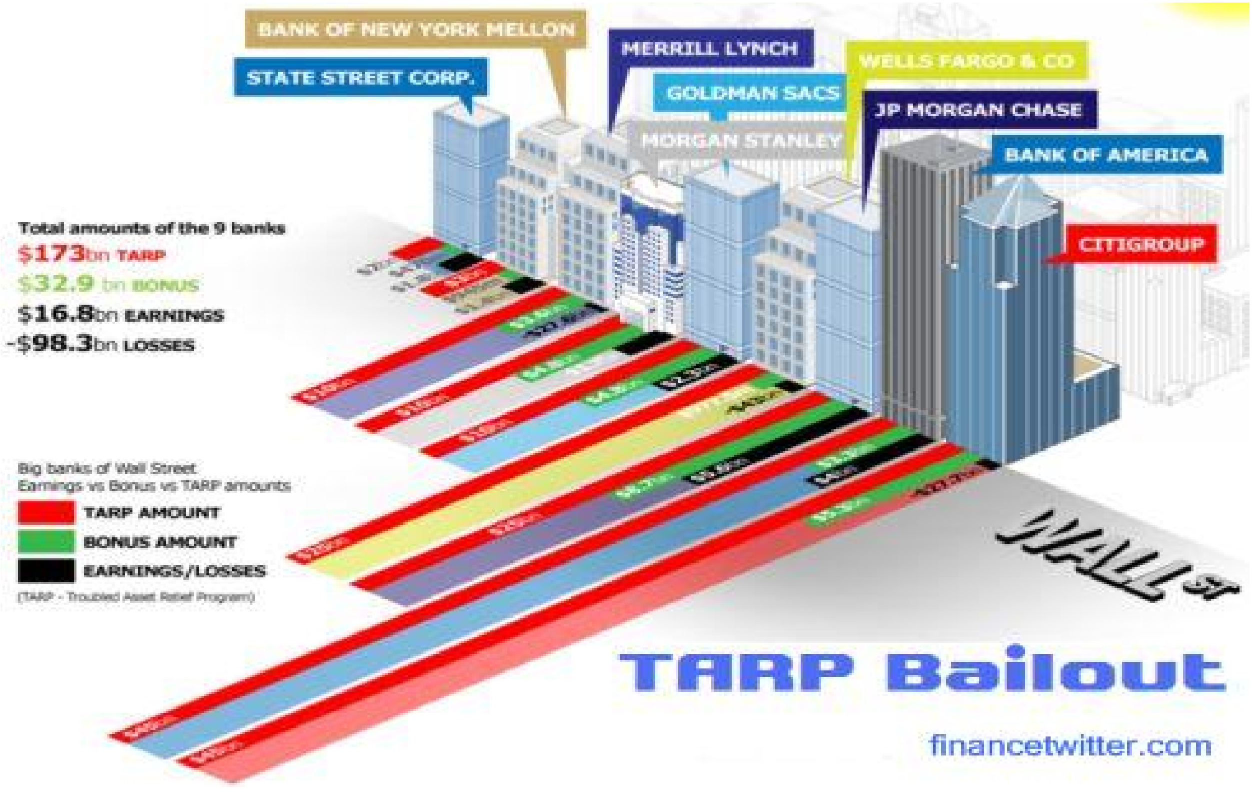
Moral Hazards

Financed by Taxpayers by Tax Revenues

JUST SO WE'RE CLEAR....

An IRS Parable of the Prodigal Sons



In economics, **moral hazard** occurs when one person takes more risks because someone else bears the cost of those risks. A moral hazard may occur where the actions of one party may change to the detriment of another after a financial transaction has taken place. Plaintiff [believes] that financial bailouts of lending institutions do encourage risky lending behavior since there are guarantees to lending institutions that some type of bailout or tax write will occur.

