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IRS And SEC Have Contrary Views On Disgorgement

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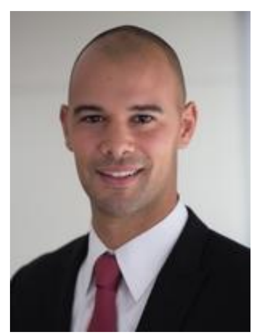
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On May 6, 2016, the IRS released a chief counsel advice[1] stating that disgorgement payments to the U.S. Securities and Exchange Commission in a corporate Foreign Corrupt Practices Act enforcement action are not tax-deductible. The corporate taxpayer in the CCA allegedly violated the internal controls and books-and-records provisions of the Foreign Corrupt Practices Act. The taxpayer entered into a consent agreement with the SEC that required it to pay disgorgement for the profits gained as a result. The taxpayer also agreed to pay a penalty and agreed with the U.S. Department of Justice that the penalty would not be deductible for tax purposes.

The IRS determined in the CCA that the disgorgement payment was a nondeductible "fine or penalty" under Internal Revenue Code Section 162(f). The taxpayer argued that the disgorgement payment is deductible because it was made to encourage prompt compliance with the securities laws, was intended as a compensatory or remedial measure, and because the consent agreement did not prohibit deductibility. The IRS rejected all of these arguments.

Notably, the CCA does not take the position that all disgorgement payments are nondeductible under Section 162(f), and in fact the IRS and the Tax Court have previously allowed a deduction for disgorgement payments.[2] Rather, the CCA argues that whether disgorgement is primarily compensatory (and deductible) or punitive (and nondeductible) depends on the facts of a particular case. The CCA determined that the taxpayer at issue could not establish that the disgorgement was intended to compensate the SEC for actual losses and therefore opined that the disgorgement was not tax-deductible. In support of its position, the IRS noted that compensatory payments normally flow to the injured party, but here there was no allegation that the government was damaged by the company's FCPA violations. Furthermore, there was no indication that the purpose of the disgorgement payment was to compensate the government or some other party for specific losses caused by the taxpayer. Therefore, the IRS concluded that the disgorgement payment was primarily punitive.

In contrast to the IRS' view that disgorgement can be penal and therefore not tax-deductible, the SEC maintains that disgorgement is never penal for the purposes of the five-year statute of limitations in civil enforcement actions, and therefore claims for disgorgement are never time-barred. There is a five-year statute of limitations on suits to enforce any "civil fine, penalty, or forfeiture" under 28 U.S.C. § 2462. Section 3.1.2 of the SEC Enforcement Manual states 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." Thus the enforcement manual characterizes disgorgement as an equitable remedy — not a "penalty" — to be considered by the SEC in assessing the societal interest when determining accountability. See, e.g., SEC Enforcement Manual § 6.1.1(c)(4). Punitive remedies, or penalties, on the other hand, are time-barred if they are not pursued within the statute of limitations. Gabelli v. SEC, 133 S. Ct. 1216 (2013).

Until recently, courts and administrative tribunals have generally agreed with the characterization of disgorgement paid to the SEC as an equitable remedy for the purposes of the five-year statute of limitations. Administrative Law Judge Cameron Elliott, in In re Matter of Timbervest LLC, et. al., Release No. 658 (Aug. 20, 2014), found "[d]isgorgement is an equitable remedy that requires a violator to give up wrongfully obtained profits causally related to the proven wrongdoing." (citing SEC v. First City Fin. Corp., 890 F.2d 1215, 1230-32 (D.C. Cir. 1989)). Therefore, as annunciated in Johnson v. SEC, 87 F.3d 484 (D.C. Cir. 1996), the five-year statute of limitations does not apply to disgorgement. In contrast, the five-year statute of limitations does apply to civil monetary penalties because they are penal in nature. See Gabelli v. SEC, 133 S. Ct. 1216 (2013).

However, in a recent opinion, SEC v. Graham — issued after the IRS released the CCA — the Eleventh Circuit disagreed with the SEC and held that disgorgement is subject to the five-year statute of limitations in § 2462. No. 14-13562, (11th Cir. May 26, 2016). The court analogized disgorgement to forfeiture — both pecuniary and otherwise — and noted that both disgorgement and forfeiture require the divesting of ownership of particular property of a person on account of that person's breach of a legal duty. The court reasoned that disgorgement, like forfeiture, should be subject to the five-year statute of limitations.

In the proceeding below, the district court concluded that the injunctive and declaratory relief sought by the SEC were penalties and that disgorgement constituted a forfeiture, all within the meaning of § 2462. 21 F. Supp. 3d 1300, 1310-11 (S.D. Fla. 2014). On appeal, the Eleventh Circuit looked to the plain meaning of the term "penalty" to find that an injunction is not a penalty because it is a forward-looking remedy that prevents future harm. A penalty addresses a wrong committed in the past; therefore, the court found that the five-year statute of limitations is inapplicable to injunctions. Conversely, the court found that declaratory relief is backward-looking and as a public declaration of wrongdoing, it is intended to punish. As a result it operates as a penalty under § 2462.

