CEO Can't Deduct $44 Million Criminal Forfeiture After All

By Donald P. Board • Wood LLP

Everyone likes receiving money that is nontaxable. Nobody likes receiving phantom income on which they have to pay tax from other sources. And nobody likes collecting income (and paying taxes), only to then have to give all the money back.

Even if you are in the right, you can end up worse off than if you had never gotten the income in the first place. That seems wrong. And if the facts are grayer, the results can be grim.

That was one of the intriguing things about the decision of the Court of Federal Claims in *J.P. Nacchio* [FedCl, 2014-1 USTC ¶50,231, 115 FedCl 195 (2014)]. The court opened the door for Joseph Nacchio, the former CEO of Qwest Communications, to actually get a *refund* of $18 million in taxes he had paid on a series of illegal stock transactions back in 2001. [*See* Donald P. Board, *Clawbacks, Code Sec. 1341, and the Item Concept*, 24 THE M&A TAX REPORT 1 (Apr. 2016).]

However, that was then. The $18 million golden door has now been slammed firmly shut again, thanks to a decision of the Federal Circuit reversing the Claims Court. [*Nacchio*, CA-FC, 824 F3d 1370 (June 10, 2016).] The Federal Circuit's key holding was that Mr. Nacchio could not use Code Sec. 165(c)(2) to deduct $44 million in illegal profits he forfeited when he was convicted of insider trading in 2007.

Numerology of Sorts

Code Sec. 1341 provides a refundable credit for taxes paid on an item of income that the taxpayer is forced to surrender in a subsequent tax year. Not surprisingly, a taxpayer cannot qualify for this highly favorable treatment without jumping through some technical hoops. For Mr. Nacchio, the unjumpable hoop turned out to be Code Sec. 1341(a)(2).

This provision requires the taxpayer to show that surrendering the previously included item entitles him to a deduction under some *other* provision of the Internal Revenue Code (the "Code"). Think of it as a piggy-back requirement. Mr. Nacchio persuaded the Claims Court that he could deduct his 2007 forfeiture as a loss under Code Sec. 165(c)(2).

The Federal Circuit reversed, declaring that the forfeiture was a "fine or similar penalty" described in Code Sec. 162(f). The court went on to hold that this barred Mr. Nacchio from deducting the forfeiture under Code Sec. 165(c)(2). That squelched Mr. Nacchio's attempt to use Code Sec. 1341 to recover the $18 million in taxes he had paid in 2001.

Party Like It's 2001

In 2001, Mr. Nacchio exercised 1,330,000 Qwest options he had been granted as part of his CEO compensation package. He immediately sold his new shares for $52 million. On his 2001 return, Mr. Nacchio reported $44 million of income from his stock transactions, on which he paid $18 million in tax.

It was not long, however, before things started to go south. Word began to leak out that Qwest had been misrepresenting the nature and sources of its revenues. An SEC investigation ensued. By mid-2002, the price of Qwest shares had fallen by more than 90 percent. Mr. Nacchio resigned as CEO, and he was eventually indicted for securities fraud.

In 2007, a jury convicted him on 19 counts of insider trading. He did not get off lightly. Mr. Nacchio was sentenced to 70 months in federal prison, fined $19 million and ordered to forfeit $44 million in profits from his 2001 stock sales.

Refund Claim

In April 2009, Mr. Nacchio reported to a low-security federal prison to start serving his time. Shortly before checking in, he amended his 2007 Form 1040 to claim an $18 million refund for the taxes he had paid in connection with his 2001 transactions.

Mr. Nacchio's amended return got the IRS's attention. Code Sec. 1341 allows a credit for taxes paid on an item of income if the taxpayer is required to surrender the item in a subsequent year. Under Code Sec. 1341(a)(2), however, the taxpayer must be entitled to a deduction in the current year "because it was established after the close of [the] prior taxable year … that the taxpayer did not have an unrestricted right" to the previously included item.

According to Mr. Nacchio, his 2007 forfeiture established that he did not have an "unrestricted right" to his 2001 profit. He said this entitled him to deduct his loss in 2007 under Code Sec. 165(c)(2).

The IRS, however, refused to cut Mr. Nacchio an $18 million refund check. The forfeiture was a loss under Code Sec. 165(c)(2), but the IRS insisted that the deduction was barred by Code Sec. 162(f). That familiar provision says that a taxpayer may not deduct "any fine or similar penalty paid to a government for the violation of any law."