Financed by Taxpayers through Tax Deductions for the Moral Hazards of Greed and [Worthship]

An IRS Parable of the Prodigal Sons

Financed by Taxpayers through Tax Deductions for the Moral Hazards of Greed and [Worthship]

BUSINESS

Too Big to Tax: Settlements Are Tax Write-Offs for Banks

BY **LYNNLEY BROWNING** ON 10/27/14 AT 11:16 AM

11/07/14

IN THE MAGAZINE

Jamie Dimon, chief executive officer of JPMorgan Chase, center; Goldman Sachs CEO Lloyd Blankfein, left; and Bank of America Corp. Chief Executive Brian Moynihan at a hearing on Capitol Hill on January 13, 2010. Doug Mills/The New York Times/Redux

At the Justice Department, senior officials like to congratulate themselves on the headline-making, big bucks settlements they have imposed upon banks and lenders for their part in causing the 2008 mortgage meltdown that sparked the biggest American financial crisis since the Great Depression.

But wait a moment. Those settlement figures are not quite what they seem. Buried deep in the announcements of the astronomical sums that Wall Street banks are being forced to pay is a dirty secret: A big chunk of the hundreds of billions of dollars banks have paid in settlements to various federal agencies and regulators since 2010 is deductible from the taxes banks and lenders pay.

When is a fine not a fine? When it can be put against your tax bill.

Because settlements can be deducted from tax liabilities, for nearly every dollar a bank or lender has pledged to pay in cash or pony up in other ways—such as through buying back soured mortgage-backed securities, extending cheaper loans or forgiving failed loans held by struggling homeowners—up to 35 cents will find its way back into bank coffers, a reflection of the 35 percent federal corporate tax rate.

Deep in the legalese weeds of the settlement documents lies buried treasure. Big banks such as Bank of America and JPMorgan Chase will receive deductions against the corporate tax that will amount to between half and nearly three-quarters of their multibillion-dollar settlements, at least. Meanwhile, midsized banks and nonbank lenders generally get to deduct the whole shebang.

Under Attorney General Eric Holder, whose agency has not prosecuted a single major bank or executive in the aftermath of the 2008 meltdown, the Justice Department has been criticized, not least by Democrats, for believing banks are too big to fail and their top brass too big to jail. But here's the twist. It turns out that banks are also too big to tax: Windfall tax deductions set against the civil settlements imposed by the Justice Department total more than $44 billion, according to *Newsweek* estimates.

That's a big sum. Yet it is not a figure the Justice Department appears aware of. In fact, the nation's top law enforcement agency in charge of cracking down on perpetrators of the mortgage crisis says it has no clue exactly how much money and consumer-relief services the banks have agreed to hand over in settlements with the agency—or how much of a tax deduction the banks are getting through the settlement deals.

Asked by *Newsweek* the grand total of all mortgage-related settlements between the agency and banks and nonbank lenders since the 2008 crisis, an agency spokeswoman says, "A global figure? We just don't have that."

Things aren't much clearer over at the Federal Housing Finance Agency (FHFA), the overseer of home mortgage companies Fannie Mae and Freddie Mac. The two government-sponsored mortgage-finance giants have engaged in their own chest-thumping by muscling banks and lenders into buying back the stinky mortgages they deceptively packaged into securities and sold to the finance giants, but which later blew up.

When *Newsweek* asked an FHFA spokeswoman the same question—what is the grand total of all settlements related to inappropriate mortgages that led to the 2008 crisis—she cited the agency's public list of $18.2 billion worth of settlements with 17 banks for deception and fraud in misrepresenting the value of mortgage-backed securities.

One thing the list doesn't point out: The figure isn't $18.2 billion, according to a *Newsweek* tally of the individual settlement documents; it's $24.7 billion, at least on paper. But the grand total is tax-deductible by those who paid the

penalties, FHFA spokeswoman Stefanie Johnson tells *Newsweek*, leading to more than $8.6 billion in tax savings for the banks and a true fine of only around $16 billion.

Astonishingly, for an economic crisis estimated to have cost the U.S. economy anywhere from $6 trillion to $14 trillion in lost output and value—if not twice that, according to a September 2013 study by the Dallas Federal Reserve bank—tracking the settlements and the deductions against taxes via government websites is almost impossible.

So *Newsweek* got out its calculator.

An estimate in August by SNL Financial, a data company, puts the total cost of settling with all regulators by the six largest banks—Bank of America, Wells Fargo, JPMorgan Chase, Citigroup, Goldman Sachs and Morgan Stanley—at $128 billion. (That figure doesn't include various federal settlements with big foreign banks, midsized and smaller American banks, and nonbank lenders, including Deutsche Bank, Barclays Bank, Credit Suisse, HSBC Holdings plc, UBS, First Horizon National Corp. and nonbank lenders including Ocwen Financial Corp., Ally Financial and General Electric.)

