



Subsidizing Bad Behavior

How Corporate Legal Settlements for Harming the Public Become Lucrative Tax Write Offs, with Recommendations for Reform

U.S. PIRG
Education Fund



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Executive Summary

BP's recent \$4.5 billion legal settlement with the Justice Department for its misdeeds in the Gulf oil spill was historic for being the largest ever criminal settlement. But it was historic for another reason as well—none of it is allowed to be tax deductible. Unfortunately, too many settlements for wrongdoing end up as tax deductions.

Corporations accused of wrongdoing commonly settle legal disputes with government regulators out of court. Doing so allows both the company and the government to avoid going to trial and the agency gets to appear as if it is teaching the company a lesson for its misdeeds. However, very often the corporations deduct the costs of the settlement on their taxes as an ordinary business expense, shifting a significant portion of the burden onto ordinary taxpayers to pick up the tab. Especially when Congress is struggling to reduce budget shortfalls, every dollar that corporate wrongdoers avoid paying by deducting a settlement must be made up for through higher tax rates for others, cuts to public programs, or an increase in the national debt.

Taxpayers should not subsidize BP's recklessness and deception in the Gulf, big banks' costly tampering with interest rates in the Libor scandal, or other wrongdoing.

The law clearly states that punitive penalties and fines issued by government agencies are *not* tax-deductible, but agencies that negotiate settlements all too rarely make clear what portion of a settlement should be regarded as punitive. Corporate tax lawyers can take advantage of this ambiguity by acting as if none of the settlement was meant to be punishment for misdeeds. The Internal Revenue Service is ill prepared to challenge these claims, and taxpayers end up holding the bag.

To help ensure that corporate wrongdoing is not publicly subsidized and that taxpayers are not saddled with the burden, U.S. PIRG offers the following policy recommendations that could save billions of dollars each year:

- The President should instruct federal regulatory bodies to assume full responsibility for determining the

extent to which settlement payments are punitive and therefore non-deductible.

- Congress should clarify ambiguities in law and require settlement payments to be designated in ways that will have clear consequences for whether those payments are deductible or non-deductible.
- Agencies should disallow tax deductibility of settlement payments when companies wrongly treat public harm as an acceptable business risk. In cases where company costs truly are incurred from normal business activities, regulators should clearly define and distinguish, in the settlements, between the agreed-upon punitive payments which will not be tax-deductible and normal costs of doing business.
- Agencies should be instructed to publicize the expected after-tax amounts of settlements, which would more accurately report the net penalty that will be paid by the corporation. This is a matter of truth in advertising. Likewise, any company's public statements about the settlement should

list how much of the settlement the company would likely pay *after* taxes.

- Any publicly traded corporations that deduct part or whole of a settlement with federal agencies should be required to provide brief justification for deducting such expenses on their annual filings with the Securities and Exchange Commission (SEC).
- The Internal Revenue Service should continue its progress towards comprehensive information sharing with federal agencies to help agencies designate what can be tax deductible and to establish standard procedures to determine the tax treatment of settlements. The IRS should likewise develop a system of communicating with state and local governments to ensure that settlements negotiated by these entities receive proper federal tax treatment.
- Following the recommendations of the past three administrations, Congress should prohibit the tax deduction of punitive settlement payments to *private* parties. At present, this prohibition is only for settlement costs paid to the government.

Introduction

This past year, we have seen some of the world's largest and most profitable corporations agree to large financial settlements with federal agencies, states and other parties to resolve charges of abuse ranging from interest rate manipulation¹ and fraudulent practices by pharmaceutical companies² to flouting sanctions against Iran and Cuba³ and levying illegal late fees on credit card holders.⁴ Just since 2009, Bank of America alone has spent over \$29 billion on settlements.⁵

Settlements are often touted as a win-win for everyone. In doing so, the company and the government avoid going to trial, and the agency can agree to some compromise level of payment. Regulatory agencies conserve their limited resources. Companies avoid admission of liability and potentially embarrassing legal proceedings; and both regulators and companies can move on with their lives.

