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IRS Brass Defends Stance On Settlement Deductibility

By **Drew Singer**

Law360, Washington (May 09, 2014, 1:39 PM ET) -- Attorneys and U.S. Internal Revenue Service officials butted heads Friday at an American Bar Association conference over the right approach to determining the deductibility of settlement payments.

Banks have paid more than $100 billion in settlements since the financial collapse, but parties can only deduct settlement payments when they are compensatory. By law, payments meant to be punitive are not deductible, but determining which portions of a settlement payment qualify for a deduction can be a major point of contention between parties and the IRS, which is usually not a party to the negotiations themselves.

“Even if something is labeled as a penalty, I think it can still be treated as remedial or compensatory and if that’s the case, what label the statute puts on it may not make a difference,” Hayden Brown of Mayer Brown LLP said at a conference event. “One of things we’ve always advised people to do is go behind the government and ask ‘How did they disperse the funds, what accounts did these funds go into?”

But IRS Senior Attorney Alan Williams countered that the money’s destination does not necessarily matter.

“While that would be relevant, what’s done with the funds isn’t going to be determinative,” he said. These funds often go into a general fund and a decision isn’t made on what to do with them until later.”

Instead, the agency primarily considers what the parties intended the funds to be used for when they reached the settlement agreement, Williams said.

The debate occurred during a session of an American Bar Association’s conference for its tax session in Washington, D.C.

The issue of settlement deductibility has grown in prevalence ever since January, when the U.S. Department of Justice inked a $2.6 billion settlement with JPMorgan Chase & Co. that contained provisions to prevent the bank from taking a tax deduction on the payments.

When JPMorgan agreed to pay for its inaction on Bernard L. Madoff's $65 billion Ponzi scheme, the Justice Department negotiated into the deal a rare clause that prohibited the corporation from deducting those costs from its taxable income.

But other agencies are unlikely to press the tax issue during future negotiations, despite calls by lawmakers to make the process more transparent.

The compensatory parts of settlements are tax-deductible as normal business expenses, but after BP PLC pocketed $10 billion in tax write-offs thanks to the settlement over the Deepwater Horizon spill, lawmakers renewed their effort to shame government agencies into considering the tax fallout of high-profile negotiations.

“Allowing major corporations to write off penalties for breaking the law and harming the public is impossible to justify to taxpayers,” a group of senators wrote to the Justice Department in November, upon learning that up to half of a separate, $13 billion JPMorgan settlement covering the bank's housing-bubble misdeeds was tax-deductible. “Fines and penalties are intended not just to compensate the public, but also to serve as deterrents to others who might break the law in the future."

--Editing by Rebecca Flanagan.

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