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## Tax Deductions

Brian W. Kittle and Geoffrey M. Collins of Mayer Brown examine implications of the Federal Circuit ruling that resolved the tax consequences of former Qwest CEO Joseph Nacchio's insider trading conviction. The authors look at how *Nacchio v. United States* differs from the typical case involving deduction of fines or penalties and offer best practices for taxpayers in similar situations.

### First Principles for Section 162(f): 'Nacchio' Reminds That Criminal Fines Aren't Deductible

BY BRIAN W. KITTLE AND GEOFFREY M. COLLINS

**W**hen taxpayers negotiate settlements with the government, the tax consequences must be considered up front. Many payments will be deductible—but many won't, because under tax code Section 162(f), which codified the public policy doctrine, "fines or similar penalties" that are paid to a government aren't deductible.

Assuming a payment is made to a government, a government agency or a government instrumentality (all of which are "government[s]" for Section 162(f) purposes),<sup>1</sup> whether that payment is a fine or similar penalty depends on the purposes of the statute giving rise to the government's claim and, in some cases, the purposes of a particular payment.

After denying a motion for rehearing, the U.S. Court of Appeals for the Federal Circuit Oct. 3 issued its mandate in *Nacchio v. United States*, finalizing a high-profile case involving Section 162(f) issues.<sup>2</sup>

<sup>1</sup> See Treas. Reg. Section 1.162-21(a)(3).

<sup>2</sup> See Mandate, *Nacchio v. United States*, Dkt. No. 15-5114, Index No. 54 (10/3/16); Order, *Nacchio v. United States*, Dkt.

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In *Nacchio*, there was no dispute as to whether the payment—to the U.S.—was made to a government.<sup>3</sup> Instead, the dispute was about whether the payment was a fine or similar penalty. And unlike the majority of Section 162(f) disputes, *Nacchio* centered on the purpose of the statute giving rise to the government's claim (the first question above), and involved a criminal rather than a civil payment.

### The 'Nacchio' Story

Twenty years ago, former Qwest Communications International Inc. Chief Executive Officer Joseph Nacchio seemed to be living the American dream. In 1997, he became CEO of Qwest,<sup>4</sup> taking the company public later

No. 15-5114, Index No. 53 (9/23/16) (denying taxpayer's motion for rehearing).

<sup>3</sup> Cf. Chief Counsel Advice Memorandum 201623006, subject: "Section 162(f) 'Agency or Instrumentality' and FINRA" (May 2, 2016) (discussing whether payments to Financial Industry Regulatory Authority were payments to a "government" for Section 162(f) purposes).

<sup>4</sup> See Greg Griffin, "Until the Denver Detour That Could Put Him In Prison, Nacchio's Story was as American as Apple Pie," *The Denver Post* (Dec. 25, 2005), available at <http://www.denverpost.com/2007/03/08/until-the-denver-detour-that-could-put-him-in-prison-nacchios-story-was-as-american-as-apple-pie/>.

that year.<sup>5</sup> And by 2000, he grew Qwest into the fourth largest long-distance carrier and a major player in local telephone service after its \$44 billion acquisition of U.S. West.<sup>6</sup>

Unfortunately for Qwest's shareholders, things weren't as they appeared. Over the next two years, they would learn that Qwest had billions in losses, that the Securities and Exchange Commission was probing Qwest's accounting<sup>7</sup> and that Qwest's debt was being downgraded to junk status.<sup>8</sup>

By the time Nacchio finally stepped down in 2002, Qwest's stock had fallen from more than \$60 to only \$4. Losing his job was only the beginning for Nacchio: Three years later, the U.S. would indict him on 42 counts of insider trading.<sup>9</sup> Eventually, in April 2007, a jury convicted him of 19 of the 42 counts.<sup>10</sup> He was sentenced to six years' imprisonment, a criminal fine of \$19 million and a criminal forfeiture of approximately \$52 million (the gross proceeds of the insider trading).<sup>11</sup> Following appeal to the 10th Circuit, his sentence was reduced to 70 months, the same fine and a reduced forfeiture of \$45 million (the net, rather than gross, proceeds of the insider trading).<sup>12</sup>

At issue in the Federal Circuit was whether he could deduct the criminal forfeiture payment.

