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## TAX RULES! THE DEDUCTIBILITY OF DISGORGEMENT PAYMENTS UNDER SECTION 162(F)

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*The SEC has the power to order businesses to disgorge ill-gotten gains. Thus, when a business profits from violating securities law, it must give back the profits, often either to the SEC directly or to the victims harmed by the violation. Even though disgorgement is not directly a question of tax law, like all transactions, disgorgement has tax implications.*

*Section 162 of the Internal Revenue Code allows businesses to deduct “ordinary and necessary” business expenses from their tax returns. Subsection (f) of Section 162 provides an exception to this rule, saying that no deduction is allowed when a governmental entity orders a business to pay due to some violation of a law, unless the payment constitutes restitution. This Note analyzes whether disgorgement payments are restitution and if they may be deducted under Section 162(f).*

*Treasury regulations promulgated in January 2020 speak directly to this question, but a close look at typical SEC cease-and-desist disgorgement orders reveals that the regulations are not well-tailored to SEC-ordered disgorgement. This Note argues that disgorgement is restitution when the payments go out to victims. Hence, these types of disgorgement payments should be tax deductible under Section 162(f). Finally, this Note recommends that Treasury should amend its 2020 regulations to be more tailored to the content of SEC cease-and-desist orders. Doing so would be more in line with Congress’s intent in passing Section 162(f) and tax policy.*

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## I. INTRODUCTION

Large corporations and businesses are no strangers to frequent litigation and investigation from governmental bodies.<sup>1</sup> For example, the Securities and Exchange Commission (“SEC”) often orders businesses to pay disgorgement,<sup>2</sup> which is defined as “[t]he act of giving up something (such as profits illegally obtained) on demand or by legal compulsion.”<sup>3</sup> The SEC typically orders these businesses to give up profits obtained through illegal activity such as insider trading.<sup>4</sup> This type of SEC investigation happens frequently, as a quick Google news search for the word “disgorgement” elicits a number of headlines and articles describing businesses most recently required to pay disgorgement.<sup>5</sup>

1. See, e.g., *Settlements and Lawsuits*, DEP’T JUST., <https://www.justice.gov/crt/settlements-and-lawsuits> (last visited Nov. 10, 2022) [<https://perma.cc/94VE-CX59>].

2. SIMON M. LORNE & JOY MARLENE BRYAN, 11 ACQUISITIONS AND MERGERS: NEGOTIATED AND CONTESTED TRANSACTIONS *Disgorgement in SEC Enforcement Actions* § 1:26.50 (2021).

3. *Disgorgement*, BLACK’S LAW DICTIONARY (11th ed. 2019).

4. LORNE & BRYAN, *supra* note 2, § 1:26.50.

5. See, e.g., Jeff Berman, *Kestra to Pay \$10.3M Over Undisclosed Mutual Fund Compensation*, THINKADVISOR (July 12, 2021, 2:54 PM), <https://www.thinkadvisor.com/2021/07/12/kestra-to-pay-10-3m-over-undisclosed-mutual-fund-compensation/> [<https://perma.cc/48FK-UAVL>].

Disgorgement payments are relevant for dozens of reasons, but an important question every business always wants to know is: Is it tax deductible?

While disgorgement falls within the realm of securities law,<sup>6</sup> it may have tax implications. Section 162 of the Internal Revenue Code (“the Code”) allows for businesses to deduct business expenses from their tax returns.<sup>7</sup> That same section contains an exception to this broad rule, stating that when a governmental entity orders a business to pay due to violation of a law, expenses may not be deducted, unless the payments constitute restitution.<sup>8</sup> When analyzing the deductibility of disgorgement payments, a logical question becomes, is disgorgement a form of restitution?

This Note will argue that disgorgement is restitution when the funds are returned to harmed investors, and that businesses should be able to deduct disgorgement from their tax returns as business expenses under Section 162. Part II of this Note will provide background information on disgorgement and specific instances of it, using recent news headlines as examples. Part II will also provide background information on tax concepts, the Code, Section 162, and restitution. Part III of this Note will analyze whether disgorgement is deductible under Section 162 by using the pure language of the statute itself, recent United States Department of the Treasury (“Treasury”) regulations, and Supreme Court authority shedding light on these topics. While both federal courts and the SEC have the power to order disgorgement,<sup>9</sup> this Note will focus primarily on SEC-ordered disgorgement in the form of cease-and-desist orders.

Finally, Part IV of this Note will recommend that businesses should be able to deduct disgorgement payments from their tax returns and that Treasury should amend its recent regulations to be more tailored towards typical SEC cease-and-desist orders. Doing so would reduce confusion and further facilitate the deduction. Treasury should do this because making these disgorgement payments deductible will be more consistent with the policy motivation behind Section 162, aligning with Congress’s and Treasury’s intent.<sup>10</sup> This deduction also makes sense from a broader tax policy perspective.<sup>11</sup> While the behavior that leads to disgorgement is illegal and should not be tolerated, allowing for a disgorgement deduction is vital to help facilitate businesses and to make sure they are not overly penalized for wrongdoing.<sup>12</sup> Even though tax is not necessarily a sexy topic, it touches so many aspects of American life, affects the decisionmaking of virtually every single individual and business, and is constantly changing, so it is of vast importance.<sup>13</sup>

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6. LORNE & BRYAN, *supra* note 2, § 1:26.50.

7. I.R.C. § 162(a).

8. *Id.* § 162(f)(2).

9. *See infra* Subsection II.A.1.

10. *See infra* Subsection IV.B.1.

11. *See infra* Subsection IV.B.2.

12. *See infra* Subsection IV.B.2.

13. *See Tax Reform*, IRS, <https://www.irs.gov/tax-reform> (Sept. 29, 2022) [<https://perma.cc/VXP9-LE48>] (“Whether you are a small or large business, tax reform may affect your company.”).

## II. BACKGROUND

This Part will provide background information on disgorgement, tax rules, and restitution. First, this Part will provide definitions and examples of disgorgement, then address how courts and scholars have conceptualized disgorgement. Next, this Part will discuss general tax concepts, how to read the Code, and Section 162. Lastly, this Part will provide background information on restitution and examples of it.

### A. *What Is Disgorgement?*

This Subsection will first provide practical definitions and examples of disgorgement, then look at disgorgement from a more conceptual point of view.

#### 1. *Definitions and Examples*

Disgorgement is an equitable remedy that deprives violators of securities laws of any gains derived from the violations.<sup>14</sup> In addition to depriving a wrongdoer of unjust enrichment, the threat of disgorgement serves as a major deterrent against violating securities law.<sup>15</sup> For example, if a business gains profit from insider trading, the SEC might investigate that business and order it to disgorge the profits obtained from that illegal activity.<sup>16</sup>

This type of disgorgement is exactly what occurred in *SEC v. Contorinis*.<sup>17</sup> The defendant, an individual, violated securities law by executing a series of illegal insider trades.<sup>18</sup> He used nonpublic information from an investment bank employee to execute the trades on behalf of a separate fund over which he had control.<sup>19</sup> The fund made a profit of over \$7 million as a result of this illegal activity.<sup>20</sup> After he was criminally indicted, the SEC brought a civil action against him, and a federal court ordered him to disgorge over \$7 million in profit to the SEC.<sup>21</sup>

Federal courts are not the only institutions with the power to order disgorgement. Through the Securities Exchange Act, Congress expressly authorized the SEC to order disgorgement directly: “[i]n any action or proceeding brought by the Commission under any provision of the securities laws, the Commission may seek, and any Federal court may order, disgorgement.”<sup>22</sup> Rather than take violators to court and have a court enforce disgorgement, the SEC investigates businesses directly and publishes administrative proceedings detailing its findings of

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14. 69A AM. JUR. 2D *Securities Regulation-Federal* § 1519 (2022).

15. *Id.*

16. *See id.*

17. 743 F.3d 296 (2d Cir. 2014).

18. *Id.* at 299–300.

19. *Id.* at 300.

20. *Id.*

21. *Id.*

22. 15 U.S.C. § 78u(d)(7).

violations.<sup>23</sup> These proceedings are usually in the form of a cease-and-desist order, and they are publicly available on the SEC's website.<sup>24</sup> The proceedings themselves specifically order the violators to pay disgorgement, usually along with other penalties such as prejudgment interest.<sup>25</sup>

By way of example, in July 2021, the SEC ordered two investment adviser companies to pay disgorgement to their clients.<sup>26</sup> Kestra Advisory Services and Kestra Private Wealth Services (together, Kestra Advisers) violated securities law by investing client assets in mutual funds that were more expensive than lower-cost options that were available to clients.<sup>27</sup> Kestra Advisers' broker-dealer received compensation from the transaction fees charged to Kestra Advisers' clients.<sup>28</sup> This type of activity was a breach of fiduciary duty to Kestra Advisers' clients, so the SEC ordered Kestra Advisory Services to "pay disgorgement of \$7,229,802" and Kestra Private Wealth Services to "pay disgorgement of \$208,187."<sup>29</sup> While the SEC orders do not specify exactly how much profit Kestra Advisers made directly from the illegal activity, the orders make a note to say that "the disgorgement . . . does not exceed the net profits from the violations."<sup>30</sup> Unlike in the *Contorinis* case, where the disgorgement was ordered back to the SEC,<sup>31</sup> the SEC ordered Kestra Advisers' disgorgement to be distributed back to the investors that were harmed by the illegal activity.<sup>32</sup>

## 2. *Disgorgement Conceptually*

Scholars and courts have struggled to agree on a uniform conceptualization of disgorgement. Some say disgorgement is a punishment against the wrongdoer.<sup>33</sup> Others go out of their way to specifically state that disgorgement is not punitive in nature and that it is instead a remedial measure used to restore the status quo.<sup>34</sup>

Most relevant to conceptualizing disgorgement are two recent Supreme Court decisions dealing directly with disgorgement, *Kokesh v. SEC*<sup>35</sup> and *Liu v.*

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23. See, e.g., Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

24. See, e.g., *id.*

25. See, e.g., *id.*

26. Press Release, SEC, SEC Charges Two Investment Advisers and Orders Them to Repay Clients Harmed by Undisclosed Conflicts (July 9, 2021), <https://www.sec.gov/enforce/ia-5771-s> [<https://perma.cc/46T4-CJNP>].

