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TAX MATTERS

# Former Qwest CEO could qualify for tax refund from forfeited insider trading gain

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*The Court of Federal Claims holds on public policy grounds that the IRS could not deny a taxpayer convicted of insider trading a tax deduction for $44.6 million in forfeited stock gain.*

In a case involving a claim of right under Sec. 1341 and losses under Sec. 165, the Court of Federal Claims concluded that illicit stock gain forfeited by Joseph Nacchio, former CEO of Qwest Communications International Inc., could qualify as a deductible loss if Nacchio believed he had an unrestricted right to the gain when he reported and paid tax on it.

The deduction would not, according to the court, frustrate the policy prohibiting securities fraud or diminish his punishment. It also was not barred by statute because it was not similar to a fine. Nacchio's conviction for willfully violating securities laws did not preclude relief under Sec. 1341 because he had not pleaded guilty to insider trading. Whether he believed he had a claim of right to include the gain in income was a question of material fact that could not be resolved on summary judgment.

**Facts:** Nacchio served as the CEO of Qwest from 1997 to 2001, during which time he received a large portion of his compensation in the form of stock options. In April 2001, Nacchio exercised his options and began selling his Qwest shares. Between April and May 29, 2001, when the price of Qwest stock dropped markedly, Nacchio realized net gain of $44.6 million on the sale of Qwest shares. Nacchio and his wife reported the gain on their 2001 joint tax return and paid almost $18 million in tax on it.

In 2005, an SEC civil action accused Nacchio and others of attempting to defraud investors by misrepresenting Qwest's 2001 performance and growth, and he was indicted in federal court on 42 counts of insider trading. A jury convicted Nacchio on 19 counts of insider trading related to stock he sold in 2001, and he was sentenced to serve 70 months in prison, pay a $19 million fine, and forfeit $44.6 million in net gain on the sale of Qwest shares.

Nacchio and his wife filed an amended 2007 joint tax return claiming a credit of $17.9 million for 2001 taxes paid on the forfeited gain. After the IRS disallowed the claimed credit, the couple sued for a refund, and the government moved for summary judgment.

**Issues:** Nacchio argued that he was entitled to a refund under Sec. 1341 for the taxes he paid in 2001 on gain later forfeited, which was deductible as a loss or business expense under Sec. 165 or 162, respectively.

Sec. 1341 allows a taxpayer to claim a refundable credit in a current year for income reported and taxes paid in a prior year if the taxpayer discovers that he or she did not have a claim of right to the previously reported income. Sec. 165 allows a deduction for a loss not compensated by insurance or otherwise. Sec. 162 allows a deduction for all ordinary and necessary expenses paid or incurred during the year in carrying on a trade or business.

The government argued that the couple's claim should be denied, first, on public policy grounds and because criminal fines or similar penalties are disallowed as deductions under Sec. 162(f). Second, it argued that Nacchio did not qualify for Sec. 1341 relief because his conviction for acting willfully, knowingly, and with the intent to defraud precluded a showing that he believed he had a right to the forfeited gain when he originally reported and paid taxes on it.

**Holding:** The court determined that Nacchio's forfeiture was a deductible loss under Sec. 165. According to the court, allowing Nacchio the deduction would not frustrate public policy because it would not increase the likelihood of insider trading or reduce the effectiveness of the laws designed to combat it. In addition, disallowing the deduction would result in a punitive tax consequence not called for in the law. The court found that Sec. 162(f) did not preclude the loss deduction because Nacchio's forfeiture represented the disgorgement of illicit net gain from insider trading, not a fine or similar penalty paid to a government for a violation of law. Nacchio's forfeiture served to compensate victims of the Qwest securities fraud, not general crime victims, as had the $19 million fine.

The court also determined that the applicability of Sec. 1341 depended not on whether Nacchio had obtained funds unlawfully, but whether it appeared to him that he had an unrestricted right to those funds. Nacchio did not plead guilty, and during the criminal trial, he did not testify. Thus, Nacchio's subjective belief as to his claim of right to the forfeited gain was not adjudicated in his criminal trial, and he was not barred from litigating his belief. Consequently, the state of Nacchio's mind in 2001 was an issue of material fact that could not be resolved on summary judgment, the Claims Court held.

■ *Nacchio*, No. 12-20T (Fed. Cl. 3/12/14)

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