

Settlements With Banks Raise Deductibility Questions

By Sam Goldfarb — sgoldfar@tax.org

In recent weeks, Wall Street banks have agreed to relinquish more than \$40 billion following federal regulatory probes into whether they misled investors about the risk of investment instruments known as auction rate securities. Yet banks could end up losing less than that amount after deducting some of the cost of their settlements as a business expense, a fact that has public interest groups and a prominent lawmaker crying foul.

In a statement released on August 15, Senate Finance Committee ranking minority member Chuck Grassley, R-Iowa, warned of a potential “tax windfall for these financial institutions . . . paid for by U.S. taxpayers.” (For Grassley’s statement, see *Doc 2008-17998* or *2008 TNT 162-22*.) Grassley has a long history on the issue. In 2006 he took the lead in protesting Boeing’s ability to use the tax code to lessen the pain of a \$615 million settlement with the Justice Department. And five years ago Grassley took on 10 of the nation’s largest investment banks after they had reached a \$1.4 billion settlement with the Securities and Exchange Commission over allegations of conflict of interest in stock research.

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In 2003 Grassley, along with two other senators, introduced a bill that would have made it more difficult for corporations to use settlements to gain a tax break. (For previous coverage, see *Doc 2003-11266* or *2003 TNT 87-9*.) But that bill, the Government Settlement Transparency Act of 2003, never passed, leaving the relevant portions of section 162 unchanged.

Under current rules, businesses generally are allowed to deduct the cost of compensating investors who have suffered losses, but no deduction is allowed for punitive payments made to a government. In the case of the auction rate securities settlements, most of what the banks are being forced to pay under the settlements is being used to buy back securities from investors.

To the extent that the banks suffer a loss from those transactions, their cost would appear to be deductible, according to practitioners familiar with the issue. Somewhat less clear, however, is how the IRS should treat the millions of dollars in so-called penalties the banks are being forced to pay, mostly to the state of New York.

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“When something is called a penalty, the knee-jerk reaction is to say that it’s a penalty,” said Robert Wood, a partner with Wood & Porter in San Francisco. But businesses have in the past argued that some kinds of penalties were “remedial in nature” and therefore deductible, Wood said.

What’s more, there is “a prejudice for deduction because most anything that a business does is in the course of business,” said Sheldon Cohen, a director of Farr, Miller & Washington LLC and a former IRS commissioner.

In 2003, in addition to introducing legislation, Grassley wrote to the SEC, asking it to take tax issues into consideration when determining the structure of the settlements. In his latest letter to the SEC Chair Christopher Cox, however, Grassley took a different approach, suggesting that Cox “consider ‘grossing up’” the total payments made by the investment banks to offset potential tax deductions.

An SEC spokesperson declined to respond to Grassley’s comments, and an aide to Grassley said the SEC had not yet responded to the senator’s letter.

With more settlements over auction rate securities expected, whether the SEC will follow Grassley’s advice is an open question. But Wood, for one, does not think it likely.

“The government is pretty bifurcated and splintered,” he said. If the SEC is “being tasked to try to get \$100 million, they’re probably not going to put into the document: ‘And thou shalt not deduct it.’ I don’t know if that’s their job.” If the SEC took tax deductions into consideration, Wood said, it could also make it more difficult to reach large settlements because corporations would come into negotiations offering a lower amount.

Grassley does have support from some quarters. “Senator Grassley is on the right track,” said Ed Mierzwinski, director of the consumer program at U.S. PIRG, a federation of public interest research groups. “It is clearly a problem if you are deducting settlement payments.” ■

Michael Joe contributed to this article.