27. *Id.*

28. *Id.*

29. *Id.*

30. Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

31. SEC v. Contorinis, 743 F.3d 296, 300 (2d Cir. 2014).

32. Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

33. See 69A AM. JUR., *supra* note 14, § 1519 (defining disgorgement as "punitive").

34. See *Contorinis*, 743 F.3d at 301 ("[D]isgorgement does not serve a punitive function.").

35. 137 S. Ct. 1635 (2017).

SEC.<sup>36</sup> *Kokesh* stated that “SEC disgorgement is imposed for punitive purposes.”<sup>37</sup> On the other hand, *Liu*, which was decided three years later, stated that disgorgement can qualify as equitable relief even though equitable relief “historically excludes punitive sanctions.”<sup>38</sup> To reconcile its holding with *Kokesh*, the Supreme Court narrowed its holding in *Liu*, stating that “a disgorgement award that does not exceed a wrongdoer’s net profits and is awarded for victims is equitable relief.”<sup>39</sup>

Under these guidelines, the disgorgement in *Contorinis* would not be equitable relief because the funds were just distributed to the SEC, not victims.<sup>40</sup> On the contrary, disgorgement ordered to Kestra Private Wealth Services could be equitable relief because it was to be awarded to victims.<sup>41</sup>

### B. Tax Concepts

This Subsection will lay out very basic tax concepts, starting with Congress’s power to tax, then describing how to read the Code, and finally, diving into Section 162.

#### 1. The Power to Tax and Deduct

Much to everyone’s dismay, Congress has the power to lay taxes.<sup>42</sup> Federal tax law is codified in the Code, which is Title 26 of the United States Code (“U.S.C.”).<sup>43</sup> Since its inception, the Code has gotten increasingly complex and lengthy, spanning over 2,600 pages across multiple volumes, and it is constantly updated.<sup>44</sup> Though the base of federal tax law is in the Code, the statutes themselves are not nearly enough for a comprehensive understanding of the law.<sup>45</sup> Treasury publishes regulations that provide interpretations of the Code.<sup>46</sup> The regulations are roughly four times as long as the Code itself.<sup>47</sup> Lastly, case law provides a useful interpretive backdrop for understanding taxes.<sup>48</sup> While no one likes paying taxes, issues stemming from tax are so large and so common in the

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36. 140 S. Ct. 1936 (2020).

37. *Kokesh*, 137 S. Ct. at 1643.

38. *Liu*, 140 S. Ct. at 1940.

39. *Id.*

40. *See* SEC v. Contorinis, 743 F.3d 296, 300 (2d Cir. 2014).

41. *See* Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

42. U.S. CONST. art. I, § 8; *id.* amend. XVI.

43. *Tax Code, Regulations, and Official Guidance*, IRS, <https://www.irs.gov/privacy-disclosure/tax-code-regulations-and-official-guidance> (Jan. 13, 2022) [<https://perma.cc/7JLB-S6YA>].

44. Joseph Bishop-Henchman, *How Many Words Are in the Tax Code?*, TAX FOUND. (Apr. 15, 2014), <https://taxfoundation.org/how-many-words-are-tax-code/> [<https://perma.cc/HCS2-PRPC>].

45. *See id.*

46. IRS, *supra* note 43.

47. Bishop-Henchman, *supra* note 44.

48. *See id.*

United States that Congress created an entirely separate Article I court for tax claims.<sup>49</sup> Thus, understanding tax issues is vital.

Congress's authority to tax income stems from the Constitution.<sup>50</sup> The Taxing Clause in Article I, Section 8 gives Congress the general power to tax,<sup>51</sup> and, more importantly, the Sixteenth Amendment authorizes Congress to lay an individual tax on income.<sup>52</sup> The power to tax income is incredibly broad: "Congress shall have the power to lay and collect taxes on incomes, *from whatever source derived*, without apportionment among the several States, and without regard to any census or enumeration."<sup>53</sup>

Congress has the power to tax income,<sup>54</sup> but the taxpayer has the power to reduce his or her taxable income by offsetting it with deductions.<sup>55</sup> A deduction is "[a]n expense (such as a medical expense, home-mortgage interest, or a charitable contribution) that can be subtracted from adjusted gross income to determine taxable income."<sup>56</sup> Despite the power to offset income with deductions, a taxpayer has no constitutional right to a deduction—nowhere does the Constitution mention the word "deduction."<sup>57</sup> Thus, "[d]eductions are not a matter of constitutional right but of *legislative grace*,"<sup>58</sup> and deductions are sometimes narrowly construed because they "can be taken only when and to the extent the statute allows."<sup>59</sup>

While the constitutional authority to lay a tax on income seems to focus on individuals, it applies to corporations as well—even before the Sixteenth Amendment, the Supreme Court held that taxing corporations is within the scope of Congress's constitutional authority.<sup>60</sup> For tax purposes, Mitt Romney is not wrong: "Corporations are people, my friend."<sup>61</sup>

## 2. The Code

The Code can be cryptic and difficult to read because it is filled with internal cross-references, exceptions, and exceptions to exceptions. For example, according to Section 11 of the Code, a tax is imposed on the *taxable* income of

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49. *History*, U.S. TAX CT., <https://www.ustaxcourt.gov/history.html> (last visited Nov. 10, 2022) [<https://perma.cc/2HS7-32BU>].

50. U.S. CONST. art. I, § 8; *id.* amend. XVI.

51. *Id.* art. I, § 8.

52. *Id.* amend. XVI.

53. *Id.* (emphasis added).

54. *Id.*

55. *Credits and Deductions for Individuals*, IRS, <https://www.irs.gov/credits-deductions-for-individuals> (last visited Nov. 10, 2022) [<https://perma.cc/8DWV-MFA7>].

56. *Deduction*, BLACK'S LAW DICTIONARY (11th ed. 2019).

57. *See generally* U.S. CONST.

58. *First Nat'l Bank & Tr. Co. v. United States*, 115 F.2d 194, 195 (5th Cir. 1940) (emphasis added).

59. *Id.*

60. *Flint v. Stone Tracy Co.*, 220 U.S. 107, 165 (1911) (recognizing "the power of Congress to tax the business activities of private corporations").

61. Philip Rucker, *Mitt Romney Says 'Corporations Are People'*, WASH. POST (Aug. 11, 2011), [https://www.washingtonpost.com/politics/mitt-romney-says-corporations-are-people/2011/08/11/gIQABwZ38L\\_story.html](https://www.washingtonpost.com/politics/mitt-romney-says-corporations-are-people/2011/08/11/gIQABwZ38L_story.html) [<https://perma.cc/6B8J-C74L>].

every corporation at a rate of 21%, but this section does not define taxable income.<sup>62</sup> Instead, Section 63 defines taxable income as “gross income minus the deductions allowed . . .”, but defines neither gross income nor deductions.<sup>63</sup> Section 61 defines gross income as “all income from whatever source derived” with a non-exhaustive list of fourteen examples.<sup>64</sup> Deductions are defined more specifically throughout different Code sections (including Section 162, the main focus of this Note), but the general idea—that deductions are expenses incurred that are subtracted from gross income—remains constant.<sup>65</sup> Four additional Code sections were necessary to figure out what Section 11 meant, illustrating that the Code can be confusing.

With these concepts in mind, intuitively, two ways that corporations and businesses can reduce tax liability is through a lower tax rate or by lowering their taxable income by taking deductions.<sup>66</sup> Tax brackets, including the corporate tax rate, are codified in the Code, meaning Congress, not businesses, has direct control over it.<sup>67</sup> Therefore, corporations and businesses are incentivized to maximize their deductions to lower their tax liability as much as possible.<sup>68</sup>

### 3. Section 162

This Subsection will first run through the language of Section 162, and then it will describe the legislative intent.

#### a. What the Statute States

Section 162 is also filled with the same difficulties: internal cross-references, exceptions, and exceptions to exceptions.<sup>69</sup> Subsection (a) allows for a deduction on business expenses: “[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.”<sup>70</sup> A typical deduction taken under this section is for employee salaries.<sup>71</sup> The rest of Section 162 contains exceptions or explanations to this general rule.<sup>72</sup>

Section 162(f), the main subsection at issue in this Note, contains an exception and exceptions to that exception.<sup>73</sup> Section 162(f)(1), the initial exception, states that a deduction that is otherwise allowed will not be allowed if it is incurred because a governmental entity ordered the corporation to pay due to some

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62. I.R.C. § 11(a)–(b).

63. *Id.* § 63(a).

64. *Id.* § 61(a).

65. *See, e.g., id.* § 162 (allowing for business expenses to offset income).

66. *See supra* text accompanying notes 62–65.

67. I.R.C. § 11.

68. *See supra* text accompanying notes 65–67.

69. *See* I.R.C. § 162.

70. *Id.* § 162(a).

71. *Id.* § 162(a)(1).

72. *See id.* § 162.