But typically there are hidden downsides to taxpayers and the general public from these settlements. The law has long made clear that when companies pay to settle their liability for a fine or penalty, they

are forbidden from deducting such costs from their taxes as a normal business expense. However, the law allows companies to deduct for payments of “compensatory damages” for the results of business risk taking that isn’t being punished.⁶

What does this mean in practice? If a delivery company must pay compensation to another auto owner for a collision, it would be treated for tax purposes as a normal business expense which may be deducted—no matter how reckless the driving. But if a public agency finds that the company disregards safety requirements, and punishes the company by issuing a fine, the resulting payments should not be deducted as ordinary business expenses. It’s not only when companies pay fines or penalties to public agencies that companies are forbidden from deducting their costs. The law states that the “amounts paid in settlement of the taxpayer’s actual *or potential* liability for a fine or penalty (civil or criminal)” are not deductible.⁷ Thus, if a company charged with wrongdoing settles with a government agency over charges that could have resulted in a fine or penalty,

then the portion of the settlement meant to be punishment for wrongdoing should not be deductible.

For smaller penalties and fines that agencies simply levy on companies for wrongdoing, the prohibition on deducting them from taxes has been straight forward. But tax deductibility has been more complicated for larger penalties where agencies typically negotiate the terms with the company facing those sanctions. Although the law makes clear that settlements over potential fines and penalties are nondeductible, companies can assert that settlement amounts were not in place of potential fines or penalties but rather in place of compensatory damages or restitution in the course of doing business. In that case, the company is permitted to deduct the settlement costs.

A large tax deduction from a settlement can be very valuable even if a company would not report taxable profits that year. Companies can “carry forward” their taxable losses to future years and thus eliminate future taxes, even if they would not pay taxes in the present year. Likewise, companies can sometimes apply these losses backward to eliminate tax liability from up to two years previously.

Unfortunately, agencies often fail to explicitly define what portions of a settlement are intended as punishment. Corporations take full advantage of this ambiguity to deduct large portions or even the entirety of settlements, and effectively shift much of the burden back onto taxpayers and the government. Even when a corporation pays a fine for violating a law it may still deduct the cost from its taxable income—and thereby reduce its tax bill—by arguing that the payment was “compensatory” rather than “punitive.”⁸

Looking at the larger picture, when a company negotiates a tax-deductible settlement for its misdeeds, the public loses four times over. First, the public suffers the direct impact of corporate wrongdoing. Second, taxpayers are forced to shoulder part of the amount of the penalty because the public must cover the forgone revenue by raising tax rates, cutting public programs, or adding to the national debt. Third, future deterrence of corporate wrongdoing is weakened. And fourth, the absence of a trial eliminates opportunities for a public airing of evidence about corporate misdeeds and the lax regulations that can lead to them.

Problems and Movement Toward Reform

Corporate Wrongdoers Exploit Ambiguities in the Law

Companies that have committed wrongdoing can shift part of the burden of their penalty onto taxpayers by taking advantage of ambiguities in the law. The Code of Federal Regulations states that payments made to settle a public punishment should not be deducted like a normal business cost. It prohibits the deduction of any “fine or similar penalty paid to...the government of the United States.”⁹ It makes clear that “compensatory damages...paid to a government do not constitute a fine or penalty.”¹⁰ Thus, if a cleaning company accidentally spills bleach on the rug in a federal government office and must pay to replace it, this compensation *can* be deducted as a normal business risk.

While there can be special exceptions, sorting out which fines or settlements are supposed to be deductible is straightforward analytically. As a general rule, the only payments that are non-deductible are punitive payments made to a public agency

or those that are otherwise specified as non-deductible. Fines, penalties and settlement payments can be thought of as falling into four categories, depending on whether they are punitive or not, and whether they are paid to a government or to private parties.

1. **Private settlement costs that are not punitive are tax deductible.**

For example, if a cleaning company destroys a homeowner’s rug and they negotiate (or if a judge decides in a lawsuit) that the cleaning company must pay the homeowner, then the amount the company pays is fully tax-deductible.