The court did not focus on the penal nature of disgorgement when examining whether disgorgement is subject to the statute of limitations. Instead, it found that disgorgement is a type of forfeiture, and forfeiture is expressly covered by § 2462. Again, the court turned to plain meaning to come to this conclusion. It said that there was "no meaningful difference in the definitions of disgorgement and forfeiture," that the U.S. Supreme Court used the two terms interchangeably, and therefore for the purposes of § 2462 the remedy of disgorgement is a forfeiture for which the statute of limitations applies. The court rejected the SEC's "technical" argument that disgorgement cannot be a forfeiture because disgorgement only includes relinquishing direct proceeds from wrongdoing, whereas forfeiture can include both ill-gotten gains and any additional profit earned on those ill-gotten gains. It found that Congress did not intend to adopt this technical distinction, and even under the SEC's definition, disgorgement can still be considered a subset of forfeiture — whether pecuniary or not.

The Eleventh Circuit's decision in SEC v. Graham demonstrates that views are still evolving on whether disgorgement is an equitable remedy for the purposes of the five-year statute of limitations. The

Eleventh Circuit's characterization of disgorgement as a forfeiture expressly subject to the statute of limitation in § 2462 avoids the tension between the IRS' view that disgorgement can be penal and therefore not tax-deductible, and the SEC's view that disgorgement is never penal for the purposes of the five-year statute of limitations. Instead, it concluded that disgorgement and forfeiture, whether penal or otherwise, are synonyms and therefore remedies subject to § 2462. As discussed above, the IRS' view is that the deductibility of disgorgement payments turns on whether the payments are compensatory or penal in nature.

Another remedy that is similar to disgorgement is restitution. Under federal law, a person who is unjustly enriched at the expense of another for crimes involving fraud or deceit is subject to mandatory restitution. 18 U.S. Code §§ 3663A(a)(1) and (c)(1)(A)(ii). The purpose of restitution is primarily compensatory. Paroline v. United States, 134 S.Ct. 1710, 1726 (2014). Thus disgorgement paid to victims is like restitution in that it compensates the victim for losses. When disgorgement is paid to the government, it is unlike restitution in that its primary purpose is to make illegal conduct unprofitable for the offender by having the offender return the fruits of that conduct. In that setting, disgorgement's "primary purpose ... is deterrence." SEC v. First Jersey Sec. Inc., 101 F.3d 1450, 1475 (2d Cir. 1996); SEC v. Commonwealth Chem. Sec. Inc., 574 F.2d 90 (2d Cir. 1987) ("[T]he primary purpose of disgorgement is not to compensate investors."). Unlike compensatory damages, district courts may "grant disgorgement without inquiring whether, or to what extent, identifiable private parties have been damaged by [the] fraud." SEC v. Blavin, 760 F.2d 706, 713 (6th Cir. 1985).

In determining whether restitution, disgorgement, and forfeiture are deductible for tax purposes, courts and the IRS ask whether the payments are penal or compensatory in nature. For example, the IRS recently ruled that a restitution payment made to the government was not a fine or penalty and was deductible, where it was clear that the payment was intended to compensate the government for actual losses suffered as a result of the taxpayer's conduct. PLR 201528026.[3] The IRS also noted that the restitution payment was not made in lieu of forfeiture. On the other hand, forfeiture payments are generally held to be penalties and therefore nondeductible. See, e.g., Nacchio v. United States, 117 A.F.T.R. 2d 2016-xxxx (June 10, 2016) (holding taxpayer could not take a deduction for forfeiture of insider trading profits to government); King v. United States, 152 F.3d 1200 (9th Cir. 1998) (holding taxpayer could not deduct forfeiture of drug profits to the FBI). In Nacchio, decided earlier this month, the Federal Circuit reversed the Court of Claims on the application of Section 162(f) to the forfeiture payments. The Court of Federal Claims held that the forfeiture payments were deductible because, even though not expressly characterized as restitution, the amounts ultimately were returned to victims of the taxpayer's crimes. The Federal Circuit disagreed, relying in part on nontax cases characterizing forfeiture as punitive (in contrast to restitution, which is compensatory).

As discussed above, the IRS position is that disgorgement may be a nondeductible "fine or penalty" depending on the facts. In contrast, the SEC characterizes disgorgement as equitable relief (i.e., not a penalty) and specifically relies on that characterization when arguing to the courts that disgorgement should not be subject to the five-year statute of limitations applicable to SEC penalties. The Eleventh Circuit seems to be taking a third approach: disgorgement paid to the government is akin to forfeiture and therefore subject to the five-year statute of limitations.

Whether disgorgement paid to victims, which is much more akin to restitution, will be subject to the five-year statute of limitations remains to be seen. In such a scenario, it is more likely that the disgorgement would be viewed as compensatory for tax purposes, and therefore deductible. In light of many agencies' and SROs' insistence on multimillion-dollar disgorgement payments, a person faced with disgorgement should consider the fact that the purpose of the payment and the identity of the intended recipient(s) could determine not only whether the five-year statute of limitations applies but also whether the payment is deductible.

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[1] A chief counsel advice is nonprecedential guidance from the IRS Office of Chief Counsel.

[2] See Wang v. Commissioner, T.C. Memo 1998-389, aff'd, 35 Fed. Appx. 643 (9th Cir. 2002); LAFA 20152103F (holding that disgorgement payment made as a result of alleged violations of the Federal Food, Drug, and Cosmetic Act was likely deductible and not subject to the section 162(f) limitation).

[3] A private letter ruling is nonprecedential guidance.