government do not constitute a fine or penalty"; and section 1.162-21(c), Example (3) (to similar effect).

7 See *Wang v. Commissioner*, 76 TCM 753 (1998).