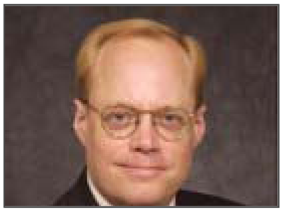
Forbes

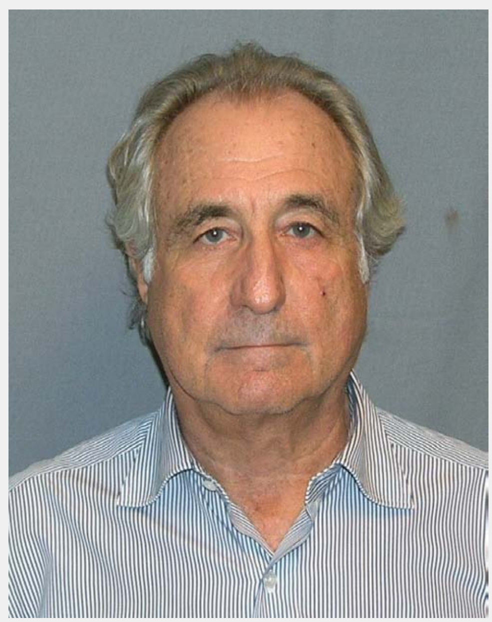


Robert W. Wood

THE TAX LAWYER

TAXES | 1/09/2014

JP Morgan's Nondeductible Madoff Deal Could Kill Deductible Legal Settlements



Bernard Madoff's mugshot (Photo credit: Wikipedia)

For JPMorgan Chase JPM +0.94%, its latest settlement is anything but ho-hum. At $2.6 billion, it adds to over $20 billion in settlements the bank struck within the last year. It's a standout in other ways too. This one is over allegedly looking the other way while Bernard Madoff fleeced victims out of vastly greater sums.

Prosecutors claim the bank violated the Bank Secrecy Act, allegedly pulling its own money out of Mr. Madoff's enterprise while keeping quiet to regulators. It was bad enough that the bank took the unusual step of agreeing to a deferred prosecution agreement with U.S. Attorney Preet Bharara. If the bank flies right for the next two years, the charges go away. CEO Jamie Dimon is surely hoping 2014 will be less about lawsuits and settlements, especially the non-tax deductible kind.

Even before this Madoff deal was struck there was a clamor about tax deductions. Americans For Tax Fairness expressed dismay over taxes on the bank's $13 billion settlement in 2013. And the U.S. Public Interest Research Group (PIRG) argued for regulators to make non-deductibility a condition of the Madoff deal. If Americans can't deduct their parking tickets or library fines, said a PIRG official, JP Morgan shouldn't either. See PIRG's fact sheet and Subsidizing Bad Behavior: How Corporate Legal Settlements for Harming the Public Become Lucrative Tax Write-Offs.

Ultimately, the lack of a tax deduction became part of the deal, something that is fairly unusual. The Justice Department's press release and settlement documents say the bank ***cannot*** deduct its $1.7 billion payment to the government. Notably, much of the money is apparently earmarked for Madoff's victims. That means normal tax rules would suggest a tax deduction could be claimed.

The tax code prohibits deducting ''any fine or similar penalty paid to a government for the violation of any law,'' including criminal and civil penalties plus sums paid to settle potential liability for fines. See IRC Section 162(f). However, remedial payments are different. Many companies deduct settlements. And the dollars count.

Exxon's $1.1 billion Alaska oil spill settlement cost Exxon $524 million after tax. BP's Gulf spill raised similar issues. See BP, Oil, and Deducting Punitive Damages. U.S. PIRG says that preventing J.P. Morgan from writing off its $1.7 billion payment saved taxpayers as much as $595 million.

Under current law, in determining what is a nondeductible fine or penalty, names alone are not controlling. If the fine or penalty is intended to be punitive, then the payment is probably nondeductible. But if it is remedial, it may be deductible despite a "fine or penalty" label.

Yet the JP Morgan deal was nicely timed with proposed legislation introduced by Senators Elizabeth Warren (D-MA) and Tom Coburn (R-OK). Their Truth in Settlements Act would make government settlements more transparent. The bill would require disclosure of any tax deductions and tax credits for settlement payments. Plus, settlements above $1 million would be posted on federal agency websites. A Fact Sheet on the bill is here.

The Warren-Coburn legislation would even require companies to state in SEC filings whether they have deducted settlement payments. Some may still be smarting over J.P. Morgan Chase's $13 billion settlement over mortgage securities. Much of that was tax deductible. But the Warren-Coburn bill is not the first to address legal settlements.

Sens. Jack Reed (D-RI) and Chuck Grassley (R-IA) also introduced the Government Settlement Transparency and Reform Act (S. 1654) that would restrict the tax deductibility of future corporate settlements. According to the IRS, almost every defendant deducts legal settlements as a business expense unless explicitly forbidden in the settlement agreement.

In fact, this issue has been brewing for a decade. This is hardly the last battle over settlements and their deductibility.

You can reach me at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.