Code Sec. 162(f) and Public Policy

Code Sec. 162(f) was added to the Code in 1969. Its origin lies in a long line of cases establishing what came to be known as the "public-policy doctrine." Under the public-policy doctrine, an otherwise permissible deduction can be disallowed.

The big question is whether permitting the deduction would frustrate a sharply defined national or state policy proscribing a particular type of conduct. [*See, e.g., Tank Truck Rentals, Inc.*, SCt, 58-1 USTC ¶9366, 356 US 30, 78 SCt 507 (1958).] If so, you can have the rug pulled from under you even if you thought your footing was solid.

Code Sec. 162(f) is often described as having "codified" the public-policy doctrine. However, its legislative history indicates that it was actually intended to *cut back* on the scope of the doctrine as it might otherwise have been applied to trade-or-business deductions under Code Sec. 162(a).

Code Sec. 162(f) only prohibits the deduction of fines and penalties for outright violations of law, which are only the most explicit instances of conduct contrary to public policy. "Public policy, in other circumstances, generally is not sufficiently clearly defined to justify the disallowance of deductions." [S. Rep. No. 552, 91st Cong., 1st Sess., at 274 (1969), 19693 CB 423, 597.]

Code Sec. 162(f) limits the public-policy doctrine to fines and similar penalties, but it literally applies only to deductions claimed under Code Sec. 162(a). The IRS and the courts have therefore continued to invoke the public-policy doctrine to deny deductions claimed under *other* provisions, most notably Code Sec. 165. [*See, e.g., J.T. Stephens*, CA-2, 90-2 USTC ¶50,336, 905 F2d 667 (1990); Rev. Rul. 77-126, 1977-1 CB 47.]

Assessing Frustration

The Claims Court acknowledged that the public-policy doctrine *could* prevent Mr. Nacchio's from deducting his forfeiture under Code Sec. 165(c)(2). After all, he had been convicted. However, the court refused to apply the doctrine *automatically* simply because Mr. Nacchio had forfeited his profits for violating the securities laws.

Instead, the court examined the particular facts of Mr. Nacchio's case. It wanted to make its *own* assessment of whether allowing the deduction would actually frustrate the sharply defined public policy against insider trading. This, the Claims Court noted, required it to consider "the severity and immediacy of the frustration."

The court framed the issue as whether allowing the deduction "would have directly and substantially diluted the actual punishment imposed." [*Tank Truck Rentals, Inc.*, SCt, 58-1 USTC ¶9366, 356 US 30, 34–35, 78 SCt 507 (1958).] The Claims Court approached these questions realistically. Mr. Nacchio, it pointed out, had obviously been punished severely for violating the law.

In addition to paying a $19 million fine and forfeiting $44 million in illicit profits, he had spent over almost five years in federal custody before being released for good behavior. So it was hardly realistic to suppose that Mr. Nacchio had *not* gotten the deterrent massage.

The Claims Court concluded that allowing Mr. Nacchio to deduct his loss "would not increase the odds in favor of insider trading or destroy the effectiveness of the securities laws." At the same time, the court expressed concern that disallowing the deduction would subject Mr. Nacchio to the "double sting" of having to pay taxes on his profits and forfeit them with no credit for the taxes paid.

Weighing the costs and benefits, the Claims Court concluded that public policy simply did not warrant denying Mr. Nacchio a deduction under Code Sec. 165(c)(2).

The Federal Circuit did not address this line of reasoning when it reversed the Claims Court. Had it done so, it might have observed that courts applying the public-policy doctrine have taken a categorical approach to fines and penalties imposed for violations of law.

Instead of proceeding on a case-by-case basis, the courts have held that allowing a deduction *inevitably* frustrates public policy because it "lessens the sting" of the state-imposed sanction. [*See, e.g.*, *Tank Truck Rentals, Inc.*, SCt, 58-1 USTC ¶9366, 356 US 30, 35–36, 78 SCt 507 (1958).] Under this *per se* rule, the fact that Mr. Nacchio had already paid a high price for his misconduct would have been irrelevant.

Compensatory or Punitive?