2. **Private settlement costs that are punitive are currently deductible,**

despite proposals by the last three Presidents and many bills in Congress that sought to change the law. If a cleaning company makes people around town sick and citizens successfully file a class action lawsuit, then the amount the company pays as punishment—like the amount of damages

	Private settlement	Public settlement
Not punitive	1. Private and non-punitive	3. Public and non-punitive
Punitive	2. Private and punitive	4. <i>Public and punitive</i>

allotted to compensate the victims—is fully deductible under current law.

3. Public settlement costs that are not punitive are fully deductible. If a cleaning company destroys the rugs at the Department of Motor Vehicles, and then the company’s lawyers negotiate that it will pay to replace the rugs, these costs are normal deductible costs for tax purposes.

4. Public settlement costs that are punitive are not deductible. If a cleaning company makes people around town sick and the Environmental Protection Agency charges that the company used chemicals prohibited for cleaning use, and the company’s lawyers negotiate a penalty paid to the agency, then this amount should not be deductible. If the settlement agreement also included payments to public or private parties to compensate for specific damages they suffered—for closing their offices temporarily, for instance—then that portion of the settlement is tax-deductible.

The Justice Department Protects Taxpayers with Second BP Settlement

Should the damage done by the Deepwater Horizon disaster—an event anything but ordinary or unavoidable—be considered an ordinary and necessary business expense, and therefore be tax-deductible?

The tax treatment of BP’s earlier settlement and restitution fund for private victims of the spill illustrates the problem of allowing certain settlements to be deductible just because they were compensatory. Two years ago, BP claimed \$10 billion in tax savings by writing off \$37.2 billion put aside for expenses related to the Gulf oil spill disaster.¹¹ To put this amount in perspective, BP’s \$10 billion tax windfall was half the size of the \$20 billion restitution fund that the company established.¹² Taxpayers were effectively forced to shoulder the other half.

This wasn’t the first time a giant oil company reaped huge rewards by deducting the expenses of its wrongdoing for an oil spill. In the wake of the 1989 Exxon Valdez disaster, Exxon took full advantage of tax deductions to pay only a fraction of its \$1.1 billion settlement.¹³

But a different precedent was set in BP’s more recent November 2012 settlements. The Department of Justice announced a \$4 billion settlement with BP, in which the company pled guilty to a number of criminal charges.¹⁴ The same day, the SEC announced a \$525 million settlement with BP, resolving charges that the company lied about the rate at which oil was escaping into the Gulf of Mexico.¹⁵ At the Department of Justice press conference, Lanny Breuer, the Assistant Attorney General for the Criminal Division, was asked whether any of the penalties will be deductible.¹⁶ His response could not have been clearer:

“They are not. The Attorney General was very clear that nothing in the criminal settlement could be tax deductible nor could it be an offset to any further civil resolution, and that

was a very explicit term of these agreements at the request of the Attorney General.”¹⁷

It is not unprecedented for agencies to explicitly forbid tax write-offs of settlements. In fact, in 2003 the SEC instituted a policy requiring that its settlements must include language which makes clear that penalty payments are not tax deductible.¹⁸ In keeping with that policy, the SEC required that its \$535 million civil penalty agreement with Goldman Sachs in 2010 would not be deductible.¹⁹ The agreement explicitly states that “the civil penalty shall be treated as a penalty paid to the government for all purposes, including all tax purposes.”²⁰ A 2011 settlement between J.P. Morgan Securities and the SEC, totaling \$51.2 million including a \$32 million penalty, contained nearly identical language.²¹

BP’s legal struggles are not over. The Department of Justice is charging the company with additional penalties under the Clean Water Act and Oil Pollution Act, with a trial planned to begin in February 2013.²² Under the Clean Water Act, the fine per barrel of oil spilled ranges from \$1,100 to \$4,300, depending on whether gross negligence is proven.²³ BP could be liable for up to \$21 billion in fines under the Clean Water Act, and additional fines under the Oil Pollution Act.²⁴

The public should watch whether a potential settlement over these federal fines is explicitly non-deductible. Otherwise, the true amount of any settlement amount could be substantially less than the headlines proclaim—and other taxpayers will be left to make up the difference.²⁵ For example, an \$18 billion tax-deductible settlement could be worth \$6.3 billion in savings for BP, making the true cost \$11.7 billion after the tax consequences are accounted for.