73. *See id.* § 162(f).



violation of a law.<sup>74</sup> When the statute says “otherwise allowable,” it refers to deductions that taxpayers might take under a different subsection of the chapter.<sup>75</sup> The deductions that are “otherwise allowable” include ordinary and necessary business expenses under subsection (a) of Section 162.<sup>76</sup>

Section 162(f)(2) contains a relevant exception to the exception. If the taxpayer can establish that the amount incurred at the direction of a governmental entity 1) constitutes restitution and 2) is identified as restitution in the order, then subsection (f)(1) does not apply, meaning it may be deductible.<sup>77</sup>

To summarize, a simplified checklist for deductibility with emphasis on Section 162(f) will contain the following steps. Step 1: Is the payment an ordinary and necessary business expense? If so, the payment is deductible unless an exception exists.<sup>78</sup> Step 2: Was the amount paid incurred at the direction of a governmental entity due to a violation of some law? If so, no deduction is allowed, unless another exception exists.<sup>79</sup> Step 3: If Step 2 applies, does the payment constitute restitution? If so, a deduction is allowed.<sup>80</sup>

#### b. Legislative Intent and Interpretation

When Congress passed Section 162, the purpose was to help “facilitate business.”<sup>81</sup> Deductions reduce tax liability, which facilitates business because fewer taxes allow for a corporation to do more with the extra revenue.<sup>82</sup> Furthermore, the statute helps make sure that corporations do not pay double on expenses where the “benefit derived from the payment is realized and exhausted within the taxable year.”<sup>83</sup> *International Trading Co.* recognized that deductions, “whether with respect to individuals, or corporations, are a matter of legislative grace.”<sup>84</sup> Even though the “legislative grace” concept implies narrowly construing statutes that allow for deductions, the Seventh Circuit nevertheless stated that Section 162 must be broadly construed, which would better give purpose to Congress’s intent to facilitate business.<sup>85</sup> Thus, when analyzing a deduction claim under Section 162(a), the taxpayer should read it broadly.<sup>86</sup>

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74. *Id.* § 162(f)(1). The full text states the following:

Except as provided in the following paragraphs of this subsection, no deduction otherwise allowable shall be allowed under this chapter for any amount paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government or governmental entity in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law.

*Id.*

75. *See id.*

76. *See id.* § 162(a).

77. *Id.* § 162(f)(2)(A).

78. *Id.* § 162(a).

79. *Id.* § 162(f)(1).

80. *Id.* § 162(f)(2).

81. *Int’l Trading Co. v. Comm’r*, 275 F.2d 578, 583 (7th Cir. 1960).

82. *See id.*

83. *Stevens v. Comm’r*, 388 F.2d 298, 300 (6th Cir. 1968).

84. *Int’l Trading Co.*, 275 F.2d at 584.

85. *Id.* at 583.

86. *See id.*

Congress added subsection (f) to Section 162 in the Tax Reform Act of 1969.<sup>87</sup> The section merely codified longstanding case law from *Tank Truck Rentals, Inc. v. Commissioner*.<sup>88</sup> This case stated that corporations should not be able to benefit through a tax deduction from payments imposed upon them that were intended to be punitive in nature.<sup>89</sup> Doing so would reduce the “sting” of the penalty.<sup>90</sup>

Legislative history indicates that Congress directly took *Tank Truck Rentals, Inc.* into account when passing this statute.

From the standpoint of tax policy, there generally has been a reluctance to deny business expenses on the ground that this departs from the concept of a tax imposed on actual net business income. . . . The Supreme Court in the *Tank Truck Rental* case, for example, [held] that the payment of fines could not be considered as ordinary and necessary. . . . On the same grounds, it appears appropriate to deny deductions for bribes, illegal kickbacks, and the penalty portion of antitrust treble damage payments.<sup>91</sup>

The Senate Committee essentially stated that although tax policy rejects denying business expense deductions, it seems wrong to allow for these deductions when the expenses stem from penalties.<sup>92</sup>

*Tank Truck Rentals, Inc.* and Section 162(f) do not disallow deductions for all payments derived from illegal activity. For example, the Supreme Court upheld the decision by a taxpayer to deduct attorney fees in his own unsuccessful criminal defense case.<sup>93</sup> In *Commissioner v. Tellier*, the taxpayer was charged with committing securities fraud and was found guilty on all counts.<sup>94</sup> He spent over \$22,000 in legal expenses for his “unsuccessful defense of this criminal prosecution.”<sup>95</sup> The Internal Revenue Service (“IRS”) conceded that the payments were ordinary and necessary expenses normally deductible under Section 162(a), but it argued that the deductions should be disallowed on public policy grounds.<sup>96</sup> The Supreme Court disagreed because Congress did not expressly disallow for this deduction.<sup>97</sup> The statute the taxpayer violated was punishable by imprisonment and fine, so the Supreme Court concluded that Congress did not intend for any additional punishment in the form of a financial burden—disallowance of the deduction.<sup>98</sup>

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87. Catherine M. Del Castillo, *Should Punitive Damages Be Nondeductible? The Expansion of the Public-Policy Doctrine*, 68 TEX. L. REV. 819, 821–23 (1990).

88. 356 U.S. 30 (1958).

89. *Id.* at 35–36.

90. *Id.*

91. S. REP. NO. 91-552, pt. 3 (1969), as reprinted in 1969 U.S.C.C.A.N. 2027, 2311.

92. *See id.*

93. *Comm’r v. Tellier*, 383 U.S. 687, 688–89 (1966).

94. *Id.* at 688.

95. *Id.*

96. *Id.* at 689–90.

97. *Id.* at 693–94.

98. *Id.* at 694–95.

### C. What Is Restitution?

Restitution is an entire substantive body of law,<sup>99</sup> but for the purposes of this Note, it has more practical meanings. Black's Law Dictionary has multiple definitions for restitution. First, restitution is "[t]he set of remedies associated with that body of law, in which the measure of recovery is [usually] based not on the plaintiff's loss, but on the defendant's gain."<sup>100</sup> Moreover, restitution can also be defined as "[r]eturn or restoration of some specific thing to its rightful owner or status."<sup>101</sup>

There is an entire Restatement written on the law of restitution.<sup>102</sup> Section 1 of the Restatement states that

[l]iability in restitution derives from the receipt of a benefit whose retention without payment would result in the unjust enrichment of the defendant at the expense of the claimant. . . . The usual consequence of a liability in restitution is that the defendant must restore the benefit in question or its traceable product, or else pay money in the amount necessary to eliminate unjust enrichment.<sup>103</sup>

The Restatement (Second) of Contracts provides a simple example of restitution: "A contracts to sell a tract of land to B for \$100,000. After B has made a part payment of \$20,000, A wrongfully refuses to transfer title. B can recover the \$20,000 in restitution."<sup>104</sup>

The Third Circuit case *Addie v. Kjaer*<sup>105</sup> provides a real-world example of restitution. In *Addie*, the plaintiffs entered into a contract with defendants to purchase a small private island.<sup>106</sup> They paid a \$1 million deposit plus an additional \$500,000 later on, but the sale was never completed.<sup>107</sup> The plaintiffs asked for their money back, and the defendants refused.<sup>108</sup> The Third Circuit held that the plaintiffs were entitled to their \$1.5 million back, which constituted restitution.<sup>109</sup> In essence, they were entitled to get their money back, restoring the original status quo.<sup>110</sup>

With these simple definitions and examples of restitution in mind, they will be applied to SEC-ordered disgorgement payments to determine if they meet the restitution exception under Section 162(f).

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99. See generally RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT (AM. L. INST. 2011).

100. *Restitution*, BLACK'S LAW DICTIONARY (11th ed. 2019).

101. *Id.*

102. See generally RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT (AM. L. INST. 2011).

103. *Id.* § 1 cmt. a.

104. RESTATEMENT (SECOND) OF CONTRACTS § 373 cmt. a, illus. 1 (AM. L. INST. 1981).

105. 737 F.3d 854 (3d Cir. 2013).

106. *Id.* at 857.

107. *Id.* at 857–59.

108. *Id.*

109. *Id.* at 861–65.

110. See *id.*

### III. ANALYSIS

The focus of this Note is to determine whether corporations that must pay disgorgement by SEC order may deduct those payments under Section 162. This Note will analyze this issue under the plain statutory language, using the simple checklist provided in Subsection II.B.3.a.<sup>111</sup> The bulk of analysis will be under Step 3, determining whether the taxpayer can establish that the disgorgement is restitution and whether it is properly identified as such in the SEC order. Next, the same analysis will be conducted using recent Treasury regulations.

#### A. *Step 1: Is Disgorgement an Ordinary and Necessary Business Expense?*

Disgorgement must be otherwise deductible under Section 162(a) before any exceptions become relevant.<sup>112</sup> If disgorgement is not deductible under Section 162(a), then the rest of the analysis does not matter.<sup>113</sup> Under Section 162(a), “[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.”<sup>114</sup> These requirements may be separated into several elements: the payment must be an 1) ordinary; 2) necessary; 3) expense paid or incurred during the taxable year; 4) while carrying on a trade or business.<sup>115</sup>

The statute directly provides three examples of expenses that qualify as ordinary and necessary: 1) employee salaries, 2) travel expenses, and 3) property rentals.<sup>116</sup> This list is not exhaustive because the statute says “including.”<sup>117</sup> Section 7701(c) of the Code states, “[t]he terms ‘includes’ and ‘including’ when used in a definition contained in this title shall not be deemed to exclude other things otherwise within the meaning of the term defined.”<sup>118</sup> Based on this definition, the list of three examples in Section 162(a) just serves to give the taxpayer an idea of the types of things Congress intended to be deducted.<sup>119</sup> Other common deductions under Section 162(a) include expenses for education<sup>120</sup> and business losses,<sup>121</sup> neither of which are expressly included in the list.<sup>122</sup> Thus, even though disgorgement does not fit into one of these three categories, the inquiry does not end there—it will be deductible so long as it satisfies the elements identified above.<sup>123</sup>

111. See *supra* Subsection II.B.3.a.

112. See I.R.C. § 162(a).

113. See *id.*

114. *Id.*

115. See *id.*

116. *Id.* § 162(a)(1)–(3).