## The Framework: Section 162(f)

Nacchio argued that the forfeiture was deductible under the claim-of-right doctrine (codified in Section 1341),<sup>13</sup> because he paid tax on the net profit of his trades in a prior year and he reasonably believed that he had an unrestricted right to those net profits until his conviction required him to forfeit the funds.<sup>14</sup>

For the claim-of-right doctrine, the Federal Circuit requires taxpayers to show that they are entitled to a deduction under "another section of the Internal Revenue Code."<sup>15</sup> To meet this requirement, Nacchio relied on Section 165, which allows a deduction "for any loss sus-

<sup>5</sup> See Dow Jones Newswires, "Investors Welcome the IPO Of Telecom Start-Up Qwest," Wall Street Journal (June 24, 1997).

<sup>6</sup> See Bloomberg News, "Qwest Completes Purchase of US West," New York Times (July 3, 2000).

<sup>7</sup> See "Nacchio Out at Qwest—Telecom CEO faced criticism for \$27M pay, debt downgrade, SEC probe," CNN Money (June 17, 2002)

<sup>8</sup> Id.

<sup>9</sup> See Indictment, *United States v. Nacchio*, No. 1:05-cr-00545-MSK (12/20/05), available at <https://www.justice.gov/sites/default/files/criminal-fraud/legacy/2015/05/22/12-20-05joseph-nacchio-indictment.pdf>. The indictment stemmed from Nacchio's exercise of employee stock options to sell more than \$100 million of Qwest shares between January and May 2001. Id. at 4–5 at table.

<sup>10</sup> See *United States v. Nacchio*, 2007 BL 67181 (D. Colo. 7/27/07).

<sup>11</sup> See *United States v. Nacchio*, 2008 BL 53984, 519 F.3d 1140, 1148 (10th Cir. 2008) (vacated in part by 555 F.3d 1234 (10th Cir. 2009)).

<sup>12</sup> *Nacchio v. United States*, 2014 BL 67384, 115 Fed. Cl. 195, 199 (2014).

<sup>13</sup> Id. at 200.

<sup>14</sup> Id.

<sup>15</sup> *Nacchio v. United States*, 2016 BL 185348, 824 F.3d 1370 slip op. at 6 (Fed. Cir. 6/10/16).

## Building the Case for a Deduction

Deductibility of settlements paid to the government can turn on the following factors:

■ **Statute:** If payments under the statute are clearly fines or penalties for Section 162(f) purposes, no deduction is available.

■ **Cooperation:** Tax and legal departments should work together from the start to ensure the right information is available to substantiate a deduction once negotiations are complete.

■ **Negotiations:** If the statute's purpose is unclear, evidence documenting the parties' intent—such as evidence of negotiations regarding proper compensatory damages—matters.

■ **Recipients:** Where the payment's nature is unclear, its use to compensate victims can be evidence of the parties' intent.

tained during the taxable year" that isn't compensated by insurance or otherwise.<sup>16</sup>

Section 165, however, is subject to several limitations, and the parties stipulated that one of those limitations was the "frustration of public policy" doctrine.<sup>17</sup> The frustration of public policy doctrine prohibits deductions that would "frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof."<sup>18</sup>

Congress codified the frustration of public policy doctrine in 1969 as Section 162(f).<sup>19</sup> Section 162(f) limits deductions under Section 162(a) by preventing allowances for "any fine or similar penalty paid to a government for the violation of any law."<sup>20</sup> Courts have held that, although Section 162(f) doesn't explicitly address Section 165, the frustration of public policy doctrine continues to apply to Section 165.<sup>21</sup> For that reason, courts have looked to Section 162(f) in Section 165 cases.<sup>22</sup>

The Federal Circuit did the same.<sup>23</sup>

For simplicity, we follow the Federal Circuit by treating Section 162(f) as applicable to Section 165 and coterminous with the frustration of public policy doctrine.

## Nacchio's Short-Lived Success In the Trial Court

On summary judgment, the trial court held that the "public policy against insider trading did not prevent

<sup>16</sup> Id.; Section 165(a).

<sup>17</sup> Id. at 7.

<sup>18</sup> Id. at 7 (quoting *Tank Truck Rentals v. Commissioner*, 356 U.S. 30, 33–36 (1958)).

<sup>19</sup> See Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487, 710 Section 902(a) (1969).

