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J.P. Morgan's $5.1 Billion Settlement Is Tax Deductible

Bank Could Save Nearly $1.5 Billion in Taxes

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J.P. Morgan Chase & Co.'s $5.1 billion settlement with Fannie Mae and Freddie Mac will be entirely tax deductible for the bank, according to a person familiar with the situation—effectively lessening the bank's true payout and shifting part of the settlement's cost to taxpayers.

The ability to deduct the cost of the settlement could save J.P. Morgan nearly $1.5 billion in taxes, based on the bank's 29.1% effective tax rate for the first half of 2013. It isn't known whether J.P. Morgan will actually go ahead and take the deduction.

The bank could save yet more if other parts of its tentative $13 billion settlement with the government over alleged mortgage-bond abuses are also deemed tax-deductible—an issue that J.P. Morgan and regulators have discussed and that has been noted by outside analysts.

The Wall Street Journal reported Tuesday that a part of the broader settlement is in jeopardy because the bank and the government can't agree on who should bear responsibility for the liabilities of Washington Mutual, which J.P. Morgan acquired during the financial crisis.

If the settlement were to collapse and a government case against J.P. Morgan were to go to court, any judgment against the bank would receive tax treatment similar to that of a settlement, tax experts said.

If it is finalized, the overall settlement is expected to include potentially deductible components such as billions of dollars to compensate investors who lost money on mortgage bonds issued by J.P. Morgan and companies it acquired. J.P. Morgan and the government have discussed whether a portion of the remainder of the broad settlement will be tax deductible, but it isn't clear how much or whether the government will allow it in the end.

Tax experts say it isn't surprising that a big chunk of the settlement would be deductible. "This is exactly the kind of thing everybody deducts. That's the way the tax system works," said Robert W. Wood, a tax attorney with Wood LLP in San Francisco.

Under J.P. Morgan's settlement Friday with the Federal Housing Finance Agency, which oversees Fannie and Freddie, the bank will pay about $5.1 billion to the two housing-finance companies to settle claims over soured mortgage securities and single-family mortgages that J.P. Morgan sold to them. But none of that amount is classified as fines or penalties, which typically can't be deducted under the law.

Rather, the settlement consists entirely of payments to Fannie and Freddie that arose from actions "in the ordinary course of J.P. Morgan's business," said Robert Willens, a tax and accounting expert and president of Robert Willens LLC. Such payments can be deducted on the bank's taxes unless the settlement agreement specifically prohibits such a move, he said—and there is nothing in Friday's pact that does so. A spokesman for the Internal Revenue Service declined to comment.

"Absent a specific clause in the agreement that would bar the deductibility, there's no question about it being deductible," Mr. Willens said. (If the larger settlement collapses, that won't affect the FHFA pact, said a person close to the talks.)

Even fines and penalties could be deductible under certain circumstances, Mr. Wood said, if they're considered to be "remediation" or restitution.

The bank and the government may well be building in the effect of taxes when agreeing to such a giant settlement, with an eye toward J.P. Morgan's after-tax payout as the "real" settlement amount, said Steve Rosenthal, a visiting fellow at the Tax Policy Center, a nonpartisan Washington group that provides tax analysis.

Such tax deductions are common when companies reach settlements, but they have spurred criticism. "In essence, companies are allowed to receive a tax break for their wrongdoing," the U.S. Public Interest Research Group, a consumer-advocacy group, said in a statement Tuesday.

At least two members of Congress say J.P. Morgan shouldn't stick taxpayers with any of its settlement burden. Democratic Reps. Peter Welch of Vermont and Luis Gutierrez of Illinois have sent a letter to James Dimon, the bank's chairman and chief executive, arguing that taxpayers "should not be required to contribute a nickel" toward the settlement.

"We strongly urge J.P. Morgan to accept full responsibility for the full payment of any fine related to its conduct in this matter," the letter read. A J.P. Morgan spokesman said the firm hadn't received the letter.

The congressmen are also planning to sponsor a bill that would prevent companies from deducting settlement payments to the government.