117. *Id.* § 162(a).

118. *Id.* § 7701(c).

119. See *id.* (explaining that when the word “including” is used in the Code, it does not exclude other items).

120. See, e.g., *Hill v. Comm’r*, 181 F.2d 906, 911 (4th Cir. 1950).

121. See, e.g., *McBride v. Comm’r*, 50 T.C. 1, 11 (1968).

122. See I.R.C. § 162(a).

123. See *id.*

The bulk of litigation surrounding Section 162(a) is to determine whether the expense at issue is “ordinary and necessary.”<sup>124</sup> The Supreme Court determined that “ordinary” means occurring frequently in the business involved.<sup>125</sup> It does not mean that the payments are habitual payments for the individual taxpayer wishing to take the deduction.<sup>126</sup> In *Welch*, Justice Cardozo gave a hypothetical example: “A lawsuit affecting the safety of a business may happen once in a lifetime. . . . [Nonetheless], the expense is an ordinary one because we know from experience that payments for such a purpose . . . are the common and accepted means of defense against attack.”<sup>127</sup> Even though the legal issue in *Welch* was whether the taxpayer’s expenses were necessary, this dictum helps define ordinary.<sup>128</sup>

Disgorgement is an ordinary expense. *Welch* itself provides this answer in its hypothetical example.<sup>129</sup> A lawsuit, even though it may happen just once in a corporation’s lifetime, is an ordinary expense.<sup>130</sup> Corporations must pay disgorgement all the time.<sup>131</sup> Thus, even if a corporation is ordered to pay disgorgement just once, it will still be an ordinary expense.<sup>132</sup>

*Welch* also provides the standard for the second element: necessary.<sup>133</sup> Necessary means “appropriate and helpful” and “necessary for the development of the [taxpayer’s] business.”<sup>134</sup> If the SEC orders a corporation to pay disgorgement, that expense is certainly a necessary one because if it does not pay up, it is subject to other fines and penalties and will be worse off if it does not comply.<sup>135</sup> Paying the disgorgement when ordered is in the corporation’s best interest, making it “appropriate and helpful” to the “development of the [taxpayer’s] business.”<sup>136</sup> Thus, the second element is met, as disgorgement is a necessary business expense.

Next, the payment must be an expense paid or incurred during the taxable year.<sup>137</sup> This provision is one of timing, meaning an expense incurred in 2021 should be deducted from the 2021 tax return.<sup>138</sup>

An important distinction to determine under this element is whether the payment is a regular expense or capital expenditure because capital expenditures

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124. *See id.*

125. *Deputy v. Du Pont*, 308 U.S. 488, 495 (1940); *Welch v. Helvering*, 290 U.S. 111, 114 (1933).

126. *Welch*, 290 U.S. at 114.

127. *Id.*

128. *Id.*

129. *Id.*

130. *Id.*

131. *See, e.g., SEC, supra* note 26.

132. *See Welch*, 290 U.S. at 114 (defining “ordinary”).

133. *See id.* at 113.

134. *Id.*

135. *See Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771*, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order) (imposing additional penalties and interest if timely payments are not made).

136. *Welch*, 290 U.S. at 113.

137. I.R.C. § 162(a).

138. *See id.*

are nondeductible under Section 263.<sup>139</sup> Capital expenditures are typically expenses dealing with acquisition of new property or expenses related to improvements to property.<sup>140</sup>

Disgorgement is a regular expense that is incurred. It is an equitable remedy that deprives wrongdoers of their ill-gotten gains, and it is not an expense related to the acquisition of or improvement of property.<sup>141</sup> This means that it is not a capital expenditure, so the third element for deductibility is easily met.

Lastly, the payment must be from carrying on a trade or business.<sup>142</sup> This means that the expense must be related to the general business activity that the individual or corporation conducts: “to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity that the taxpayer’s primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.”<sup>143</sup> In other words, it must not be personal in nature because no deduction is allowed for “personal, living, or family expenses.”<sup>144</sup>

In the context of a corporation or business, the distinction between a business expense and a personal expense seems unnecessary. Disgorgement is clearly related to an entity’s business activities because it involves some type of income it received while conducting its business, albeit illegally.<sup>145</sup> For example, Kestra Advisers’ disgorgement payments arose from investing client assets in high-cost mutual funds when lower-cost ones were available.<sup>146</sup> This activity is in the course of Kestra Advisers’ business as an investment adviser, which generally involves investing client assets in different mutual funds.<sup>147</sup> Thus, the fourth element is met.

Disgorgement is an ordinary and necessary business expense that is deductible under Section 162(a) because all four elements of the statute are met.

*B. Step 2: Is Disgorgement Paid at the Direction of a Governmental Entity?*

As illustrated by Section III.A, disgorgement is an ordinary and necessary business expense that is deductible under Section 162(a).<sup>148</sup> The next step is to determine whether the exception in Section 162(f) applies.

The analysis first depends on whether the disgorgement is paid at the direction of a governmental entity.<sup>149</sup> The answer is yes. The SEC is a governmental entity—Congress created the SEC in 1934 in response to the stock market crash

139. *Id.* § 263.

140. *See generally* Treas. Reg. § 1.263(a)–1 (as amended in 2021).

141. *See supra* Subsection II.A.1.

142. I.R.C. § 162(a).

143. *Comm’r v. Groetzinger*, 480 U.S. 23, 35 (1987).

144. I.R.C. § 262(a).

145. *See* Press Release, SEC, *supra* note 26.

146. *Id.*

147. *See id.*

148. *See supra* Section III.A.

149. *See* I.R.C. § 162(f)(1).

of 1929.<sup>150</sup> The SEC regulates and protects investors, and it serves as an enforcement mechanism for United States securities laws.<sup>151</sup> Congress directly authorized the SEC to order corporations to pay disgorgement.<sup>152</sup> Thus, when analyzing deductibility of SEC-ordered disgorgement, these payments will be at the direction of a governmental entity, meeting the exception under Section 162(f)(1).<sup>153</sup>

*C. Step 3: Is Disgorgement Restitution and Properly Identified?*

This Subsection will first describe what is found inside a typical SEC disgorgement order, then conduct a plain statutory analysis of disgorgement as restitution using the language of Section 162, and then do a similar analysis using Treasury's regulations. After conducting the analysis, this Subsection will address potential issues with the regulations.

*1. A Closer Look at the SEC Orders*

To conduct an analysis of whether SEC-ordered disgorgement is restitution, a closer look at a handful of SEC disgorgement orders is necessary. For example, in 2021, the SEC instituted cease-and-desist orders and forced disgorgement against Gateway One Lending & Finance, LLC,<sup>154</sup> GTV Media Group, Inc.,<sup>155</sup> and Kestra Private Wealth Services.<sup>156</sup>

A closer look at the SEC orders shows that they have some things in common. First, each order contains a detailed description of what each company did wrong and why it violated securities law.<sup>157</sup> For example, Kestra Private Wealth Services invested client assets in mutual funds that were more expensive than lower-cost options that were available to its clients.<sup>158</sup> Its broker-dealer received compensation from the transaction fees charged to these clients.<sup>159</sup> This type of activity was a breach of fiduciary duty to Kestra Advisers' clients and a violation of securities laws.<sup>160</sup>

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150. James Chen, *Securities and Exchange Commission (SEC) Defined, How It Works*, INVESTOPEDIA (Apr. 27, 2022), <https://www.investopedia.com/terms/s/sec.asp> [<https://perma.cc/B8QW-28PT>].

151. *Id.*

152. 15 U.S.C. § 78u(d)(3)(A)(ii).

153. *See* I.R.C. § 162(f)(1).

154. Gateway One Lending & Fin., Securities Act Release No. 10,951, 2021 WL 2635945 (June 24, 2021) (cease-and-desist order).

155. GTV Media Grp., Inc., Saraca Media Grp., Inc. & Voice of Guo Media, Inc., Securities Act Release No. 10,979, 2021 WL 4149064 (Sept. 13, 2021) (cease-and-desist order).

156. Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

157. *See* Gateway One Lending & Fin., Securities Act Release No. 10,951, 2021 WL 2635945 (June 24, 2021) (cease-and-desist order); GTV Media Grp., Inc., Saraca Media Grp., Inc. & Voice of Guo Media, Inc., Securities Act Release No. 10,979, 2021 WL 4149064 (Sept. 13, 2021) (cease-and-desist order); Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

158. Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

159. *Id.*

160. *See id.*

Next, the orders all institute cease-and-desist proceedings and disgorgement.<sup>161</sup> In addition, disgorgement is typically not the only money the businesses must cough up—the orders contain many other payments and fines.<sup>162</sup> For example, in addition to paying \$434 million of disgorgement, the SEC order against GTV Media Group orders the corporation to pay prejudgment interest of \$15 million to the SEC and an additional civil penalty of \$15 million to the SEC.<sup>163</sup> The other two orders also contain prejudgment interest payments coupled with civil penalties to be paid to the government.<sup>164</sup>

The next thing these orders have in common is noting that the payments will be distributed to harmed investors.<sup>165</sup> All three orders, however, contain a middleman between the business and the harmed investors.<sup>166</sup> Gateway One Lending and Kestra Private Wealth Services are both ordered to deposit the funds into an escrow account.<sup>167</sup> The middleman for GTV Media Group was the SEC itself.<sup>168</sup> In addition, strict deadlines are enforced, and additional penalties in the form of additional interest paid to the SEC accrue if the payments are not timely.<sup>169</sup>

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161. See Gateway One Lending & Fin., Securities Act Release No. 10,951, 2021 WL 2635945 (June 24, 2021) (cease-and-desist order); GTV Media Grp., Inc., Saraca Media Grp., Inc. & Voice of Guo Media, Inc., Securities Act Release No. 10,979, 2021 WL 4149064 (Sept. 13, 2021) (cease-and-desist order); Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

162. See Gateway One Lending & Fin., Securities Act Release No. 10,951, 2021 WL 2635945 (June 24, 2021) (cease-and-desist order); GTV Media Grp., Inc., Saraca Media Grp., Inc. & Voice of Guo Media, Inc., Securities Act Release No. 10,979, 2021 WL 4149064 (Sept. 13, 2021) (cease-and-desist order); Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

163. GTV Media Grp., Inc., Saraca Media Grp., Inc. & Voice of Guo Media, Inc., Securities Act Release No. 10,979, 2021 WL 4149064 (Sept. 13, 2021) (cease-and-desist order).