<sup>20</sup> *Nacchio*, slip op. at 7; Section 162(f).

<sup>21</sup> See, e.g., *Stephens v. Commissioner*, 905 F.2d 667, 671 (2d Cir. 1990).

<sup>22</sup> Id.

<sup>23</sup> *Nacchio*, slip op. at 8.

the deduction of the amount forfeited here.”<sup>24</sup> It concluded that, although the \$19 million fine was clearly punitive, the forfeiture represented a disgorgement of his “illicit net gain from insider trading.”<sup>25</sup> For further support, it noted that the Department of Justice ultimately returned the forfeiture to victims of his crimes, even though it wasn’t “characterized as restitution.”<sup>26</sup>

Rather than hold a trial on the factual issues, the government stipulated the forfeiture was otherwise deductible.<sup>27</sup> As a result, the case went directly to the appeals court.

## The Federal Circuit Reverses

Unlike many settlement cases,<sup>28</sup> the statutory basis of the payment was clear: The 10th Circuit held that Nacchio’s forfeiture was made under by 18 U.S. Code Sections 981(a)(1)(C) and 2461(c).<sup>29</sup> As a result, the question was simple: Are payments under 18 U.S.C. Sections 981(a)(1)(C) and 2461(c) fines or similar penalties for Section 162(f) purposes?

First, the Federal Circuit looked to the statute. It noted that the design of the statute required Nacchio to use after-tax dollars to pay the forfeiture: The express language of 18 U.S.C. Section 981(a)(2)(B) provides that, when computing the amount of a forfeiture, “[t]he direct costs shall not include . . . any part of the income taxes paid . . . .”<sup>30</sup> This, according to the court, suggested that forfeiture “does not account for tax paid” on income received through illegal transactions.<sup>31</sup>

Next, the Federal Circuit compared the statute to the definition of “fine or similar penalty” from Treasury Regulations Section 1.162-21(b)(1). The regulation provides that a fine or similar penalty includes amounts paid “pursuant to a conviction . . . for a crime (felony or misdemeanor).”<sup>32</sup> Nacchio’s forfeiture fit this definition because:

- 18 U.S.C. Section 981(a)(1)(C) required forfeiture of amounts traceable to numerous felony offenses (including fraud in the sale of securities—i.e., insider trading); and
- where it applies, 18 U.S.C. Section 2461(c) requires forfeiture on conviction.<sup>33</sup>

<sup>24</sup> Id. at 9.

<sup>25</sup> Id. at 10.

<sup>26</sup> Id.

<sup>27</sup> The government stipulated to the remaining factual question for the claim-of-right doctrine, that is, whether Nacchio subjectively believed that he had a right to the net proceeds of his trades. *Nacchio*, slip op. at 9. The government did, however, reserve the right to argue that the criminal conviction estopped him from asserting that he reasonably believed he was entitled to the net profits of his illicit trades.

<sup>28</sup> In cases involving the deductibility of settlements, one challenge is often determining the statute under which the payment was imposed: The Department of Justice, like private plaintiffs, typically alleges numerous bases in its complaint; a settlement agreement may not necessarily specify the basis of payment.

<sup>29</sup> *United States v. Nacchio*, 2009 BL 170323, 573 F.3d 1062, 1087–90 (10th Cir. 2009).

<sup>30</sup> *Nacchio*, slip op. at 13.

<sup>31</sup> Id.

<sup>32</sup> Treas. Reg. Section 1.162-21(b)(1).

<sup>33</sup> See *Nacchio*, slip op. at 14–15 (discussing, among others, *Wood v. United States*, 863 F.2d 417, 418 (5th Cir. 1989), and

In short, the court held that the criminal forfeiture was a fine or similar penalty because it was a criminal forfeiture that was a mandatory punishment for Nacchio’s crimes. As a result, there was no factual question about whether the particular payment served punitive purposes: Under the statute, its purpose was necessarily punitive.

