Preserving Disgorgement Tax Deductibility In SEC Settlements

By **David Petron, Nathan Clukey and Laura Barzilai** (October 18, 2021)

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Without any public announcement, the U.S. Securities and Exchange Commission appears to be implementing through recent enforcement settlements a new approach to disgorgement awards that can affect a settling party's ability to claim a tax deduction for amounts paid as disgorgement.

Using fairly standard language in its orders, the SEC seems to take the position that disgorgement awards can be transferred to the Treasury General Account, the general checking account of the U.S. Department of the Treasury, if it is infeasible to return the funds to injured investors.

That approach creates challenges for deducting disgorgement payments under final regulations, recently released by the Internal Revenue Service and the Treasury Department, under Section 162(f) of the Internal Revenue Code.[1] Parties settling SEC enforcement cases that include disgorgement need to consider the new requirements to maximize their ability to deduct the disgorgement payments.

The law governing disgorgement in SEC enforcement cases has changed dramatically over the past few years.[2] Historically, the SEC has used disgorgement aggressively as part of its arsenal of enforcement tools. Some of its allure stemmed from the belief that disgorgement was not subject to a statute of limitations, and from the SEC's considerable discretion with respect to the amount of disgorgement it could obtain.

In 2017, however, a unanimous U.S. Supreme Court ruled in Kokesh v. SEC that disgorgement as traditionally obtained by the SEC is a penalty subject to the same five-year statute of limitation that applies to SEC actions for civil money penalties.[3] The Kokesh court reserved the question whether the SEC was authorized to obtain disgorgement at all.

Last year, the Supreme Court in Liu v. SEC clarified that the SEC may obtain disgorgement as part of its authorization to obtain equitable remedies, subject to certain equitable limitations.[4] The Liu court left unanswered whether the SEC's practice of depositing disgorgement funds with the Treasury — as opposed to requiring direct payments to or for injured investors — was consistent with those equitable limitations.[5]

Following these two rulings, Congress slipped an amendment into the fiscal year 2021 National Defense Authorization Act that provided the SEC with an explicit statutory grant of power to order disgorgement, among other technical changes.[6]

Since Liu and the NDAA amendments, the SEC seems to have taken the position that disgorgement awards may be deposited with the Treasury when it has proven impracticable to return those funds to injured investors.

Recent settled SEC enforcement orders have included consistent language asserting that disgorgement awards comply with equitable principles and will be returned to harmed

investors to the extent feasible, but that any amounts infeasible to return to investors will be "transferred to the general fund of the U.S. Treasury."[7]

For example, in the September agreement settling In the Matter of George L. Divel III, the SEC included the following now-standard paragraph:

> The disgorgement and prejudgment interest ordered in paragraph IV.B is consistent with equitable principles and does not exceed Respondent's net profits from his violations, and will be distributed to harmed investors to the extent feasible. The commission will hold funds paid pursuant to paragraph IV.B in an account at the United States Treasury pending distribution. Upon approval of the distribution final accounting by the commission, any amounts remaining that are infeasible to return to investors, and any amounts returned to the commission in the future that are infeasible to return to investors, may be transferred to the general fund of the U.S. Treasury, subject to Section 21F(g)(3) of the Exchange Act.[8]

The principal intent of this paragraph appears to be consistent with Liu: As a matter of equitable principles, the disgorged funds should be distributed to harmed investors. At the same time, however, the SEC asserts that it can also transfer disgorged funds to the Treasury if the SEC determines that it is infeasible to return the funds to harmed investors.

For example, the SEC could take the $454,434 of disgorgement ordered in Divel, return $200,000 to harmed investors, and then transfer the remaining $254,434 to the Treasury because the SEC decided it was infeasible to do otherwise.

Even assuming the transfer to the Treasury is permissible — a matter that the court did not decide in Liu — that transfer could make $254,434 not deductible for federal income tax purposes.[9]

Section 162(f) of the Internal Revenue Code generally prohibits the deduction of amounts paid to or at the direction of governments, agencies and certain nongovernmental entities in relation to the violation of any law or the investigation into the potential violation of any law.[10]

Under the current provision and prior law, it has long been recognized that SEC penalties ordinarily are not deductible for federal taxes. The Tax Cuts and Jobs Act, passed in 2017, expanded the scope of Section 162(f), which had been limited to fines or penalties, and imposed additional limitations on deductibility.[11]

As amended, however, the statute also included an exception to the general rule, permitting the deductibility of amounts paid for restitution or remediation, or incurred to come into compliance with the law. In January, the IRS released final regulations treating disgorgement of net profits as restitution, which makes disgorgement payments deductible if certain other requirements are met.[12]

As originally published in May 2020, the proposed regulations would not have treated disgorgement as a form of restitution.[13] The final regulations reversed this position, based largely on the Supreme Court's decisions in Kokesh and Liu.[14]

The final regulations recognized that generally disgorgement is a form of "[r]estitution measured by the defendant's wrongful gain"[15] and that amounts paid through disgorgement that do not exceed the wrongdoer's net profits and that are paid to individual victims may constitute an equitable remedy.[16]

Under the final regulations, however, disgorgement is deductible only if two requirements are met.

