End Tax Write-Offs for Wrongdoing

Imagine getting a tax break for violating the law, committing fraud or mistreating consumers. Unfortunately, it has happened all too often. When companies have been charged with violating laws and regulatory standards—for example, by defrauding Medicare, discriminating against customers or distorting financial markets—many have been able to write off the cost of their financial settlements on their taxes.

How can this happen? Unlike public penalties or fines, which corporations cannot legally write off as tax breaks, companies *may* be able to write off payments made to settle allegations of wrongdoing by treating such payments as an ordinary and necessary business expense.[1] This is because government agencies often fail to define a settlement's deductibility in the formal agreement.[2] This ambiguity, clouded further by complicated case law, creates a **settlement loophole** that corporations can use to secure a discount on their payout. The Internal Revenue Service (IRS) notes that, unless agencies explicitly forbid it, "almost every defendant/taxpayer deducts the entire amount" as a business expense.[3] A 2005 Government Accountability Office study of 34 companies' settlements worth more than $1 billion found that 20 companies deducted some or all of their payment.[4]

Every dollar in tax savings companies receive in this way is ultimately paid for by everyday taxpayers in the form of program cuts, increased federal debt, or higher taxes to make up the difference.

In recent years, there have been some particularly high-profile examples:

FRESENIUS MEDICAL CARE

After **Fresenius Medical Care Holdings was accused by authorities of falsely billing Medicare** for unnecessary blood tests and using illegal kickbacks—including invitations to bear-hunting excursions in Alaska—to encourage healthcare providers to partner with the company, its lawyers cut a $486 million deal with the federal government to close the case.[5] Fresenius ultimately deducted most of the $385 million civil portion of its settlement, securing a $50 million tax refund, plus interest, from the government as a result.[6]

According to federal charges, between 2006 and 2010 London-based bank **HSBC enabled Latin American drug cartels to launder billions of dollars** while also violating U.S. economic sanctions against regimes in countries including Libya and the Sudan. The bank's executives dodged criminal charges and jail time by agreeing to a $1.9 billion settlement with the government.[7] The Justice Department has not disclosed whether the settlement was or was not tax-deductible, though a tax deduction would mean ordinary taxpayers would end up shouldering about $700 million of the cost.[8]

Federal regulators have charged BP with violating the Clean Water Act in connection with the disastrous explosion of its *Deepwater Horizon* oil rig in 2010. Legal proceedings are ongoing but a financial settlement has been hinted at since the trial began in February 2013.[9] The Justice Department has not commented on whether such a deal will be tax deductible. This comes after BP already cut $10 billion from its tax bill by writing off $37.2 billion in cleanup expenses.[10]

Stop Subsidizing Wrongdoing

It is time federal and state governments stopped letting corporate wrongdoers add insult to injury by passing off the costs of their misconduct to taxpayers. Taxpayers should not be forced to subsidize corporations that violate rules designed to protect the public from fraud, financial chicanery or dangerous products.

All settlement agreements should clearly define their tax consequences and should communicate that information clearly to the corporation, the IRS and the broader public. In addition, government agencies should:

- Make all settlement payouts non-deductible by default, including standard language in all agreements to that effect. The Environmental Protection Agency often does this and the Securities and Exchange Commission increasingly does as well.[11]
- Publicly disclose all settlements on agency websites and include information about any portion that corporations have not been barred from deducting on their taxes.
- Require corporate filings to the Securities and Exchange Commission to explain whether any settlement payments were written off.
- Ensure "truth in advertising" by requiring regulators and corporations to disclose the *after-tax* amounts of settlements, a more accurate portrayal of the penalty a company actually pays.

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Notes

1 26 CFR §1.162-21.

2 For more, see: Phineas Baxandall and Ryan Pierannunzi, U.S. PIRG Education Fund, *Subsidizing Bad Behavior: How Corporate Legal Settlements for Harming the Public Become Lucrative Tax Write Offs, with Recommendations for Reform*, January 2013.

3 Internal Revenue Service, *Attachment I To Industry Director Directive On Government Settlements Directive #1*, 17 January 2013, downloaded from http://www.irs.gov/Businesses, 17 October 2013. Note: this quotation is from an attachment to an IRS memorandum dealing specifically with False Claims Act settlements (of which Fresenius is an example). False Claims Act settlements are particularly common and are typically settled by the Department of Justice (DOJ). Though the original IRS memorandum's discussion emphasized DOJ and EPA settlements in particular, it "can apply to any settlement between a government entity and a defendant under any law in which a penalty can be assessed," per John Risacher, Internal Revenue Service, *Tier I Issue: Government Settlements Directive #1*, 30 May 2007.

4 United States Government Accountability Office, *Systematic Information Sharing Would Help IRS Determine the Deductibility of Civil Settlement Payments*, 15 September 2005.

5 Milt Freudenheim, "Dialysis Provider To Pay $486 Million To Settle Charges," *The New York Times*, 20 January 2000.

6 Shearman & Sterling LLP, *US District Court Rejects Talley and Permits a Business Expense Deduction For Part of Double Damages Payment Under the False Claims Act*, 21 May 2013.

7 Christie Smythe, "HSBC Judge Approves $1.9B Drug-Money Laundering Accord," *Bloomberg*, 3 July 2013.

8 The Justice Department has not publicly disclosed whether the settlement was tax-deductible: *United States of America v. HSBC Bank USA, N.A. and HSBC Holdings PLC*, No. 12-CR-00763, E.D. New York, 11 December 2012; $700 million: based on a corporate tax rate of 35 percent and a settlement amount of $1.9 billion.

9 Tom Fowler, "Settlement Offer to BP Takes Shape" *The Wall Street Journal*, 24 February 2013.

10 Gretchen Morgenson, "Paying the Price, But Often Deducting It," *The New York Times*, 12 January 2013.

11 The EPA often bars deductibility: Douglas H. Frazer and Karen M. Schapiro, "Tax Deductions for Settlements with Government Agencies," *Wisconsin Lawyer* 76 (3), March 2003, note 13; for the most well-known instance of the SEC barring tax deductibility, see: *Securities and Exchange Commission v. Goldman, Sachs & Co. and Fabrice Tourre*, No. 10-CV-3229, S.D. New York, 14 July 2010.

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