164. Gateway One Lending & Fin., Securities Act Release No. 10,951, 2021 WL 2635945 (June 24, 2021) (cease-and-desist order); Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

165. See Gateway One Lending & Fin., Securities Act Release No. 10,951, 2021 WL 2635945 (June 24, 2021) (cease-and-desist order); GTV Media Grp., Inc., Saraca Media Grp., Inc. & Voice of Guo Media, Inc., Securities Act Release No. 10,979, 2021 WL 4149064 (Sept. 13, 2021) (cease-and-desist order); Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

166. See Gateway One Lending & Fin., Securities Act Release No. 10,951, 2021 WL 2635945 (June 24, 2021) (cease-and-desist order); GTV Media Grp., Inc., Saraca Media Grp., Inc. & Voice of Guo Media, Inc., Securities Act Release No. 10,979, 2021 WL 4149064 (Sept. 13, 2021) (cease-and-desist order); Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

167. Gateway One Lending & Fin., Securities Act Release No. 10,951, 2021 WL 2635945 (June 24, 2021) (cease-and-desist order); Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

168. GTV Media Grp., Inc., Saraca Media Grp., Inc. & Voice of Guo Media, Inc., Securities Act Release No. 10,979, 2021 WL 4149064 (Sept. 13, 2021) (cease-and-desist order).

169. See Gateway One Lending & Fin., Securities Act Release No. 10,951, 2021 WL 2635945 (June 24, 2021) (cease-and-desist order); GTV Media Grp., Inc., Saraca Media Grp., Inc. & Voice of Guo Media, Inc., Securities Act Release No. 10,979, 2021 WL 4149064 (Sept. 13, 2021) (cease-and-desist order); Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).



It is worth noting that some SEC orders require the business to distribute money to the general account of the government.<sup>170</sup> As explained below in Subsection III.C.2, however, these types of orders do not qualify for the restitution exception because the disgorgement does not go to harmed investors.<sup>171</sup> Therefore, the focus for the remainder of this Note will be on the SEC orders that specify the disgorged income must go to harmed investors.

Next, each order makes a note that the disgorgement is “consistent with equitable principles” and that the payments do not exceed the business’ net profits.<sup>172</sup> Lastly, it is worth noting that none of the orders actually contain the word “restitution.”<sup>173</sup>

## 2. Plain Statutory Analysis

Section 162(f) creates an exception to the rule identified in Section III.B, which states that no deduction should be allowed for amounts paid at the direction of a governmental entity.<sup>174</sup> This exception states that the rule shall not apply if the taxpayer establishes the amount “constitutes restitution (including remediation of property) for damage or harm which was or may be caused by the violation of any law,” and “is identified as restitution . . . in the court order or settlement agreement.”<sup>175</sup>

The key term is *restitution*, though the statute does not provide a definition of restitution.<sup>176</sup> When interpreting statutes, starting with the plain meaning of the words in the statute is the best way to give effect to Congress’s intent.<sup>177</sup> Thus, the plain and ordinary meaning of the word *restitution* should be used when interpreting Section 162(f).<sup>178</sup>

The Supreme Court has stated that “the ordinary meaning of ‘restitution’ is restoring someone to a position he occupied before a particular event” and that

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170. See, e.g., WPP PLC, Exchange Act Release No. 4,257, 2021 WL 4354692 (Sept. 24, 2021) (cease-and-desist order) (“Therefore, in these circumstances, distributing disgorged funds to the U.S. Treasury is the most equitable alternative.”).

171. See *infra* Subsection III.C.2.

172. See Gateway One Lending & Fin., Securities Act Release No. 10,951, 2021 WL 2635945 (June 24, 2021) (cease-and-desist order); GTV Media Grp., Inc., Saraca Media Grp., Inc. & Voice of Guo Media, Inc., Securities Act Release No. 10,979, 2021 WL 4149064 (Sept. 13, 2021) (cease-and-desist order); Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

173. See Gateway One Lending & Fin., Securities Act Release No. 10,951, 2021 WL 2635945 (June 24, 2021) (cease-and-desist order); GTV Media Grp., Inc., Saraca Media Grp., Inc. & Voice of Guo Media, Inc., Securities Act Release No. 10,979, 2021 WL 4149064 (Sept. 13, 2021) (cease-and-desist order); Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

174. I.R.C. § 162(f)(1); see *supra* Section III.B.

175. I.R.C. § 162(f)(2)(A).

176. See *id.* § 162.

177. Jackson v. Blitt & Gaines, P.C., 833 F.3d 860, 863 (7th Cir. 2016).

178. See *id.*

restitution “is intended to compensate victims only for losses caused by the conduct underlying the offense of conviction.”<sup>179</sup>

The circuit courts widely apply this plain definition. For example, in *Charter Communications Entertainment I, DST v. Burdulis*,<sup>180</sup> the First Circuit distinguished between two definitions of restitution—one that emphasizes restitution as a substitute for damages, and another more “colloquial” definition of the term.<sup>181</sup> The definition of restitution as a substitute for damages is less focused on compensating the plaintiff and more focused on depriving the defendant of any unjust enrichment.<sup>182</sup> On the other hand, a “colloquial” usage of the term restitution would mean “both that the defendants would disgorge any ill-gotten gains, and that the plaintiff would be able to recover for any other losses it incurred as a result of the defendants’ misconduct.”<sup>183</sup> If the statute requires the word’s plain and ordinary meaning, then the colloquial definition should be used.<sup>184</sup> *United States v. Thomas*, another First Circuit case, defines restitution as “compensation for losses suffered as a result of a crime.”<sup>185</sup> Similarly, *Chernin v. United States*, an Eighth Circuit case, uses definitions of restitution that emphasize giving back, or restoring something to its rightful owner.<sup>186</sup>

Some definitions of restitution are more focused on depriving a defendant of unjust enrichment rather than compensating a victim.<sup>187</sup> Under this definition, a disgorgement payment such as the one in *Contorinis* would qualify as restitution because he was simply unjustly enriched.<sup>188</sup> In *Contorinis*, the defendant was ordered to give up \$7 million gained from illegal insider trading.<sup>189</sup> He was to give it to the SEC to deprive him from his ill-gotten gains.<sup>190</sup> If Section 162(f) were to use a definition of restitution that focuses purely on depriving a defendant from unjust enrichment, the defendant in *Contorinis* would probably be able to deduct this \$7 million disgorgement from his tax return under the restitution exception because of his unjust enrichment.<sup>191</sup> As illustrated below, however, this is not the definition the statute uses, which would deprive the defendant in *Contorinis* of the deduction in reality.

Given the court definitions and plain meanings identified above, depriving a defendant from unjust enrichment is not enough. All the cases seem to point to two things—a defendant was unjustly enriched, and that defendant had to pay the money back to the victims.<sup>192</sup> Hence, two parties must be involved for

179. *Hughey v. United States*, 495 U.S. 411, 416 (1990).

180. 460 F.3d 168 (1st Cir. 2006).

181. *Id.* at 182–83.

182. *Id.*

183. *Id.*

184. *See Jackson v. Blitt & Gaines, P.C.*, 833 F.3d 860, 863 (7th Cir. 2016).

185. *United States v. Thomas*, 635 F.3d 13, 21 (1st Cir. 2011).

186. *Chernin v. United States*, 149 F.3d 805, 816 (8th Cir. 1998).

187. *See Charter Commc’ns Ent. I*, 460 F.3d at 182.

188. *See SEC v. Contorinis*, 743 F.3d 296, 301 (2d Cir. 2014).

189. *Id.* at 300.

190. *Id.*

191. *See id.* at 302.

192. *See supra* text accompanying notes 180–86.

something to properly be considered restitution.<sup>193</sup> Simply giving up ill-gotten gains is not restitution, even though it may be disgorgement.<sup>194</sup> Thus, for the purposes of Section 162(f), restitution should be seen as requiring 1) the defendant's unjust enrichment and 2) the victim(s) being restored to their original monetary position.<sup>195</sup>

Given this understanding of restitution, an analysis under the plain statutory language is simple; both requirements are easily satisfied. First, the typical SEC order shows that a company was unjustly enriched because it describes in detail the income it received from violating securities law.<sup>196</sup> Second, the typical SEC order specifically states that funds must be returned to harmed investors, which would restore the status quo.<sup>197</sup> Thus, the disgorged income from these SEC orders is restitution, and it qualifies for a deduction under the plain meaning of the statute.

Section 162(f) also establishes that the court order or settlement agreement must identify the payment as restitution to be able to get the deduction.<sup>198</sup> The statutory language does not expressly require the word "restitution" to appear within the order, just that the order identifies the payment as restitution.<sup>199</sup> While this requirement is ambiguous, each order identifies a specific amount to be paid as disgorgement, separated out from other penalties such as prejudgment interest.<sup>200</sup> If disgorgement paid back to victims is by definition restitution, and the orders identify the payments as disgorgement, this should suffice under the plain statutory language.<sup>201</sup> If this result is unsatisfactory, the regulations discussed in the Subsection below make clear that this sort of interpretation is sufficient in fulfilling the identification requirement.<sup>202</sup>

In addition to the plain interpretation of the statute supporting disgorgement as restitution, the courts have consistently interpreted disgorgement to be restitution. For example, the *Kokesh* decision, which stated that disgorgement is

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193. See *supra* text accompanying notes 179–85.