Once other settlements with regulators—including the Consumer Financial Protection Bureau, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corp., various state attorneys general and state banking regulators such as New York's Department of Financial Services—are included, the total comes to $143.2 billion. (The figure does not include settlements with a handful of investment-advisory firms and individual mortgage brokers, or lawsuits settled between banks and private sector investors.)

Federal tax rules allow companies to deduct from their tax returns as an ordinary cost of doing business any settlement payments that are construed, explicitly or not, as restitution or compensation. Payments flagged as penalties or fines, typically outlined in criminal cases, are generally not deductible, as opposed to the civil settlements with banks.

Nicole Navas, a Justice Department spokeswoman, tells *Newsweek* that the agency has "engaged in a broad effort to hold financial institutions accountable for their misconduct related to the housing market."

Misconduct, certainly. But accountable? Hardly.

"I would have thought that the DOJ would have had every reason to stipulate that these settlements are punitive and do not qualify for deductibility," says Peter Enrich, a professor at Northeastern University School of Law. "It's out of keeping with what the legal framework is meant to reflect." Since 2003, the U.S. Securities and Exchange Commission has banned the deduction of settlement costs for deals it crafts on its own. The total value of tax deductions when you subtract the SEC totals and likely settlement terms leaves Bank of America with around $12 billion in deductibles out of the $16.6 billion settlement deal it made with the Justice Department last August, though possibly more. Its total cost of settlements, therefore, could be reduced to around $12.4 billion, based on a 35 percent tax rate.

Similarly, JPMorgan Chase can deduct at least $7 billion of its $13 billion deal last November, and Citigroup can put at least $3 billion of its $7 billion deal last July against its taxes. This makes the total amount on which deductions can be taken as a result of settlements related to the wrongdoing that led to the 2008 financial crisis at least $44.1 billion, which translates into potential tax savings of about $15 billion. By comparison, the Congressional Budget Office estimated in 2012 that the government's $700 billion taxpayer-funded bailout of Wall Street financial institutions will ultimately cost U.S. taxpayers just $23 billion—and that mostly went to insurer AIG—as banks have paid back the federal funds they borrowed. (In another sign that government agencies can't seem to agree, the Office of Management

and Budget puts the bailout tab at $63 billion, meaning the settlement deductions would account for nearly 70 percent of the amount outstanding.) Though the documents that record the settlements use hard words like “fraud,” “misrepresentation” and “deception” to describe the banks’ shenanigans, which would usually imply that deductibility was inappropriate, because the settlements were the result of civil rather than criminal actions brought by the Justice Department, punitive penalties translate in practice into a slap on the wrist.

There is plainly a disconnect between what regulators say they are levying on miscreant banks and bankers and what eventually is paid. And some say that disconnect makes for a poor system of justice. “It is very troubling when prosecutors announce blockbuster fines that are tax-deductible and potentially misleading to the public in terms of what the bottom line punishment actually is to the company,” Brandon Garrett, a professor at the University of Virginia School of Law who focuses on corporate settlements, tells *Newsweek*. “DOJ has never given a good explanation for why it has allowed tax-deductible settlements in those cases.”

Tax lawyers have an idea: Offering up the carrot of deductibility makes it possible to craft a larger settlement, with blockbuster numbers that in turn make the Justice Department appear tough on fraud. “If the government wants to announce as a headline big numbers and big dollars, it improves its chances of settling at a big number if the company can deduct,” Hap Shashy, a corporate tax lawyer at King & Spalding, says.
Says Dennis Kelleher, the chief executive of Better Markets, a nonprofit Wall Street watchdog group: “It’s PR crap.

These banks caused the biggest crash since 1929 and they get civil settlements with immunity and tax deductions, all behind closed doors? It’s outrageous.”

But there’s another, more self-serving reason for the Justice Department to hike civil settlement payments while allowing for most of the sum to be tax-deductible. The agency receives a cut of up to 3 percent of its share of the total settlements for its Working Capital Fund, a slush fund common across major government agencies. For example, the Treasury Department’s fund, according to a 2012 Government Accountability Office report, “is intended to provide increased efficiencies in how the department funds and offers shared services—such as payroll, telecommunications, financial services, mail, and publications—valued at over $1 billion annually.”

