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Who's Paying For Citigroup's \$968M Fannie Mae Settlement? You Are

If you feel like you already paid for the financial crisis once or twice, you might have that same old feeling. With failing institutions, lost investments, foreclosed properties and taxpayer funded bailouts, taxpayers got it every which way. And now they could be getting it again.



Citigroup (Photo credit: Wikipedia)

[Citigroup C +0.58%](#) says it will pay \$968 million to [Fannie Mae](#) to resolve claims it breached representations and warranties on 3.7 million residential mortgages. Citi says the sum is covered by its existing reserves for mortgage repurchases. See [Citi To Pay Almost \\$1B In Fannie Mae Mortgage Settlement](#). How are taxpayers hurt?

It would be surprising if Citigroup doesn't deduct it on its taxes. True, some mortgage purchases have to be capitalized so can't be immediately written off. Thus, when [Bank of America BAC +0.54%](#) agreed to pay Fannie Mae \$3.6 billion it also [repurchased nearly \\$7 billion in mortgages](#). Citigroup's deal after taxes could be a lot less than \$968M.

Most payments in business are deductible, even punitive damages. See [Can Rolls-Royce Deduct Bribes? How About Fines?](#) However, the tax code prohibits deducting “any fine or similar penalty paid to a government for the violation of any law.” See [IRC Section 162\(f\)](#). That includes criminal and civil penalties, yet many companies are able to deduct fine-like settlements.

The line-drawing can be extreme. If a fine or penalty is intended to be punitive, it is probably nondeductible. But if the fine is remedial in nature, it may be deductible despite its “fine or penalty” name. Environmental payments and other payments to governmental entities may qualify.

Example: Suppose you pay a \$100 million fine. If it’s nondeductible, it costs \$100 million. But if you are in a 40% tax bracket and can deduct it, the fine actually costs you \$60 million after taxes.

Some find this troubling from a policy standpoint. Remember Exxon’s \$1.1 billion Alaska oil spill settlement? It actually cost Exxon \$524 million after taxes. See [BP, Oil, and Deducting Punitive Damages](#). More than half of the \$900 million in civil damages Exxon paid were also deductible.

It is sometimes possible to settle with a government agency and to address this issue. The settlement agreement may specify that a fine is remedial rather than punitive in character. If the settlement agreement isn’t specific—and sometimes even if it is—tax deductions may land companies in court a second time. See [Tax Deductions for Damage Payments: What, Me Worry?](#)

There is often considerable ambiguity, and that can encourage taxpayers to claim deductions. See [IRS Cracking Down on Government Settlements](#). Talking about this issue can be a public relations disaster. The public can and does become incensed. For example, consider whether BP should be allowed to deduct payments to compensate victims of the Gulf oil spill.

Compensatory damages are clearly deductible. So are punitive damages paid in the course of a trade or business. Thus, deductions are likely despite the fact that tax deductions for wrongdoers rub many the wrong way.

Last year, Sen. Bill Nelson, D-Fla., called for a congressional inquiry into BP’s tax treatment. Senator Nelson didn’t focus solely on the extent to which BP would deduct fines, penalties or related counsel fees. He also asked whether

BP should be allowed to deduct the \$20 billion placed in escrow for injured parties, and even the compensatory damages paid to federal and state governments.

This is not a new issue. Increasingly, the public and the press notice the discrepancy between pre- and post-tax settlement costs. And what about Citigroup?

If you feel as if you have already paid for the financial and housing crises in several ways—including as a taxpayer—it may not be over yet. I don't know what Citi will do on its tax returns. However, my guess is that we should all get ready to pay again.

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.