194. See, e.g., *Contorinis*, 743 F.3d at 299–301.

195. See *supra* text accompanying notes 180–86.

196. See Gateway One Lending & Fin., Securities Act Release No. 10,951, 2021 WL 2635945 (June 24, 2021) (cease-and-desist order); GTV Media Grp., Inc., Saraca Media Grp., Inc. & Voice of Guo Media, Inc., Securities Act Release No. 10,979, 2021 WL 4149064 (Sept. 13, 2021) (cease-and-desist order); Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

197. See Gateway One Lending & Fin., Securities Act Release No. 10,951, 2021 WL 2635945 (June 24, 2021) (cease-and-desist order); GTV Media Grp., Inc., Saraca Media Grp., Inc. & Voice of Guo Media, Inc., Securities Act Release No. 10,979, 2021 WL 4149064 (Sept. 13, 2021) (cease-and-desist order); Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

198. I.R.C. § 162(f)(2)(A)(ii).

199. See *id.*

200. See Gateway One Lending & Fin., Securities Act Release No. 10,951, 2021 WL 2635945 (June 24, 2021) (cease-and-desist order); GTV Media Grp., Inc., Saraca Media Grp., Inc. & Voice of Guo Media, Inc., Securities Act Release No. 10,979, 2021 WL 4149064 (Sept. 13, 2021) (cease-and-desist order); Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

201. See I.R.C. § 162(f)(2)(A)(ii).

202. See *infra* Subsection III.C.3.

punitive, recognized that “disgorgement is a form of ‘[r]estitution measured by the defendant’s wrongful gain.’”<sup>203</sup> Similarly, the *Liu* decision equates disgorgement with restitution on multiple grounds.<sup>204</sup>

### 3. Analysis Under Treasury Regulations

When the Code is ambiguous, Treasury regulations, which help explain Congress’s intent, help to disambiguate the statutes.<sup>205</sup> In May 2020, Treasury proposed regulations interpreting Section 162(f) that would make disgorgement per se nondeductible.<sup>206</sup> Treasury cited *Kokesh* as its reason for this new rule, interpreting the opinion to define disgorgement as a penalty, making it nondeductible.<sup>207</sup> Commenters were not very happy with this interpretation. They emphasized that *Kokesh* recognizes disgorgement as a form of restitution, so disallowing a deduction would be contrary to Congress’s expressed intent.<sup>208</sup> The commenters also pointed to *Liu*, which was decided after the May 2020 proposed regulations.<sup>209</sup> They noted that *Liu* 1) states that amounts awarded to victims may constitute an equitable remedy and 2) expressly declined to answer whether *Kokesh* defined disgorgement as a penalty.<sup>210</sup>

After these comments, Treasury finalized new regulations that help explain Section 162(f), stating in the preamble that it changed its decision regarding disgorgement based on the commenters’ suggestions.<sup>211</sup> These regulations speak to disgorgement directly, stating,

restitution may include amounts paid or incurred as disgorgement or forfeiture, if paid or incurred at the direction of a government or governmental entity directly to the person . . . harmed by the violation or potential violation of any law. . . . This paragraph . . . does not apply if the order or agreement identifies the payment amount as in excess of the taxpayer’s net profits or, pursuant to the order or agreement, the amounts are disbursed to the general account of the government or governmental entity for general enforcement efforts or other discretionary purposes.<sup>212</sup>

This language directly mirrors the limitation provided in *Liu*, which states “a disgorgement award that does not exceed a wrongdoer’s net profits and is awarded for victims is equitable relief.”<sup>213</sup> The emphasis is on the money going to victims, not the government. Restitution is the “[r]eturn or restoration of some

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203. *Kokesh v. SEC*, 137 S. Ct. 1635, 1640 (2017) (quoting RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 51, cmt. a (AM. L. INST., 2010)).

204. *Liu v. SEC*, 140 S. Ct. 1936, 1943 (2020).

205. Bishop-Henchman, *supra* note 44.

206. Denial of Deduction for Certain Fines, Penalties, and Other Amounts; Related Information Reporting Requirements, 86 Fed. Reg. 4970-01, 4973-74 (proposed Jan. 19, 2021) (to be codified at 26 C.F.R. pt. 1).

207. *Id.*

208. *Id.* at 4974.

209. *Id.*

210. *Id.*

211. *Id.*

212. Treas. Reg. § 1.162-21(e)(4)(i)(B) (as amended in 2021).

213. *Liu v. SEC*, 140 S. Ct. 1936, 1940 (2020).

specific thing to its rightful owner or status.”<sup>214</sup> Equitable relief is typically seen as “injunction or specific performance, obtained when available legal remedies, usu[ally] monetary damages, cannot adequately redress the injury.”<sup>215</sup> Treasury regulations seem to substitute restitution for equitable relief.<sup>216</sup> Regardless, the emphasis is placed on 1) the money going to victims, not to the government, and 2) the money not being in excess of a wrongdoer’s net profits.<sup>217</sup>

The finalized regulations also shed light on the identification requirement:

The identification requirement is met if an order or agreement specifically states the amount of the payment . . . and that the payment constitutes restitution. . . . If the order or agreement uses a different form of the required words (such as “remediate” . . . ) and describes the purpose for which restitution or remediation will be paid . . . the order or agreement will be treated as stating that the payment constitutes restitution. . . .<sup>218</sup>

Most importantly, the regulations state, “[s]imilarly, if an order or agreement specifically describes the damage done, harm suffered . . . and describes the action required of the taxpayer to provide restitution . . . the order or agreement will be treated as stating that the payment constitutes restitution . . . .”<sup>219</sup>

The analysis under the regulations is a bit more extensive than under the plain meaning of the statute. Nevertheless, even though the regulations provide a very specific framework for deducting disgorgement payments, a broad reading of them still allows for a successful deduction in cases like the SEC orders identified above.

First, Treasury regulations state that the disgorgement must be paid directly to the person harmed by the violation of the law.<sup>220</sup> Because most orders contain a middleman in the form of either an escrow account or the SEC, the word “direct” might cause issues.<sup>221</sup> A broad reading of the regulation, however, satisfies this element—the payments are direct in the sense that the harmed investors receive back the money and are restored to their original position as best as possible, and no one else gets to use that money.<sup>222</sup> Furthermore, the definition of restitution does not preclude a middleman or escrow account.<sup>223</sup> The emphasis is just on harmed investors being restored to their original position after unjust

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214. *Restitution*, BLACK’S LAW DICTIONARY (11th ed. 2019).

215. *Remedy*, BLACK’S LAW DICTIONARY (11th ed. 2019).

216. See Treas. Reg. § 1.162-21(e)(4)(i)(B) (as amended in 2021).

217. See *id.*

218. *Id.* § 1.162-21(b)(2)(ii).

219. *Id.*

220. *Id.* § 1.162-21(e)(4)(i)(B).

221. See *id.*

222. See Gateway One Lending & Fin., Securities Act Release No. 10,951, 2021 WL 2635945 (June 24, 2021) (cease-and-desist order); GTV Media Grp., Inc., Saraca Media Grp., Inc. & Voice of Guo Media, Inc., Securities Act Release No. 10,979, 2021 WL 4149064 (Sept. 13, 2021) (cease-and-desist order); Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

223. See *supra* Subsection III.C.2.

enrichment, *i.e.*, the end is what matters, not the means.<sup>224</sup> Thus, this element is satisfied.

Second, Treasury regulations say the amounts must not be in excess of net profits.<sup>225</sup> Each SEC order specifically states that the disgorgement payments are not in excess of net profits.<sup>226</sup> Thus, the next element is satisfied.

Third, the regulations state that the disgorgement amounts cannot be disbursed to the general account of the government.<sup>227</sup> Again, some confusion arises if the government is merely a middleman between the business and the harmed investor.<sup>228</sup> In these examples, the government does not get to keep the money for other purposes, and the money goes to harmed investors,<sup>229</sup> which is what the definition of restitution requires.<sup>230</sup> Thus, a broad reading is again necessary to satisfy this element.

Lastly, the regulations state that the identification requirement may be satisfied if the order describes the action required to provide restitution.<sup>231</sup> Here, each order describes the laws that were violated, why the companies must disgorge this portion of their income, and how it will be distributed to harmed investors.<sup>232</sup> Thus, per the regulations, the description is enough to treat the orders as identifying the disgorgement payments as restitution.

#### 4. *Potential Issues with the Regulations*

The regulations are silent on some things that commonly show up in SEC orders, which might cause taxpayers some confusion or even hesitancy in taking a deduction on disgorgement payments. While none of these issues fully preclude the deduction, this handful of wrinkles illustrates why a broad reading of the regulations is necessary to get the deduction.

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224. *See supra* Subsection III.C.2.

225. Treas. Reg. § 1.162-21(e)(4)(i)(B) (as amended in 2021).

226. *See* Gateway One Lending & Fin., Securities Act Release No. 10,951, 2021 WL 2635945 (June 24, 2021) (cease-and-desist order); GTV Media Grp., Inc., Saraca Media Grp., Inc. & Voice of Guo Media, Inc., Securities Act Release No. 10,979, 2021 WL 4149064 (Sept. 13, 2021) (cease-and-desist order); Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

227. Treas. Reg. § 1.162-21(e)(4)(i)(B) (as amended in 2021).

228. *See id.*

229. *See* Gateway One Lending & Fin., Securities Act Release No. 10,951, 2021 WL 2635945 (June 24, 2021) (cease-and-desist order); GTV Media Grp., Inc., Saraca Media Grp., Inc. & Voice of Guo Media, Inc., Securities Act Release No. 10,979, 2021 WL 4149064 (Sept. 13, 2021) (cease-and-desist order); Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

230. *See supra* Subsection III.C.2.

