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Deterrence and tax treatment of monetary sanctions and litigation costs

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ABSTRACT

The tax treatment of monetary sanctions and litigation expenditures varies across legal jurisdictions and time. The effects of these different tax regimes – particularly, on crime deterrence – have not been fully explored. Instead, legal intuitions in court decisions and legislative reforms are found. This paper explores the effects of these tax regimes. It shows that our common intuitions are sometimes misguided, since we tend to ignore cross-effects between crime and litigation. For example, contrary to commonly held views, it is shown that non-deductibility of monetary sanctions may *increase* the level of crime, if litigation expenses are deductible. In addition, if deductibility of legal expenses depends only on a successful trial outcome, this may also *increase* amounts spent on litigation and time allocated to crime. As this paper shows, however, a complete deductibility regime, under which both monetary sanctions and litigation expenditures are deductible, maintains the pre-tax levels of crime and litigation expenditures for risk-neutral offenders. The paper further explores the effects of different tax reforms.

1. Introduction

The tax treatment of crime-related activities and consequences may affect crime enforcement. Indeed, income derived from legal and criminal activities is generally taxed. For example, the income associated with offenses committed in the course of running an otherwise legitimate business, such as speeding taxi drivers, double-parked messenger services, or overloading by trucking companies, is regularly reported and taxed. Similarly, many offenders committing white-collar crimes, such as those violating anti-trust laws, committing fraud, or trading on insider information, are also likely to report and pay taxes on their illicit gains. Indeed, as a general principle, tax laws are not concerned with the legality of the source of income when it comes to taxing it.

On the other hand, the tax treatment of crime-related costs, particularly monetary sanctions and litigation expenses, is different in different jurisdictions and is also non-coherent within jurisdictions. For example, in Canada, both monetary sanctions and litigation expenditures are generally deductible for tax purposes if they arise from business operation. On the other hand, in the United States, the United Kingdom, and Australia monetary sanctions are non-deductible for tax purposes, because deductibility is considered to reduce the "sting" of punishment and to frustrate "sharply defined public policy". However, litigation expenditures incurred in defending against criminal charges arising from a trade or business are generally deductible in these jurisdictions, because it is deemed to manifest a constitutional right. In Israel, both monetary sanctions and litigation expenditures are generally non-deductible for tax purposes, because deductibility would be contrary to public policy. These regimes are only mentioned to serve as examples and certainly do not exhaust the variety of tax rules that can be found worldwide.[2]

This paper explores the positive effects of different tax deduction regimes. It aims to evaluate (1) the effects of the tax rules governing monetary sanctions and litigation expenditures on crime (i.e. deterrence) and litigation; and (2) the legal perceptions and intuitions according to which deductibility of crime-related expenses violates sharply defined "public policy" principles.

For example, in the landmark decision of *Tellier* (1966), the taxpayer, a securities dealer, was prosecuted and convicted for fraud and was sentenced to pay an $18,000 fine and serve four and a half years in prison. He also incurred and paid approximately $30,000 in legal expenses. How would the tax treatment of these crime-related costs affect similar behavior? This paper shows that simple intuitions may take us astray.

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[2] See Section 2 for legal background and additional tax regimes.

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The key insight of the analysis is based on the observation that crime and litigation are complements in the sense that the more offenders-taxpayers engage in crime, the more they are willing to spend on litigation, and the more they spend on litigation, the more they are willing to engage in crime. This complementarity effect produces interesting, counter-intuitive results, because taxation may affect not only the relative expected returns from legal and criminal activity, but also the costs and benefits associated with litigation. For example, contrary to commonly held views, this paper shows that disallowing deductions for monetary sanctions while allowing deduction for litigation expenditures may actually encourage crime or discourage litigation (though not both). In addition, the paper shows that allowing the deduction of both monetary sanctions and litigation expenditures does not encourage crime or litigation, but rather maintains their pre-tax levels for risk-neutral offenders. The paper also demonstrates that simple intuition works well only for a tax regime that disallows deductions for both monetary sanctions and litigation expenditures. In this case, both crime and litigation are discouraged, as would be expected.

Understanding the behavioral effects of different tax deduction rules on crime and litigation is important not only for its own sake, but also for normative analysis, since policy makers such as courts and legislators base their legal decisions on their perceptions of these effects. For example, following the Supreme Court decision in Canada allowing deductions for monetary sanctions, the Canadian government reacted recently in a proposed legislation prohibiting explicitly such deductions.

