Law360 Tax Authority
a LexisNexis® company

Portfolio Media. Inc. | 111 West 19th Street, 5th floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

High Court's SEC Enforcement Ruling Has Tax Consequences

By **Peter Lowy, Juan Vasquez & Morgan Alleyn** (June 26, 2020, 7:04 PM EDT)

The U.S. Supreme Court recently delivered its decision in Liu v. U.S. Securities and Exchange Commission,[1] an SEC enforcement case that has important tax implications for companies facing potential disgorgement of their net profits in actions brought by government agencies.

Peter Lowy

Disgorgement may arise in an array of SEC enforcement contexts, including securities fraud, insider trading, foreign bribery and other areas.

In Liu, the SEC argued, consistent with its long-standing position, that a disgorgement award that does not exceed a wrongdoer's net profits is not utilized for punitive purposes, and is thus a form of equitable relief that is permissible under Section78u(d)(5).

The Supreme Court agreed. If it had not, the decision may have brought an end to the ability of the courts to order disgorgement of profits in SEC enforcement actions.

Juan Vasquez

Notable for tax practitioners, the SEC's aforementioned long-standing position is in tension with the Internal Revenue Service's position that disgorgement is punitive in character and will fall under the pre-Tax Cuts and Jobs Act Internal Revenue Code Section 162(f) prohibition on deductions for so-called fines and other penalties.

That's right: When the government seeks to tag companies with disgorgement orders, it construes disgorgement as a nonpenal equitable remedy, but when the company seeks to deduct the disgorgement, the government casts disgorgement as a penalty and denies the deduction.

Morgan Alleyn

Effectively, the government seeks to have its cake and eat it too.

In recent years, the IRS had hung its hat on the 2017 Supreme Court decision, Kokesh v. SEC.[2] There, the court held that disgorgement orders in SEC enforcement actions would be treated as penalties for certain statute of limitation purposes.

It is important that in Kokesh the Supreme Court expressly stopped short of issuing a more sweeping decision that may have resolved the contention between the IRS and the SEC regarding whether or not disgorgements are actually penalties.

Latching onto the Kokesh decision, the IRS issued a chief counsel advice, or CCA,[3] in which it took the position that Kokesh had settled the matter. The CCA argued:

> [T]he tax treatment depends on whether the payment is more punitive or compensatory. ... Because, as the Supreme Court held, disgorgement payments are

> penalties and are not compensatory, section 162(f) prohibits a deduction under section 162(a) for an amount paid as disgorgement for violating a federal securities law.

However, the Supreme Court's June 22 decision in Liu calls the CCA's reasoning into question.

The Lui case confirmed that Kokesh's scope was limited to an interpretation of Title 28 of the U.S. Code, Section 2462, and does not stand for the broader principle on which the CCA relies.

More importantly, the court in Liu held that a disgorgement award that does not exceed a wrongdoer's net profits is generally not punitive, and is thus equitable relief permissible under Section 78u(d)(5).

In the wake of Liu, it should be clear that, contrary to the CCA, disgorgement amounts are not categorically nondeductible penalties under IRC Section 162(f). Taxpayers who have had their deductions for such amounts claimed in pre-TCJA tax periods disallowed should consider contesting the IRS' determination.

For disgorgements arising in post-TCJA periods, Liu is relevant to revised IRC Section 162(f) and whether particular disgorgements constitute so-called restitutions.

In relevant part, the TCJA amended IRC Section 162(f)(1) to disallow deductions for:

> any amount paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government or governmental entity in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law.

IRC Section 162(f)(2), however, expressly excepts restitution from this general rule. Because disgorgements are payments made at the direction of a governmental entity — the SEC — due to the violation of a law, this sweeping definition will generally include disgorgements unless they fall into the ambit of IRC Section 162(f)(2)'s restitution exception.

The text of Section 162(f) does not supply a definition of restitution, only that the statute excepts "restitution (including remediation of property) for damage or harm which was or may be caused by the violation of any law or the potential violation of any law."

In May, the U.S. Department of the Treasury proposed to refine and narrow the definition of restitution to situations in which the restitution "restores, in whole or in part, the person ... harmed by the violation or potential violation of law," and under the proposal, the exception for restitution does not include forfeiture or disgorgement.[4]

The preamble to the proposed regulation relies on Kokesh to support that a disgorgement imposed as a sanction for violating a federal securities law is treated as a penalty and therefore is outside the intended definition of restitution.[5]

The inclusion of the Kokesh argument, essentially the same reasoning relied upon in the CCA, suggests that the drafters of the proposed regulation had a very specific perspective on what a disgorgement is: a punitive deterrent to prevent violations of securities law.

Several aspects of Liu should cause the Treasury to reevaluate the reasoning behind the foregoing feature in the proposed regulation, and recalibrate any perspective that was due to confusion caused by Kokesh. The reliance on Kokesh may be out of step with the court's clarification in Liu that a disgorgement award that does not exceed a wrongdoer's net profits is not necessarily a punitive sanction and may qualify as a form of equitable relief.

The court in Liu also observed that the terms restitution and disgorgement are used interchangeably.

In addition, the SEC pointed out in Liu that it is not always feasible to distribute the disgorged funds to the persons harmed by the violation. Generally, when this occurs, the SEC deposits the funds in a special account with the Treasury.

The court acknowledged that there is an open question as to whether and to what extent the SEC's practice of retaining funds satisfies the requirement under Section 78u(d)(5) that the remedy be made for the benefit of investors. However, the court did not answer the question.

This may also open a discussion about the proposed regulation's similar requirement that amounts must restore the harmed party, when in practice it is often infeasible for the SEC to distribute funds to the persons injured by the taxpayer's actions.

In any event, even under the rigidity in the proposed regulation, the Supreme Court's holding in Liu highlights that, under the right set of facts, SEC disgorgement payments may still be deductible for federal income tax purposes.

It will depend, in part, on the content of the new Treasury regulation when it is finalized, and if the courts resolve whether the SEC's or the IRS' view of disgorgement is proper. The comment period for the proposed regulation closes July 13.

Securities lawyers should further be aware that the Supreme Court expressly required in Liu that "courts must deduct legitimate expenses before awarding disgorgement under [Section] 78u(d)(5)," noting that "[a] rule to the contrary that 'make[s] no allowance for the cost and expense of conducting [a] business' would be 'inconsistent with the ordinary principles and practice of courts.'"

As such, clients involved in SEC or other potential enforcement actions involving disgorgement should carefully consider the tax and other implications from Liu when negotiating disgorgement amounts and drafting stipulations.

Peter Lowy and Juan F. Vasquez Jr. are shareholders, and Morgan Alleyn is an associate, at Chamberlain Hrdlicka White Williams & Aughtry.

[1] Liu v. SEC, No. 18-1501, 2020 WL 3405845 (U.S. June 22, 2020).

[2] Kokesh v. SEC, 137 S. Ct. 1635 (2017).

[3] IRS CCA 201748008 (Dec. 1, 2017).

[4] Prop. Treas. Reg. 1.162-21.

[5] Id.