231. Treas. Reg. § 1.162-21(b)(2)(ii) (as amended in 2021).

232. *See* Gateway One Lending & Fin., Securities Act Release No. 10,951, 2021 WL 2635945 (June 24, 2021) (cease-and-desist order); GTV Media Grp., Inc., Saraca Media Grp., Inc. & Voice of Guo Media, Inc., Securities Act Release No. 10,979, 2021 WL 4149064 (Sept. 13, 2021) (cease-and-desist order); Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

First, the regulations do not speak to the idea of a middleman—the regulations simply state that payments must go directly to harmed parties.<sup>233</sup> The SEC orders all specify a middleman between the companies and harmed investors, usually in the form of an escrow account,<sup>234</sup> but sometimes the middleman is the government itself.<sup>235</sup> The regulations say the money must not go to the government’s general account,<sup>236</sup> but this presumably means for the government’s use, like the disgorgement in *Contorinis*.<sup>237</sup> Regardless of the fact that a middleman is used, the disgorged income in the typical SEC order finds itself in the hands of the harmed investors,<sup>238</sup> which is the main requirement of the regulations.<sup>239</sup>

Second, the regulations are silent on the existence of penalties in addition to disgorgement found within the order.<sup>240</sup> Some places in tax law show that the mere existence of a power or condition shuts down the deal—meaning it makes something taxable or precludes a deduction—whether that power is exercised or condition actually occurs is irrelevant.<sup>241</sup> For example, Section 676 of the Code says that a trust is taxable to the grantor (not the trust’s recipient) if the grantor has the power to revoke the trust.<sup>242</sup> Even if the grantor never exercises this power, the attempt at taxing income to the recipient is shut down, and the income from the trust is taxable to the grantor because of the mere existence of the power.<sup>243</sup>

Similarly, SEC orders typically contain additional penalties other than the disgorgement, such as prejudgment interest.<sup>244</sup> The orders also say that if the amounts are not paid within a specific time limit, additional penalties will be imposed.<sup>245</sup> If this is interpreted like the trust context, the presence of a potential additional penalty might preclude the disgorgement deduction.<sup>246</sup> Whether the penalty ever gets triggered by a late payment is irrelevant; its mere existence is

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233. See Treas. Reg. § 1.162-21(e)(4)(i)(B) (as amended in 2021).

234. See Gateway One Lending & Fin., Securities Act Release No. 10,951, 2021 WL 2635945 (June 24, 2021) (cease-and-desist order); Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

235. See GTV Media Grp., Inc., Saraca Media Grp., Inc. & Voice of Guo Media, Inc., Securities Act Release No. 10,979, 2021 WL 4149064 (Sept. 13, 2021) (cease-and-desist order).

236. See Treas. Reg. § 1.162-21(e)(4)(i)(B) (as amended in 2021).

237. See SEC v. Contorinis, 743 F.3d 296, 299–301 (2d Cir. 2014).

238. See Gateway One Lending & Fin., Securities Act Release No. 10,951, 2021 WL 2635945 (June 24, 2021) (cease-and-desist order); GTV Media Grp., Inc., Saraca Media Grp., Inc. & Voice of Guo Media, Inc., Securities Act Release No. 10,979, 2021 WL 4149064 (Sept. 13, 2021) (cease-and-desist order); Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

239. See Treas. Reg. § 1.162-21(e)(4)(i)(B) (as amended in 2021).

240. See *id.*

241. See, e.g., I.R.C. § 676.

242. *Id.*

243. See *id.*

244. See, e.g., Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order) (containing penalties such as prejudgment interest).

245. See, e.g., *id.* (“If timely deposit into the escrow account is not made, additional interest shall accrue . . .”).

246. See I.R.C. § 676.

what matters.<sup>247</sup> This issue may be dismissed because in the trust context, the preclusion based on the existence of certain powers is expressly mentioned in the statute.<sup>248</sup> The regulations are simply silent on the matter, so this issue would not preclude the deduction.<sup>249</sup>

With the existing statute and regulations, disgorgement may be deducted because it is an ordinary and necessary business expense under Section 162(a) that qualifies for the restitution exception under Section 162(f),<sup>250</sup> though a broad reading of Treasury's recent regulations is necessary to come to this conclusion.<sup>251</sup> Therefore, Treasury should amend and broaden its regulations to coincide more with the statute and the typical SEC cease-and-desist order for disgorgement.

#### IV. RECOMMENDATION

When the SEC directly orders a business to pay disgorgement, these businesses should be able to deduct these payments from their tax returns without interference from the IRS. As Part III illustrates, these payments may be deducted when analyzing just the statutory language of Section 162(f) and under a broad reading of Treasury's January 2021 regulations.<sup>252</sup> To reduce confusion and make sure businesses are able to take the deduction, Treasury should amend their January 2021 regulations by broadening them and tailoring them more specifically to the typical SEC cease-and-desist order instituting disgorgement. This recommendation stems from two lines of reasoning. First, allowing for the broad deductibility of corporate disgorgement payments gives effect to Congress's intent. Second, this deduction makes sense from a broader tax policy perspective.

##### A. *How Would New Regulations Look?*

Treasury should amend its regulations to coincide more with the typical SEC order. Given the SEC's *carte blanche* power to enforce disgorgement against violators,<sup>253</sup> it makes sense that a good chunk of the disgorgement will be in the form of the cease-and-desist orders identified in Part III.<sup>254</sup> Thus, to facilitate more deductions, the new regulations would contain language and suggestions that clear up any confusion for the taxpayer considering taking a disgorgement deduction.

First, the regulations would take out the word "directly" and read: "restitution may include amounts paid or incurred as disgorgement or forfeiture, if paid or incurred at the direction of a government or governmental entity to the person

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247. *See id.*

248. *Id.*

249. *See* Treas. Reg. § 1.162-21(e)(4)(i)(B) (as amended in 2021).

250. *See supra* Part III.

251. *See supra* Subsections III.C.3, III.C.4.

252. *See supra* Part III.

253. *See* 15 U.S.C. § 78u(d)(3)(A)(ii).

254. *See supra* Part III.



... harmed by the violation” instead of “paid *directly* to the person.”<sup>255</sup> This makes sense because the typical SEC order has the violating entity deposit funds into an escrow account or with the government, which are then disbursed to harmed investors.<sup>256</sup> The definition of restitution does not preclude any sort of middleman; it only requires that funds be returned to the person harmed by the unlawful activity.<sup>257</sup>

Second, to reinforce this idea, the regulations should contain an additional sentence that says something along the lines of: “so long as funds end up in the hands of harmed investors, the transferring of funds to a third party (such as an escrow account) between the violating entity and the harmed investor shall not preclude the deduction.” This additional sentence would clear up confusion with respect to a middleman in the transaction.

Third, the regulations should contain a sentence that expressly allows for the deduction even if the order contains other penalties. The sentence should read as follows: “the presence of additional penalties (such as prejudgment interest or interest accrued due to late payment) found within the order of disgorgement shall not preclude the deduction.” The typical SEC order contains penalties in addition to disgorgement, the presence of which might give businesses some pause in taking a deduction.<sup>258</sup> This additional sentence would clear up confusion with respect to the presence of additional penalties.

This revised regulation would provide clarity and broader deductibility of disgorgement payments going back to harmed investors. A broad reading of the regulations would no longer be necessary, giving businesses some more leeway and ease when preparing their tax returns.

#### B. *Why Should Treasury Do This?*

This Subsection will provide reasoning as to why Treasury should amend its regulations, starting with Congress’s intent and then addressing tax policy concerns.

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255. Treas. Reg. § 1.162-21(e)(4)(i)(B) (as amended in 2021).

256. See Gateway One Lending & Fin., Securities Act Release No. 10,951, 2021 WL 2635945 (June 24, 2021) (cease-and-desist order); GTV Media Grp., Inc., Saraca Media Grp., Inc. & Voice of Guo Media, Inc., Securities Act Release No. 10,979, 2021 WL 4149064 (Sept. 13, 2021) (cease-and-desist order); Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

257. See *supra* Subsection III.C.2.

258. See Gateway One Lending & Fin., Securities Act Release No. 10,951, 2021 WL 2635945 (June 24, 2021) (cease-and-desist order); GTV Media Grp., Inc., Saraca Media Grp., Inc. & Voice of Guo Media, Inc., Securities Act Release No. 10,979, 2021 WL 4149064 (Sept. 13, 2021) (cease-and-desist order); Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

### 1. *Congress's Intent*

The primary goal for statutory interpretation is to give effect to the legislature's intent.<sup>259</sup> Congress's intent for Section 162 was to allow corporations to reduce tax liability and thus "facilitate business."<sup>260</sup> Furthermore, the statute is meant to be construed broadly.<sup>261</sup> SEC-ordered disgorgement is an exception to the ordinary and necessary rule because it is paid at the direction of a governmental entity.<sup>262</sup> But courts have consistently interpreted disgorgement to be a form of restitution.<sup>263</sup> Under the plain statutory language of Section 162 and a broad interpretation of Treasury's regulations, disgorgement is deductible.<sup>264</sup>

Treasury also intended for disgorgement to be deductible. This idea can be shown by contrasting its initial proposed regulations to the finalized ones released in January 2021. In May 2020, Treasury proposed regulations that would specifically exclude disgorgement from the restitution exception in Section 162.<sup>265</sup> These regulations would have made disgorgement per se nondeductible.<sup>266</sup> Fortunately, after commenters noted that recent Supreme Court decisions were contrary to this categorical exclusion, Treasury decided not to finalize this proposal and instead released the finalized regulations discussed above in Subsection III.C.3.<sup>267</sup> Treasury initially wanted to make disgorgement per se nondeductible, but then it flipped on that decision in the final regulations,<sup>268</sup> illustrating that its intent was to allow for deductions. Given that the SEC is a major player in forcing companies to disgorge ill-gotten gains,<sup>269</sup> it makes sense for Treasury to tailor its regulations to a typical SEC order to reduce any confusion.

