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Recent Guidance Regarding Deduction of Fines

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Internal Revenue Code (Code) section 162(f), relating to fines and penalties that would otherwise constitute ordinary and necessary expenses deductible under Code section 162(a), provides: "No deduction shall be allowed under subsection (a) for any fine or similar penalty paid to a government for the violation of any law." The provision was added to the Code in 1969 as a codification of prior case law, under which certain such expenses were held nondeductible because allowing a deduction would be inconsistent with public policy.[1]

The controversies that continue to arise under Section 162(f) are illustrated by two memoranda released within the past two months by the IRS Office of Chief Counsel. CCA 201619008 addresses whether an amount paid to the SEC and representing a disgorgement of profits from activities in violation of law is a "fine or similar penalty," or compensatory in nature and therefore not subject to disallowance under section 162(f); and CCA 201623006 addresses whether the Financial Industry Regulatory Authority (FINRA), a self-regulatory organization with federally mandated duties under the Securities Exchange Act of 1934 (1934 Act), is a "corporation or other entity serving as an agency or instrumentality of" the federal government within the meaning of the regulations interpreting section 162(f),[2] such that an amount paid to FINRA should be treated as an amount paid to a government for purposes of this provision.

Punitive vs. Compensatory

CCA 201619008 involved a corporation headquartered in the United States (Parent) that was engaged in business in another country through a disregarded entity (DRE) owned by another subsidiary treated as a corporation for tax purposes. Employees of DRE intentionally falsified entries in the books and records of DRE relating to payments to government officials in the country where DRE was engaged in business, and those entries affected the books and records of Parent in light of consolidation for financial accounting purposes. Parent also failed to implement adequate internal accounting and financial controls to prevent corruption-related violations, including violations of the U.S. Foreign Corrupt Practices Act (FCPA).

Parent consented to the entry of final judgment against it to resolve a civil proceeding brought by the SEC. That judgment included a permanent injunction against violations of specified provisions of the 1934 Act.

Parent also agreed to disgorge an amount representing profits gained as a result of the conduct alleged by the SEC in its complaint, plus interest (the disgorgement payment). The amount required to be paid to resolve the civil proceeding was ultimately paid by Parent to the SEC, which paid the funds to the United States Treasury.

In addition, Parent and DRE each consented to the filing of a criminal information by the Department of Justice (DOJ) charging each of them with violations of law. Each agreed to a monetary penalty, over and above the disgorgement payment, which was ultimately paid by Parent to Treasury after the sentencing of DRE for FCPA-related violations. A document entered into by Parent with the DOJ stated that no United States tax deduction may be sought in connection with the payment of this penalty, but that document did not address the tax treatment of the disgorgement payment.

Parent made several arguments as to why the disgorgement payment was deductible notwithstanding section 162(f). First, it pointed out that section 162(f) has been held not to prevent the deduction of payments that, although labeled civil penalties, are required to be made to encourage prompt compliance with the law, such as late filing charges and interest charges, rather than primarily to punish. The IRS was not persuaded that the disgorgement payment was in the nature of a late filing or interest charge.

Parent also argued that the disgorgement of profit was intended as a compensatory or remedial action, pointing to case law cited in the CCA to the effect that the deduction of payments that are compensatory in nature is not disallowed under section 162(f). In this context, Parent also referred to a statement in Reg.

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section 1.162-21(b)(2) that "[c]ompensatory damages" (such as damages imposed under section 4A of the Clayton Act, relating to antitrust matters) "paid to a government do not constitute a fine or penalty," and argued that the measure of the disgorgement payment—apparently determined by reference to profits earned in activities conducted in violation of law—suggested an intent to avoid unjust enrichment rather than to punish.

The CCA concludes that, in order for a disgorgement payment to be considered "compensatory" for these purposes, it must be designed to return both the payor and the injured party to the status quo ante. Whether or not disgorgement is primarily punitive or primarily compensatory will turn on the facts and circumstances of each case.[3] Here, there was no indication that the purpose of the payment was to compensate the Treasury or some other party for specific losses caused by violations of the FCPA by Parent or DRE. Therefore, the CCA concluded, the payment should be considered primarily punitive rather than compensatory, and was not deductible under section 162 (or as a loss under Code section 165).

The CCA also rejected Parent's assertion that the statement in a document entered into with the DOJ, to the effect that the penalty paid relating to the criminal information would not result in any tax benefit, implied that the separate disgorgement payment was not of the same punitive nature and was deductible.

Government Agency or Instrumentality

The phrase "paid to a government" in section 162(f) is interpreted by Reg. section 1.162-21(a) to include payments to "[a] political subdivision of, or corporation or other entity serving as an agency or instrumentality of," the government of the United States or of any State or any foreign country. Without addressing the circumstances of any particular situation before the IRS, CCA 201623006 responds to the question, apparently arising in various matters before the IRS, of whether FINRA is a "corporation or other entity serving as an agency or instrumentality of" the United States government for purposes of the regulations under section 162(f).