Moreover, if tax rates are even moderately high, the tax rules governing monetary sanctions and litigation expenditures are likely to have tremendous effects. For example, if the tax rate is 25%, the difference between allowing or disallowing deductions for monetary sanctions is equivalent to increasing the magnitudes of fines by 33%.[3] Similarly, the difference between allowing and disallowing deductions for litigation expenditures is equivalent to penalizing/taxing the costs of litigation by 33%. This clearly should have a large impact on the incentives to engage in crime and spend on litigation, particularly since offenders spend a great amount on the latter. For example, the Rigas family who controlled Adelphia Communications Corp. spent $25,000,000 on their criminal defense. The estimated cost of defending Barnes & Noble and Borders in a Robinson-Patman Act suit brought by the American Booksellers Association was $68,000,000.[4]

The existing literature on the effects of taxation on crime is limited. The very few works in this area have focused on the tax treatment of fines and similar penalties. The pioneering papers of Png and Zolt (1989) and Zolt (1989) and the paper of Tabbach (2003) show that a tax regime, under which both legal and criminal income are taxable and fines are deductible, maintains the pre-tax level of crime as long as risk-neutral offenders are considered. They also show that disallowing deductions for fines discourages crime, compared to allowing deductions or to a world with no taxation at all. Polinsky and Shavell (1998) derive a similar result with respect to the tax treatment of punitive damages. Tabbach (2003, 2005) also examines the effects of the tax treatment of monetary sanctions on crime if offenders are risk averse or if leisure time is variable. Hillman and Katz (1984) and Tabbach (2003) explore the consequences of taxing legal activity while exempting criminal activity from taxation altogether.[5] All these works completely ignore the decision of offenders/taxpayers to spend resources on litigation to defend against criminal charges, and the tax treatment of such spending. This paper is the first to evaluate the *joint* effects of the tax rules governing monetary sanctions and litigation expenditures on crime. This is important not only because of the significant magnitude of criminal litigation costs, but because the effects of the tax treatment of monetary sanctions crucially depend on the tax rule governing the deductibility of litigation expenditures and vice versa. By examining the joint effects of different tax deduction rules, this paper qualifies some of the results derived by Png and Zolt (1989), Zolt (1989), and Tabbach (2003) and generalizes others. Therefore, it offers a more complete and comprehensive analysis, which is essential for policy makers.

The paper is organized as follows. Section 2 provides legal background. Section 3 develops the general model of taxation and crime when offenders can spend resources on litigation. The model is applied in Section 4 to examine the effects of different tax regimes, including: complete deductibility, no deductibility, partial deductibility, and contingent deductibility regimes. Section 5 applies the model to examine tax reforms—i.e. a change in tax rules. Section 6 provides concluding remarks.

2. Legal background and relevant literature

2.1. Legal background

Income tax laws generally impose taxation on both legal and criminal activity. In the United States, for example, income from criminal activity is taxed without exception since the landmark decision *James v. United States*.[6] In other jurisdictions, the general principle is that the tax system is not concerned with the legality of the source of the income when it comes to taxing it. Therefore, income derived from criminal activity is regularly taxed.[7]

While illegal income is typically taxed, the tax treatment of monetary sanctions and litigation expenditures varies across legal jurisdictions. In general, one can find four different, explicit tax regimes: (i) complete deductibility: both fines and litigation expenses are deducted; (ii) partial deductibility: only legal expenses are deducted; (iii) contingent deductibility: only litigation expenses are deducted and only upon acquittal; and (iv) no deductibility: both fines and legal expenses are non-deductible.[8]

2.1.1. Complete deductibility

In Canada, for example, no specific deduction rule concerning monetary sanctions and legal expenses exists in the tax code. According to the Canadian courts, legal expenses incurred by a taxpayer in defense against criminal charges arising from business operations are deductible.[9] In addition, Canadian courts traditionally limit the deduction of fines via various "public policy" tests.[10] However, the Supreme Court of Canada recently changed this inter-

[3] Assume, for example, a $100 fine and a tax rate of 25%. The after-tax costs of the fine is $75 assuming fines are deductible or $100 assuming fines are non-deductible. Hence, a before-tax $133 deductible fine is equivalent to an after-tax fine of $100.

[4] For other examples see "The Price of Corporate Fraud: Shareholders, Insurers and even Executives Foot Bill for Time in Court," The Washington Post (May 9, 2004), and at http://www.carlperson.com/expensive.php (last visited 15.08.07).

[5] The only indirectly related literature is on shifting litigation fees. Indeed, the tax treatment of litigation expenses functions much like fee shifting in civil actions. Yet, this literature is not informative to our case.

[6] 366 US 213 [1961].

[7] See, for example, Tilly (2005, p. 349), Silke, on South African income tax (1989C, pp. 3–7) "[t]he income tax is not concerned with the legality or illegality of a transaction. Receipts and accruals from an unlawful business are taxable if there is a scheme of profit-making involved."

[8] Theoretically, there might be a partial tax regime that would allow deductions for monetary sanctions but would deny deductions for litigation expenditures, but its adoption seems unlikely and we are unaware of such a regime in reality.

[9] See *Minister of National Revenue v. L.D. Caulk Co. of Canada Ltd.*, 52 D.T.C. 1034 (1952) (Ex. Ct.), affirmed by 54 D.T.C. 1011 (1954) (Supreme Court of Canada); *Roland Paper Co. Ltd. v. Minister of National Revenue*, 60 D.T.C. 1095 (1960) (Ex. Ct.).

[10] See, for example, *Day & Ross v. The Queen*, 76 D.T.C. 6433 (1975) (Fed. T.D.).