The Department of Justice has not yet stated whether it will seek for future settlements to be non-deductible.

Fixing the Law

There have been numerous bipartisan proposals in recent years to curtail corporations from claiming penalties and settlements as business expenses. The issue has received the support from across the political spectrum, including Presidents and members of Congress from both parties.

As Robert W. Wood, a legal expert on these issues, has noted, the administrations of Presidents Clinton, Bush, and Obama have all advocated to make punitive damages to private parties non-deductible.²⁶ The current administration’s proposed change came first in a 2009 Treasury Department proposal, which stated that, “no deduction would be allowed for punitive damages paid or incurred by the taxpayer, whether upon a judgment or in settlement of a claim. Where the liability for punitive damages is covered by insurance, such damages paid or incurred by the insurer would be included in the gross income of the insured person. The insurer would be required to report such payments to the insured person and to the Internal Revenue Service.”²⁷ The Obama Administration also maintained this proposal in their revenue proposals for fiscal year 2013.²⁸

A variety of members of Congress have also sought to ensure that settlement payments to government agencies not be deducted. In 2003, Senators Chuck Grassley (R-IA), John McCain (R-AZ), and Max Baucus (D-MT) cosponsored the “Government Settlement Transparency Act of 2003,” which would have ended deductibility for

settlements paid “in relation to the violation, or potential violation, of any law,” with the exception of restitution payments.²⁹

Introducing the legislation on the floor of the Senate, Senator Baucus stated that

“Over the past several months, we have become increasingly concerned about the approval of various settlements that allow penalty payments made to the government in settlement of a violation or potential violation of the law to be tax deductible. This payment structure shifts the tax burden from the wrongdoer onto the backs of the American people. This is unacceptable...With these efforts to achieve greater accountability in the business community and ensure the integrity of our financial markets, it is important that the rules governing the appropriate tax treatment of settlements be clear and adhered to by taxpayers.”³⁰

In 2006, Senator John McCain criticized the Department of Justice for not explicitly ensuring in its negotiated settlement with the defense contractor Boeing that the payments would not be tax deductible:

“My other concerns relate to how the Justice Department handled the deductibility issue. In response to a letter I sent to the Justice Department, with Chairman Warner and Finance Committee Chairman Grassley, the Department explained that its policy was not to address deductibility in its fraud settlement agreements.

While the Justice Department’s policy may make sense in relatively low-quantum settlements, in high-quantum settlements, it might not. That’s because how the Government addresses corporate misconduct that gives rise to settlements of \$100 million or more, has policy implications: if the settlor is permitted to recover what it pays to the Government from any third-party, that is, either the taxpayer or its insurers, the deterrence value and punitive effect of the settlement will be diluted. In defense procurement

fraud and public corruption cases, like this one, deterrence value and punitive effect are everything.

Therefore, in high-quantum corporate fraud settlements, the Department might want to revise its policy by specifically allocating the payments under a given settlement as either penalty or otherwise, and specifically prohibit the settlor from recovering penalty from any third-party. Particularly in defense procurement fraud cases, this could really make a difference.”³¹

In 2010, Representative Peter Welch (D-VT) introduced the Stop Deducting Damages Act, which would explicitly prohibit the deductibility of punitive damages and “include any amount paid as punitive damages in gross income for income tax purposes.”³² During this past session of Congress, Representative Jo Bonner (R-AL) introduced a bill that would have forbidden any party from claiming tax deductions on any “compensatory payments” related to the Deepwater Horizon disaster.³³

While all these proposals would change current law, they would also be consistent with other precedents and principles. The New York State Bar Association has noted that the tax code already prohibits the deduction of exorbitant retirement packages for business executives, as well as business expenses that a company incurs for illegal drug trafficking.³⁴ In 1958, the Supreme Court ruled that “a finding that an expense is “necessary” cannot be made if allowance of the deduction would frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof,” and that “in allowing deductions for income tax purposes, Congress did not intend to encourage business enterprises to violate the declared policy of a State.”³⁵