The Claims Court offered a second rationale for allowing Mr. Nacchio's deduction. When Mr. Nacchio was sentenced to forfeit the $44 million, his counsel asked whether the money would be put in a fund to compensate the victims of Mr. Nacchio's insider trading.

The prosecutor responded that the government intended to use the $44 million for that purpose, but that the decision would ultimately be made by the Department of Justice's Asset Forfeiture and Money Laundering Section ("AFMLS").

Under 18 USC §981(e)(6), the Department of Justice is authorized to retain property forfeited in connection with various crimes (including securities fraud) *or* to transfer the property for restoration to the victims of the offense that resulted in the forfeiture ("remission").

The decision whether to make forfeited funds available for remission is discretionary with the AFMLS. In Mr. Nacchio's case, the AFMLS decided to use the $44 million to set up a fund to compensate the victims of his fraud.

Mr. Nacchio argued that the *actual use* of his forfeited funds to pay investors for their losses established that his forfeiture was compensatory rather than punitive. A *compensatory* payment is not a "fine or similar penalty" for purposes of Code Sec. 162(f) or the public-policy doctrine applicable to Code Sec. 165(c)(2).

The Claims Court agreed with Mr. Nacchio. Plainly, he had forfeited $44 million as part of his criminal sentence. But the government's use of the funds for compensatory purposes rendered his forfeiture tantamount to restitution. That made it deductible under Code Sec. 165(c)(2).

Origin-of-the-Liability Test

The Federal Circuit took the opposite approach. Instead of focusing on how the funds were ultimately used, it concentrated on the terms of the forfeiture itself. The judge in Mr. Nacchio's criminal trial had entered judgment on a form stating that the amount of restitution being ordered was "$0.00" and that restitution was "not applicable."

The judge even commented at the sentencing hearing that "the goal of restitution, sadly … is not applicable here," observing that there was "no provision in the law for restitution." The forfeited funds had to be turned over to the Department of Justice to do with as it saw fit.

As if that were not enough, the trial judge described Mr. Nacchio's sentence of imprisonment, fine and forfeiture as "three forms of penalty." The judge expressed hope that the forfeited funds would be used to assist victims but acknowledged that this was beyond the court's control.

Given the legal circumstances surrounding the forfeiture, the Federal Circuit saw no basis for saying that it was ordered *as restitution*. The subsequent fate of the $44 million was irrelevant. The Department of Justice's "post-hoc decision to use the forfeited funds for remission did not transform the character of the forfeiture so that it was no longer a 'fine or similar penalty' under §162(f)."

The Federal Circuit's focus on the original "character" of the forfeiture is supported by the great weight of the case law. The principle, as formulated by the Sixth Circuit, is that the characterization of a payment to the government as a fine or similar penalty "turns on the origin of the liability giving rise to it," not on how the government subsequently used the funds. [*W.E. Bailey*, CA-6, 85-1 USTC ¶9239, 756 F2d 44 (1985).]

Another Take on Economic Reality

The Federal Circuit offered a second argument against treating the forfeiture as compensatory. This was the fact that Mr. Nacchio's $44 million forfeiture, while a hefty sum, was only a drop in the bucket compared with the losses suffered by his victims.

The remission administrator identified over 112,000 Qwest shareholders who had been injured—at least in theory—by Mr. Nacchio's insider trading. Their losses totaled a colossal *$12 billion*. Spreading Mr. Nacchio's $44 million profit over these claims resulted in a compensatory payment of 0.37 percent. Mind the decimal point. That is 37 cents for every *$100* lost.

The Federal Circuit noted that Mr. Nacchio had insisted that "economic reality," not mere form, must prevail. The court then turned the tables, tartly observing that "the economic reality is that Nacchio was punished through forfeiture, not that Nacchio's victims were fully compensated."

The Federal Circuit could have gone further. Saying that Mr. Nacchio's victims were not "fully compensated" could be the understatement of 2016. They recovered a miserable *0.37 percent* of their losses. Some victims were so angered by their measly checks that they sent them back to the remission administrator.

Thus, the "economic reality" was that Mr. Nacchio had been punished through forfeiture, while the compensation paid to his victims was *de minimis* at best.

En Banc Review

Mr. Nacchio has asked the Federal Circuit for *en banc* review of the panel's unanimous decision. With $18 million on the line, asking for another chance to convince the court seems like a bet worth making. But it looks like a longshot.

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