It appears that some in Congress are taking notice of the gap between settlements and federal receipts. Last month, the House Committee on Oversight and Government Reform asked the Justice Department to provide internal documents detailing the reasons for its decisions not to prosecute banks through the criminal courts. “We’re trying to determine why these things were civil, not criminal,” says a committee staffer who declined to be named, adding that the Justice Department’s slush fund “raises eyebrows because it signals an institutional interest in getting big numbers.”

“Truth in Settlements” legislation that has been proposed in the House and Senate would force the Justice Department and other federal agencies to disclose hidden tax deductions in settlements and whether total numbers are inflated for “credits” that can be offset in other areas. “When government agencies reach settlements with companies that break the law, they should disclose the terms of those deals to the public,” Senator Elizabeth Warren, a co-sponsor of the Senate bill who chaired a congressional oversight panel for the bailout, tells *Newsweek*.

The Justice Department hasn't always been shy about forbidding tax deductibility. Just look at the hefty, nondeductible bills slapped in recent years on big Swiss banks like UBS and Credit Suisse for their role in selling offshore tax-evasion services to wealthy Americans. Or on BP for its role in the Deepwater Horizon oil spill. When it comes to dealing with the Justice Department, it plainly pays to be American.

"There are very large outlier cases that have so much public attention that the notion that they would give a substantial tax benefit might be viewed as quite inappropriate," says Mark Allison, a corporate tax lawyer at Caplin & Drysdale. Apparently, the biggest financial crisis since the Depression isn't one of them.

"When people hear that this stuff is deductible, it just feels like adding insult to injury," says Phineas Baxandall, a senior policy analyst and tax specialist at U.S. PIRG, a left-leaning consumer protection research group that has written reports on the tax deductions. "And when it's not transparent, it's shady."

This story has been corrected to fix the calculation of the effective cost of Bank of America's settlement to $12.4 billion (not $4.6 billion) and to make clear that total taxes saved from $44.1 billion in deductions by banks could be around $15 billion.

http://www.newsweek.com/2014/11/07/giant-penalties-are-giant-tax-write-offs-wall-street-279993.html

What is a Tax Write-off?

You may have heard the term "write-off" as it relates to taxes. There are actually two different meanings of the term "write-off," and this term is different from a "write-down." Both write-offs and write-downs can lower your business taxes, so you can keep money in your business.
A **Tax Write-off** is a deduction for a business expense that reduces the net income of the business on a business tax form.

How a Tax Write-off Works
Your business can take any and all tax deductions for legitimate business expenses. Basically, any business expense, with some exceptions that the IRS will not allow.

To see the effect of these write-offs (deductions), look at a typical Schedule C for a small business.
1. You begin the Schedule C by including information on your business income.
2. Then you list all of your business expenses, in the categories provided by the IRS. You can also include other business expenses, on an additional listing.
Don't forget to include business travel, meals and entertainment expenses, and other incidental expenses.
3. These expenses are totaled and subtracted from your income. The total is your net income (your business profit), which is taxable to you as the business owner.
The important thing to remember is: The more write-offs, the less business income tax you owe.
In addition, the more write-offs, the lower your self-employment tax (Social Security and Medicare tax for business owners), which is also based on your business net income.

Tax Write-offs and Depreciation

You may also have heard the term "tax write-down," which is similar to a tax write-off. Sometimes the two terms are mistaken for each other.
A **write-down** is an accounting transaction which reduces the value of an asset to $0. This reduction can be because the asset no longer has value because of depreciation or because of damage. An asset is written down (sometimes stated as a write-off, just to confuse everyone) when it is no longer usable or becomes obsolete.

Here are two examples of write-offs for asset value:

A business computer had an original price of $2000. When the company bought a new computer, it wrote down the full value of the old computer because it was obsolete. So the $2000 was considered as an expense and the value of the old computer was listed as $0. A write-off can occur over time through depreciation.

A business had a piece of machinery which was old and worn but still usable. The original price was $10,000, but the damage/wear and tear caused its current value to be $6,000. The $4,000 write off created an expense for the company and the new value of the machine was listed as $6,000.