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CLIENT ALERT

Supreme Court Decision Forces Resolution of SEC-IRS Conflict on Disgorgement

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Following the Supreme Court's decision in *Kokesh v. SEC*, 137 S. Ct. 1635 (2017), on December 1, 2017, the IRS released a Chief Counsel Advice (CCA)[1] stating that section 162(f) of the tax Code prohibits a deduction for any amount paid as disgorgement for violating a federal securities law, including the Foreign Corrupt Practices Act (FCPA). The CCA reconciles previous contrary views of the IRS and SEC on the nature of disgorgement for purposes of tax and the statute of limitations for civil enforcement actions.

As detailed in our June 2016 client alert, the IRS and SEC previously took contrary positions on of the status of disgorgement payments. The split allowed the government the best of both worlds—treating disgorgement as a penalty for purposes of tax deductibility, but not as a penalty for purposes of the statute of limitations. The IRS's position was that whether disgorgement is primarily compensatory (and deductible) or punitive (and nondeductible) depends on the facts of a particular case. In its May 6, 2016 CCA, the IRS stated that disgorgement payments to the SEC in a corporate FCPA enforcement action were penalties and not tax deductible. In contrast to the IRS's view, the SEC treated disgorgement as an equitable remedy and not a penalty subject to the statute of limitations in all of its enforcement actions. Specifically, Section 3.1.2 of the SEC Enforcement Manual made it clear that "certain claims are not subject to the five-year statute of limitations under [28 U.S.C. § 2462], including claims for injunctive relief and disgorgement."

The Supreme Court, however, unanimously disagreed with the SEC's view that disgorgement is remedial, holding that disgorgement payments to the SEC are penalties. In *Kokesh*, the Court held that the five-year statute of limitations in 28 U.S.C. § 2462 for violations of the federal securities laws applies to disgorgement payments. *Kokesh*, 137 S. Ct. at 1638. The Court used a two part test to determine whether a particular sanction is a penalty: (1) whether the wrong sought to be redressed is a wrong to the public or a wrong to the individual; and (2) whether the sanction is sought for the purposes of punishment, to deter others from offending in a similar manner, or whether it is intended to compensate victims. *Id*. The Court explained that sanctions that provide a compensatory remedy for a private wrong are not penalties. It concluded that the disgorgement remedy utilized in SEC enforcement actions is not principally remedial, but instead more closely resembles a penalty because it is intended to punish and deter violations of public laws as opposed to compensate. *Id*.

Under the new CCA, the IRS changed its position on disgorgement as a result of *Kokesh*. The CCA takes the position that characterization of a payment for the purposes of section 162(f) depends on the origin of liability giving rise to the payment, and sanctions imposed as punishment for violating the law are not tax deductible, regardless of the use of the money. In light of the Court's finding that disgorgement is penal and not compensatory, and is therefore subject to the five-year statute of limitation under 28 U.S.C. § 2462, the new CCA flatly states that an amount paid as disgorgement for violating a federal securities law is a nondeductible "fine or penalty" under section 162(f).

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[1] CCAs are not precedential authority but represent the current views of the IRS Chief Counsel Office.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

Thomas A. Hanusik
Partner – Washington, D.C.
Phone: +1 202.624.2530
Email: thanusik@crowell.com

Jared Engelking
Associate – Washington, D.C.
Phone: +1 202.624.2815
Email: jengelking@crowell.com