First, under the identification requirement, the order or agreement must identify the payment — not in excess of net profits — as restitution, remediation or an amount paid to come into compliance with a law.[17]

An order or agreement will satisfy the identification requirement — even if it does not use the words "restitution," "remediation," "remediate," "come into compliance," or "comply" — if (1) the nature and purpose of the payment as described in the order or agreement are clearly and unambiguously to restore the injured party or property or to correct the noncompliance; and (2) the amount paid for such purpose is identified or otherwise determinable based on the terms of the order or agreement.[18]

Second, under the establishment requirement, the taxpayer must establish that the amount was paid as restitution, remediation or an amount paid to come into compliance with a law.[19]

To satisfy the establishment requirement, a taxpayer must have documentary evidence of (1) a legal obligation to pay the amount of the order or an agreement identified as restitution, remediation or to come into compliance with a law; (2) the amount paid or incurred; and (3) the date on which the amount was paid or incurred.[20]

Disgorgement paid to the Treasury or the general account of a governmental entity for general enforcement efforts or other discretionary purposes is generally not considered restitution or remediation, and therefore is generally not deductible.[21]

But disgorgement payments made to a fund for reimbursement of victims should be deductible, if the identification and establishment requirements are satisfied.

When settling an SEC enforcement action that includes disgorgement, respondents should consider the following practical points to enhance the likelihood that they will be able to deduct the payments for disgorgement.

First, the settlement should provide that the disgorgement will be distributed to harmed investors and not deposited with the Treasury. Distribution plans should be discussed with the SEC staff in connection with the settlement.

The commission's rules on fair funds and disgorgement plans allow the commission or a hearing officer to order that disgorgement amounts be held in a fund for the benefit of investors who were harmed by the violation, which is often called a fair fund.[22]

The plan of distribution should be clear as to which portion of the disgorgement will be returned to harmed investors.

Any residual funds sent to the Treasury are unlikely to be deductible, so a distribution plan should clearly distinguish those funds and maximize the funds to be returned to investors.

Second, the order should include language that meets the identification requirement. The order should state that the party is legally obligated to pay the disgorgement — the amount of which will be specified — and that the payment constitutes restitution, remediation or an amount paid to come into compliance with a law.

Although the standardized language in recent SEC enforcement orders does not include words like restitution or remediation, it includes other language that should still help to meet the identification requirement under the IRS regulations.[23]

In particular, the statement that the disgorgement will be distributed to harmed investors should establish that the purpose of the disgorgement is to restore the injured party to the position they were in before the violation.[24]

The SEC appears to have taken the position, however, that any disgorgement funds that cannot be feasibly returned to injured investors can be transferred to the general fund of the Treasury. Any disgorgement funds ultimately transferred to the Treasury probably will not be deductible.

Third, respondents should plan for how they will satisfy the establishment requirement under the final regulations. Respondents should be prepared to document the actual payment of disgorgement amounts to the SEC, and they should obtain confirmation that the disbursal of disgorgement awards was paid to harmed investors rather than transferred to the Treasury.

Respondents should also discuss with SEC staff how the SEC intends to complete IRS Form 1098-F for reporting certain fines, penalties and other amounts paid.

Form 1098-F requires the government agency to state separately the amount paid as restitution or remediation and the amount paid to come into compliance with law.[25]

The SEC is required to file Form 1098-F with the IRS and to provide a copy to the payor. The copy can be used as additional documentary evidence to help satisfy the establishment requirement.

If amounts paid as restitution or remediation, or to comply with any law are not set forth on the form, it could be more difficult to meet the establishment requirement.

The commission's recent orders reserving its ability to transfer disgorgement awards to the Treasury threatens the deductibility of those amounts under the IRS' new regulations.

With proper planning and preparation, however, parties who settle SEC enforcement actions involving disgorgement may be able to satisfy the identification and establishment requirements to claim a deduction for federal tax purposes.

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[1] IRC Section 162(f).

[2] See Kokesh v. Sec. & Exch. Comm'n, 137 S. Ct. 1635 (2017); Liu. v. Sec. & Exch. Comm'n, 140 S. Ct. 1936 (2020); National Defense Authorization Act, Pub. L. No. 116-283, 134 Stat. 3388 (2020); see also Ike Adams, Chris Mills, & David Petron, SEC Disgorgement Authority May Be Limited Even After Recent Amendments to the Exchange Act, American Bar Association, Business Law Section (Jan. 27, 2021), https://businesslawtoday.org/2021/01/sec-disgorgement-authority-may-limited-even-recent-amendments-exchange-act/ (describing NDAA amendment to the Securities Exchange Act of 1934).