## Comparison to the Typical Case

Nacchio is contrary to a common fact pattern for Section 162(f) disputes—settlements of civil claims paid to the government.<sup>34</sup> And although Section 162(f) applies to civil penalties,<sup>35</sup> “[c]ompensatory damages . . . paid to a government are not fines or penalties” for Section 162(f) purposes.<sup>36</sup> Thus whether a civil payment to a government is deductible depends on whether the payment was punitive or remedial in nature.<sup>37</sup>

This is more complicated in one of the most common types of Section 162(f) cases, cases involving the False Claims Act, because payments under the False Claims Act may serve punitive purposes, remedial purposes or both.<sup>38</sup> With these options, the factual circumstances of the payment are relevant—even critical—to determining deductibility.

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That added level of complexity—not present in *Nacchio*—provides a possible basis for arguments that are successful in a False Claims Act case yet were brushed aside as irrelevant in *Nacchio*.

For example, Nacchio argued that because the funds would be used to compensate his victims, the payment was deductible.<sup>39</sup> Although compelling in the False Claims Act context, the court held that Nacchio’s argument was irrelevant: “The Attorney General’s post-hoc decision to use the forfeited funds for remission did not transform the character of the forfeiture so that it was

*Fuller v. Commissioner*, 213 F.2d 102, 105–06 (10th Cir. 1954)).

<sup>34</sup> See, e.g., *Fresenius Med. Care Holdings, Inc. v. United States*, 763 F.3d 64 (1st Cir. 2014), aff’g 2013 WL 1946216 (D. Mass. 2013).

<sup>35</sup> See S. Rpt. No. 92-437, at 73–74, 1971 U.S.C.C.A.N. 1918, 1980, 1972-1 C.B. 559, 600 (“[I]t was the intention of the committee to disallow deductions for payments of sanctions which are imposed under civil statutes but which in general terms serve the same purpose as a fine exacted under a criminal statute.”).

<sup>36</sup> Treas. Reg. Section 1.162-21(b)(2).

<sup>37</sup> See, e.g., *Middle Atl. Distribs., Inc. v. Commissioner*, 72 T.C. 1136, 1142–47 (1979); *S. Pac. Transp. Co. v. Commissioner*, 75 T.C. 497, 652 (1980); *Talley Indus., Inc. v. Commissioner*, 116 F.3d 382, 385–86 (9th Cir. 1997).

<sup>38</sup> See, e.g., *Cook Cty., Ill. v. United States ex rel. Chandler*, 538 U.S. 119, 130 (2003) (“[T]he damages multiplier [under the False Claims Act] has compensatory traits along with the punitive.”).

<sup>39</sup> See *Nacchio*, slip op. at 17–18.

no longer a ‘fine or similar penalty’ under § 162(f).”<sup>40</sup> In short, there was no opportunity for the substance to be different from the form.

Accordingly, the Federal Circuit didn’t look to the facts to determine if the purpose of *Nacchio*’s payment was punitive. The forfeiture statute served solely punitive purposes. Thus the analysis ended there.

## Lessons Learned and Best Practices

At first glance, *Nacchio* seems to be a troubling case for taxpayers concerned about the potential deductibility of payments to the government. Familiar arguments about the compensatory nature of a payment weren’t only unsuccessful, they were irrelevant.

But *Nacchio* is simply the application of well-settled principles: Criminal forfeitures pursuant to conviction are fines or similar penalties for Section 162(f) purposes. As such, it serves as a reminder of some familiar best practices regarding settlements and their deductibility:

■ **Begin With the Statute.** Whether a payment to settle a government claim is a fine or penalty starts with

the statute; if payments under the statute are clearly fines or penalties, the analysis stops there.

■ **Get a Seat at the Table.** Failure to substantiate the deductibility of a payment can increase the effective cost of a settlement substantially. Tax and legal departments should work together closely from the beginning to ensure the right information is available once the negotiations are complete.

■ **Document Negotiations.** If the statute is unclear or serves both compensatory and punitive purposes (e.g., the False Claims Act), evidence of the parties’ intent will be relevant. As a result, evidence that, for example, the parties negotiated over the proper determination of compensatory damages can be helpful.

■ **Identify Recipients.** If the payment is made under a statute that clearly imposes a fine or penalty, the government’s later use of the proceeds can’t convert it into something else. But where the payment’s nature is unclear, the government’s use of it to compensate victims can be evidence of the parties’ intent. Evidence that the parties contemplated that the payment would go to affected agencies, or evidence (acquired for example through the Freedom of Information Act) that it did go to affected agencies, will be helpful.

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<sup>40</sup> Id.