There is nothing new about rules dictating that certain business outlays be

treated differently for tax purposes than a firm might on its own books. It is standard practice for policy makers to determine what kind of business expenses are allowable tax deductions. IRS regulations define such things as the deductibility of business meals and entertainment. Likewise, IRS rules define the accounting of costs for stock options and asset depreciation differently than the accounting practices corporations use when reporting to shareholders. Moreover, Congress has decided to discourage certain kinds of activities by disallowing tax deductibility for: lobbying, campaign contributions, gambling losses, bribes and kickbacks, expenses related to the sale of illegal drugs, taxes paid to countries designated as supporting international terrorism, excessive “golden parachute” severance payments made to executives, and non-performance-based executive compensation over \$1 million.³⁶

Congress has determined that the nation’s tax system should reflect the notion that a company’s outlays which are incurred as punishment for wrongdoing should not be treated as legitimate costs of doing business.³⁷

Reforming a Regulatory No-Man’s Land

Confusion over which governmental body is responsible for determining tax-deductibility status of corporate settlement is one of the largest obstacles to improving enforcement and accountability. Given any ambiguity, corporations can ignore the issue of tax deductibility while negotiating a settlement and then claim that the lack of a prohibition means they can deduct the settlement costs. A study by the federal Government Accountability Office (GAO) found that agencies typically

fail to negotiate with companies on tax deductibility, and even when they levy civil penalties—which aren’t supposed to be deductible—companies typically deduct them anyway unless explicitly told otherwise.³⁸ Agencies have claimed that they lack the “tax expertise” to determine tax treatment of settlements, and that such a job is best left for the IRS.³⁹

Different agencies have differing views of their roles in addressing the issue of tax-deductibility for settlements. The SEC explicitly forbids parties they settle with from deducting penalties as normal business expenses, but does not address the status of disgorgements, which senior SEC officials contend “should be left to the IRS.”⁴⁰ In the GAO’s 2005 report, officials from the Department of Justice’s Civil Division said that the agency has a “policy of not addressing the tax treatment of settlement payments in settlements agreements.”⁴¹ For this reason the Department’s explicit statement in November 2012 settlement with BP is an important step forward. In the past, the IRS and Department of Justice have concurred that “DOJ’s tax-neutral practices on the deductibility of civil settlement payments are appropriate.”⁴² Agency officials also claimed that “they do not categorize the payments more specifically because doing so would add complexity to the negotiation process by adding additional factors on which to obtain agreement between the parties.”⁴³

While other agencies defer to the Internal Revenue Service, the IRS has meanwhile stated that the responsibility of defining settlements as punitive or compensatory falls to the agencies entering into settlements. One example of this policy is from a 2008 “issue paper” concerned with tax deductibility of settlements, in which the IRS states that it bases its treatment of False Claim Act settlements entirely on what is provided by the Department of Justice:

"All interpretation of the FCA as it applies to each case is that of DOJ. In addition, no penalty amount is based on any computation made by IRS. All figures are those of DOJ. The entire issue is based on the facts, figures, documentary evidence and interpretation of DOJ."⁴⁴

The memo goes on to explain that the DOJ's "neutrality" in the tax treatment of settlements "requires [IRS] examiners to look into these settlements and the facts behind them in order to determine if the settlement includes multiple damages, and if so, whether all or a portion of the multiples were intended to be compensation or a penalty."⁴⁵

The current policies indicate that the IRS and other agencies simultaneously believe that the other party is taking up responsibility for ensuring the proper tax treatment of corporate settlements, when in reality neither takes responsibility.

However, there are signs of increased cooperation to make a real determination of tax-deductibility instead of treating such decisions as an afterthought. In the above instance, the IRS stated that even though the Department of Justice does not divide False Claim Act settlement amounts into deductible and non-deductible parts, there is an understanding that the DOJ intends payments up to the cost of the damages to be compensatory and therefore deductible, and additional payments to be punitive and therefore non-deductible.⁴⁶ The IRS explains that:

"DOJ's intent in this context is evidenced by documentation and communication between the parties in each particular case as well as testimony of the government settlement attorneys."⁴⁷

The IRS has made an effort to address the problems identified in the GAO's report.