[3] 137 S. Ct. 1635 (2017).

[4] 140 S. Ct. 1936, 1943 (2020) (recognizing the "countervailing equitable principle that the wrongdoer should not be punished by 'pay[ing] more than a fair compensation to the person wronged.'").

[5] See id. at 1947–1948.

[6] Pub. L. No. 116-283, 134 Stat. 3388 (2020). Congress overrode President Donald Trump's veto of the NDAA on Jan. 1, 2021.

[7] See, e.g., In re Ravi Iyer, Exchange Act Rel. No. 90628 (Dec. 10, 2020); In re Lightspeed Trading LLC, Exchange Act Rel. No. 10924 (Feb. 2, 2021); In re Winslow, Evans & Crocker Inc., Exchange Act Rel. No. 91118 (Feb. 11, 2021); In re Scott Wolfrum, Exchange Act Rel. No. 91401 (Mar. 24, 2021); In re Mason Inv. Advisory Servs. Inc., Exchange Act Rel. No. 5719 (Apr. 15, 2021); In re Maxwell Drever, Exchange Act Rel. No. 10941 (May 5, 2021); In re Centaurus Fin. Inc., Exchange Act Rel. No. 92095 (June 2, 2021); In re FELTL Advisors LLC, Exchange Act Rel. No. 5750 (June 11, 2021); In re Intervest Int'l Inc., Exchange Act Rel. No. 92166 (June 14, 2021); In re Crown Capital Sec. LP, Exchange Act Rel. No. 92258 (June 24, 2021); In re Gateway One Lending & Fin. LLC, Exchange Act Rel. No. 10951 (June 24, 2021); In re George L. Divel III, Exchange Act Rel. No. 10974 (Sept. 2, 2021); In re JW Korth & Co. LP, et al., Exchange Act Rel. No. 92945 (Sept. 13, 2021).

[8] Divel, Exchange Act Rel. No. 10974 (Sept. 2, 2021), ¶ 24, available at https://www.sec.gov/litigation/admin/2021/33-10974.pdf.

[9] "It is an open question whether, and to what extent, that practice [depositing disgorgement funds with the Treasury] nevertheless satisfies the SEC's obligation to award relief 'for the benefit of investors' and is consistent with the limitations of §78u(d)(5). ... But we need not address the issue here." Liu, 140 S. Ct. at 1948–49.

[10] See IRC § 162(f), amended by the Tax Cuts and Jobs Act, Pub. L. No. 115-97, §13306(a), 131 Stat. 2054 (2017), effective Dec. 22, 2017.

[11] TCJA, Pub. L. No. 115-97, § 13306(a), 131 Stat. 2054 (2017), effective Dec. 22, 2017.

[12] Treas. Reg. § 1.162-21, Denial of Deduction for Certain Fines, Penalties, and Other Amounts; Related Information Reporting Requirements, 86 Fed. Reg. 4970 (Jan. 19, 2021); T.D. 9946 (Jan. 14, 2021) (stating that disgorgement of net profits will not be treated as per se nondeductible under 162(f)(1) if requirements are met). See generally Sidley Tax Update, Final Treasury Regulations Clarify Limitations on Deductibility of Certain Payments to Governments (Jan. 19, 2021), available at https://www.sidley.com/en/insights/newsupdates/2021/01/final-treasury-regulations-

clarify-limitations-on-deductibility-of-certain-payments-to-governments.

[13] See former Prop. Treas. Reg. § 1.162-21(f)(3)(iii)(C). The Supreme Court treated restitution and disgorgement as two different labels for a profit-based measure of unjust enrichment. See Liu, 140 S. Ct. at 1942 ("Equity courts have routinely deprived wrongdoers of their net profits from unlawful activity, even though that remedy may have gone by different names").

[14] See T.D. 9946.

[15] Id. (quoting Kokesh, 137 S. Ct. at 1640).

[16] Id. (citing Liu, 140 S. Ct. at 1946).

[17] Id.

[18] Id.

[19] Id.

[20] Id.

[21] Id.; see also Treas. Reg. § 1.162-21(e)(4)(i)(B).

[22] 17 C.F.R. § 201.1100.

[23] See supra note [7] (citing cases).

[24] See, e.g., Divel ("The disgorgement and prejudgment interest ordered in paragraph IV.B is consistent with equitable principles and does not exceed Respondent's net profits from his violations, and will be distributed to harmed investors to the extent feasible.").

[25] See 26 C.F.R. § 1.6050X-1(a).