### 2. *Tax Policy*

This Subsection addresses the taxability of illegal income and the policy against double taxation.

#### a. *Taxability of Illegal Income*

Disallowing a deduction for disgorgement would be contrary to tax principles, which say that even illegal income is taxable.<sup>270</sup> The federal income tax is a tax on net income, regardless of the source from which it is derived.<sup>271</sup> This

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259. *Est. of Gerson v. Comm'r*, 507 F.3d 435, 439 (6th Cir. 2007).

260. *Int'l Trading Co. v. Comm'r*, 275 F.2d 578, 583 (7th Cir. 1960).

261. *Id.*

262. *See supra* Section III.C.

263. *See supra* Subsection II.A.2.

264. *See supra* Section III.C.

265. Denial of Deduction for Certain Fines, Penalties, and Other Amounts, 85 Fed. Reg. 28,524 (proposed May 13, 2020).

266. *See id.*

267. *See supra* Subsection III.C.3.

268. *See* Treas. Reg. § 1.162-21(e)(4)(i)(B) (as amended in 2021).

269. *See* 15 U.S.C. § 78u.

270. *See Comm'r v. Tellier*, 383 U.S. 687, 691 (1966).

271. *See id.*

means that even if income is received illegally, it is nevertheless taxable.<sup>272</sup> “[T]he fact that a business is unlawful [does not] exempt it from paying the taxes that if lawful it would have to pay.”<sup>273</sup> Al Capone, one of the most notorious crime bosses of the twentieth century, was famously bagged for evading taxes on his illegally received income.<sup>274</sup> Even though Capone was a well-known crime boss, federal prosecutors had trouble successfully charging him with the violent crimes he committed.<sup>275</sup> Luckily for the prosecutors, Capone lived a very extravagant lifestyle, yet he never reported any income on his tax returns.<sup>276</sup> Thus, they had a way to get him to prison: tax evasion.<sup>277</sup>

If illegal income is taxable, then illegal expenses are deductible. For example, a drug dealer in Minneapolis, Minnesota, successfully deducted certain expenses under Section 162 connected with his drug business.<sup>278</sup> The Tax Court allowed the petitioner, who was “self-employed in the trade or business of selling amphetamines, cocaine, and marijuana,” to deduct his rent, as well as “the purchase of a small scale, packaging expenses, telephone expenses, and automobile expenses.”<sup>279</sup> While recognizing the illegality of the business and some timing issues with his tax return, the Tax Court nevertheless held “that these expenses were made in connection with petitioner’s trade or business and were both ordinary and necessary.”<sup>280</sup> Thus, the IRS recognized that even though dealing drugs is as illegal as it gets, this “business” still experiences ordinary and necessary expenses that may be deducted.<sup>281</sup>

Income is taxable even if it is derived from illegal sources,<sup>282</sup> and tax policy says that “[w]ith respect to deductions, the basic rule, with only a few limited and well-defined exceptions, is the same.”<sup>283</sup> Thus, historical tax principles provide that the illegality of disgorged income does not preclude its deductibility.

#### b. Policy Against Double Taxation

Furthermore, tax policy goes against taxing the same income twice. Even though the disgorged income comes from ill-gotten gains, profits from disgorgement were likely taxed already.<sup>284</sup> If no deduction is allowed, the corporation

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272. *Id.*

273. *United States v. Sullivan*, 274 U.S. 259, 263 (1927).

274. Kelly Phillips Erb, *Al Capone Sentenced to Prison for Tax Evasion on This Day in 1931*, FORBES (Oct. 17, 2018, 8:59 PM), <https://www.forbes.com/sites/kellyphillipserb/2018/10/17/al-capone-sentenced-to-prison-for-tax-evasion-on-this-day-in-1931/?sh=2064503b7c4c> [https://perma.cc/WK7U-UMGH].

275. *Id.*

276. *Id.*

277. *Id.*

278. *Edmondson v. Comm’r*, 42 T.C.M. 1533, 1535–36 (1981).

279. *Id.*

280. *Id.* at 1536.

281. *See id.*

282. *Comm’r v. Tellier*, 383 U.S. 687, 691 (1966).

283. *Id.*

284. Kristen Garry, Mark D. Lanpher, Todd Lowther, Philip Urofsky & Richard Gagnon, *Treasury Finalizes Section 162(f) Regulations on the Deductibility of Amounts Paid to, or at the Direction of, a Governmental*

will be taxed on income it does not have, and it will receive an unnecessary “double sting.”<sup>285</sup> Given the exception for restitution in Section 162(f), Congress did not intend for this double sting. Instead, Congress only allowed for “the imposition of severe punishment upon those found guilty of . . . serious criminal offenses . . . . But we can find no warrant for attaching to that punishment an additional financial burden that Congress has neither expressly nor implicitly directed.”<sup>286</sup>

The concept of the double sting and taxing of nonexistent income might better be illustrated through a hypothetical example. Kestra Private Wealth Services violated securities law and received illegal income from January 2014 through August 2021.<sup>287</sup> Even though the income was achieved illegally, it was income nonetheless and was therefore taxable.<sup>288</sup> While it is difficult to know for sure, Kestra Private Wealth Services presumably reported this income on its 2014–2021 tax returns and paid tax on it.<sup>289</sup>

After the SEC investigation in 2021, Kestra Private Wealth Services was ordered to disgorge this income and give it back in the full amount that its clients were harmed, say \$X.<sup>290</sup> The government received a chunk of this income in the form of income taxes over the course of the illegal activity, say \$Y.<sup>291</sup> Thus, the income Kestra Private Wealth Services got to keep was \$X – \$Y. Now, it must pay back \$X in full.<sup>292</sup> This is a “double sting” because the corporation is forced to reach into its own account and pay disgorgement from funds unrelated to the illegal activity.<sup>293</sup> The disgorgement puts Kestra Private Wealth Services in a position as if it had never made that money in the first place, so Kestra Private Wealth Services was, in a sense, taxed on income it never even had.<sup>294</sup> Allowing for the deduction would essentially provide them with a refund on these taxes.<sup>295</sup> Without the deduction, the government keeps tax money from illegal activity.<sup>296</sup> This result is contrary to public policy because securities laws provide for other penalties against corporations, and these penalties are usually included within SEC orders and are distinct from disgorgement.<sup>297</sup>

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Entity, SHEARMAN & STERLING (Jan. 26, 2021), <https://www.shearman.com/Perspectives/2021/01/Treasury-Finalizes-Section-162f-Regulations> [<https://perma.cc/MR6C-WBSQ>].

285. *Id.*

286. *Tellier*, 383 U.S. at 694–95.

287. Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

288. *See supra* Subsection IV.B.2.a.

289. *Cf.* I.R.C. § 1 (requiring taxpayers to pay tax on taxable income).

290. The actual amount was \$208,187. Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

291. *See* I.R.C. § 1 (requiring taxpayers to pay tax on taxable income).

292. *See* Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

293. Garry, Lanpher, Lowther, Urofsky & Gagnon, *supra* note 284.

294. *See id.*

295. *See supra* Section II.B.

296. *See supra* Section II.B.

297. Garry, Lanpher, Lowther, Urofsky & Gagnon, *supra* note 284.

Treasury Regulations are not authoritative law, but they are very influential and persuasive.<sup>298</sup> Companies rely on them, and so do the courts.<sup>299</sup> If the regulations were changed to coincide with the typical SEC cease-and-desist order, the change would erase any confusion and result in more businesses taking deductions, which is what Congress intended—facilitation of business.<sup>300</sup>

## V. CONCLUSION

Most transactions have tax implications, and disgorgement is an example of this concept. When companies pay disgorgement back to the parties that were harmed by the illegal activity, disgorgement is restitution, and it should qualify for a tax deduction under the exception listed in Section 162(f) of the Code.<sup>301</sup> This holds true under a plain reading of the statutory language.<sup>302</sup> Treasury's January 2021 regulations interpreting Section 162(f) also allow for the deduction under a broad reading.<sup>303</sup> The regulations, however, are silent on a handful of matters that might make companies hesitate in taking a deduction.<sup>304</sup>

The SEC has broad authority to order companies to pay disgorgement, and this disgorgement is typically found in cease-and-desist orders publicly available online.<sup>305</sup> Given this broad authority, Treasury should amend its regulations and tailor them more towards the typical SEC disgorgement order.<sup>306</sup> A revised regulation would take the word “direct” out of the current regulations and add a few sentences to clear up any hesitation that companies might have.<sup>307</sup> Doing so would better fulfill Congress's intent in passing Section 162 by further facilitating businesses, and it would be more consistent with notions of tax policy.<sup>308</sup>

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298. See Amy Fontinelle, *Tips for Understanding the Tax Code*, INVESTOPEDIA, <https://www.investopedia.com/articles/tax/09/tax-codes-rules-regulations.asp> (Mar. 8, 2022) [<https://perma.cc/SM5T-ZCV5>].

299. See generally *id.*

300. See *Int'l Trading Co. v. Comm'r*, 275 F.2d 578, 583 (7th Cir. 1960).

301. See *supra* Part III.

302. See *supra* Subsection III.C.2.

303. See *supra* Subsection III.C.3.

304. See *supra* Subsection III.C.4.

305. See, e.g., Kestra Priv. Wealth Servs., Investment Advisers Act Release No. 5771, 2021 WL 2929837 (July 9, 2021) (cease-and-desist order).

306. See *supra* Part IV.

307. See *supra* Section IV.A.

308. See *supra* Section IV.B.