Aside from two 2008 "issue papers" on tax treatment of subsidies (one of which is referenced above), the IRS and the Department of Justice are developing a system for exchanging information electronically for settlements larger than \$10 million.⁴⁸ The EPA agreed to share settlement information with the IRS only "upon written request," though it worked in conjunction with the IRS and the Department of Justice to enact a new policy requiring "violators to certify that they will not deduct or depreciate expenses incurred in carrying out their settlements."⁴⁹

The November 2012 BP settlement also shows increased cooperation between regulators. In its press release, the Department of Justice "acknowledges and expresses its appreciation for the significant assistance provided by the SEC's Division of Enforcement."⁵⁰ More coordination and improved communication could help provide clarity.

Leaving the IRS to interpret the unexpressed intent of other agencies is inherently problematic; but if the IRS and regulators are going to work together effectively, they will need to establish standardized procedures and protocols over who is responsible for collecting and providing information necessary to determine tax treatment, who is responsible for interpreting such information, and how such determinations should be made.

The need for lawmakers to improve upon the current practice of determining "intent" is especially pressing given the magnitude of expected future settlements. These include the Libor scandal and the remaining charges in the Deepwater Horizon disaster. In addition, charges are still being brought against some of the country's largest financial institutions for conduct leading up to the 2008 financial crisis. In October 2012, new cases were brought by

U.S. attorneys against Wells Fargo⁵¹ and Bank of America⁵² for mortgage-related improprieties, while New York's Attorney General is going after Bear Stearns (now a part of J.P. Morgan Chase) for its mortgage

practices in the years prior to the crisis.⁵³ The tax treatment of these settlements will have very significant financial implications, and deserve increased attention and scrutiny.

Policy Recommendations

The federal government needs to address the confusion surrounding tax deductibility of corporate settlements. The recklessness and wrongdoing evidenced by the BP disaster and the developing Libor scandals should not be subsidized by taxpayers. The current economic and financial situation facing the nation makes the issue more pressing, since every dollar that corporate wrongdoers avoid paying as a result of deducting settlements must be made up for, whether through raised taxes, cuts to public programs, or an increase in the national debt.

Regulatory agencies should remember that they do not always need to reach out-of-court settlements with corporate wrongdoers. This was highlighted recently by criticism of the Securities and Exchange Commission for settling cases with corporate wrongdoers without requiring them to admit or deny guilt. In 2011, for example, a judge “threw out” the SEC’s settlement with Citigroup, calling it “neither reasonable, nor fair, nor adequate, nor in the public interest,” and said it was hard to tell whether by settling the SEC was getting more than ‘a quick headline.’⁵⁴

A number of reforms are necessary for when agencies do settle. We offer the following immediate and longer-term policy recommendations:

- The President should instruct federal regulatory bodies to assume full responsibility for determining the extent to which settlement payments are punitive and therefore nondeductible.
- Congress should devise a permanent legislative solution to clarify ambiguities in law and to require settlement payments to be designated in ways that will have clear consequences for whether those payments are deductible or non-deductible.
- Regulators should be instructed to publicize the expected *after-tax* amounts of settlements, which would more accurately report the net penalty paid by the corporation in the agreement. This is a matter of truth in advertising. Likewise, any company’s public statements about the settlement should list how much of the settlement the company would likely pay after taxes.

- Any publicly traded corporations that deduct part or whole of a settlement with federal agencies should be required to provide brief justification for deducting such expenses on their annual filings with the Securities and Exchange Commission (SEC).
- The Internal Revenue Service should continue its progress towards comprehensive information sharing to allow for consistent tax treatment of settlements and should develop a means of communicating with state and local governments to ensure the proper tax treatment of settlements at those levels of government.
- Building upon the November 2012 agreement with BP, agencies should negotiate settlements to ensure against tax deductibility of expenses when companies wrongly treat public harm as an acceptable business risk. In cases where company costs truly are incurred from normal business activities or are compensation for the injured, regulators should clearly define and distinguish in the settlements, between the agreed-upon punitive payments which will not be tax-deductible and normal costs of doing business.
- Following the recommendations of the past three administrations, Congress should prohibit the deduction from taxes of settlement payments to private parties that were meant to be punishment for wrongdoing.

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