The CCA describes FINRA as a non-profit Delaware corporation that was formed in 2007 through a consolidation of the National Association of Securities Dealers, Inc. with the regulatory arm of the New York Stock Exchange. FINRA is a registered "self-regulatory organization" (SRO) under the 1934 Act[4] that has the authority to create and enforce rules for, and to provide regulatory oversight of securities firms that do business with the public.

The CCA discusses provisions of the certificate of incorporation of FINRA, and case law relating to FINRA, confirming that FINRA has the power to enforce compliance with federal securities statutes and SEC regulations, as well as with FINRA's own rules, by its members. FINRA has not been empowered by Congress to bring actions in the courts to enforce its own fines. The SEC, however, asserts that it has the authority to review and affirm by its order sanctions imposed by FINRA, and to bring an action in federal court to enforce such an order.

On the other hand, the CCA notes that FINRA's own website states that FINRA is not part of the government.

The CCA discusses two Tax Court decisions that appear at least somewhat on point, although neither deals with FINRA. In *Guardian Industries Corp. v. Commissioner*,[5] the issue before the court, in the context of cross-motions for summary judgment, was whether a payment made by the petitioner to the Commission of the European Community (the Commission), on account of infringement of the competition provisions of the Treaty Establishing the European Economic Community by fixing prices, was not deductible by reason of section 162(f). It was stipulated that the payment constituted a fine or similar penalty paid for the violation of a law, and the sole issue before the court in *Guardian* was whether the payment to the Commission was made "to a government" for purposes of section 162(f).

The Tax Court concluded in *Guardian* that the fact that the Commission was required to act on behalf of the various states that are members of the EC *collectively* did not prevent the Commission from being viewed as an agency or instrumentality of *a* foreign government—that is, that the reference in the regulation to "foreign government" in the singular should not be interpreted to exclude an agent or instrumentality of multiple governments. The court also declined the petitioner's suggestion that the court adopt a definition "informed by applicable dictionary definitions" of the term "agency or instrumentality" as limited to a person that is controlled by a government, acts exclusively for the government, and is subordinate to the government. The court deemed such a definition to be too narrow for this context, especially because it tended to equate the term "agency or instrumentality" with the term "political subdivision" that the regulation under section 162(f) separately referenced as being a government for this purpose.

The court in *Guardian* further noted that an entity might be an "agency" or "instrumentality" of a government for one purpose but not another purpose, and ultimately adopted a "functional approach" for purposes of section 162(f) that looked to whether the entity: "has been delegated the right to exercise part of the sovereign power of a government or governments"; "performs an important government function"; and "has the authority to act with the sanction of government behind it." The court then concluded that the Commission met all of these criteria and was therefore an agency or instrumentality of a foreign government within the meaning of the regulations under section 162(f).

The CCA concludes that, under the functional approach applied by the Tax Court in *Guardian*, a payment made to FINRA is a payment made to a government agency or instrumentality for purposes of section 162(f) where the payment results from performance by FINRA of its federally mandated duties under the 1934 Act.

The CCA further asserts that *Rothner v. Commissioner*,[6] a Tax Court memorandum decision predating *Guardian*, is not authority to the contrary. *Rothner*

addressed whether a fine paid by a member of the Chicago Mercantile Exchange (CME) to the CME, after a disciplinary proceeding arising from apparent violations of CME rules by the member, was deductible under section 162(a) as an ordinary and necessary business expense. The decision states that, "[w]hen the CME conducts disciplinary proceedings involving any of its members or takes disciplinary action against any of them, it does not act as an agency or agent of any government," and that the government conceded that section 162(f) did not apply to the payment of the CME fine. The Tax Court ultimately concluded that the CME fine was deductible under section 162(a).

The CCA observes that the reason for the government's concession in Rothner is not apparent, and that the fine may have been imposed solely on a contract theory – that is, by reason of a breach of a rule imposed by contract between the CME and its members, rather than by statute or government regulation. The CCA states that section 162(f) will not apply to a fine paid to FINRA solely for violation of a "housekeeping" rule imposed by FINRA on its members by contract between the agency and its members. Conversely, where FINRA is conducting enforcement and disciplinary proceedings relating to compliance with federal securities laws, federal regulations, and "FINRA rules promulgated pursuant to [its] statutory and regulatory authority," a payment made to FINRA will be viewed as paid to a government for purposes of section 162(f).

It remains to be seen whether the courts will accept the apparent IRS view that the applicability of section 162(f) in respect of a payment to a SRO such as FINRA may turn on which rule or rules of the SRO were allegedly breached by the payor, and on the origins of those rules.

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1 See H. Rep. No. 91-782 (1969), at 331; *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958).
2 Reg. § 1.162-21(a)(3).
3 See, e.g., *Nacchio v. United States*, Dkt Nos. 2015-5114, 2015-5115 (Fed. Cir. 2016) (disallowing a deduction for a forfeiture on various grounds).
4 See, e.g., 15 U.S.C. § 78c(a)(26).
5 143 T.C. 1 (2014).
6 TC Memo 1996-442.