No. 16-810

In The Supreme Court of the United States

JOSEPH P. NACCHIO and ANNE M. ESKER,
Petitioners,

v.

UNITED STATES,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

PETITIONERS' REPLY BRIEF

Andrew M. Epstein
Counsel of Record
William D. Lipkind
Thomas A. Gentile
WILSON ELSER MOSKOWITZ EDELMAN & DICKER LLP
200 Campus Drive, 4th Floor
Florham Park, New Jersey 07932
(973) 735-5785 (Telephone)
(973) 624-0808 (Facsimile)
andrew.epstein@wilsonelser.com
william.lipkind@wilsonelser.com
thomas.gentile@wilsonelser.com

Counsel for Petitioners

Dated: April 26, 2017

THE LEX GROUP DC ♦ 1825 K Street, N.W. ♦ Suite 103 ♦ Washington, D.C. 20006
(202) 955-0001 ♦ (800) 856-4419 ♦ Fax: (202) 955-0022 ♦ www.thelexgroup.com

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REPLY IN SUPPORT OF PETITION

The Government's opposition to the petition for *certiorari* hinges on a solitary proposition: that there is something qualitative about forfeiture that renders *all* forfeitures punitive in nature and thus non-deductible. Yet the Government's attempts to substantiate this proposition fail completely. This is because not a single one of the litany of cases that the Government cites in supposed support of this notion involved the distinctive issue that this case presents: whether forfeited funds that were *remitted to victims as compensation* are deductible.

The Federal Circuit's opinion below thus stands in stark contrast to the Second Circuit's opinion in *Stephens v. Comm'r*, 905 F.2d 667 (2d Cir. 1990). *Stephens* holds that even in criminal cases, court-ordered payments that are compensatory in nature do not constitute a "fine or similar penalty" under Section 162(f) of the Internal Revenue Code, and thus are indeed deductible. The Federal Circuit's (and the Government's) fixation on the *mechanism* (forfeiture) used to extract funds from Mr. Nacchio, rather than on the compensatory nature of those funds' disposition, therefore clashes sharply with *Stephens*, creating serious split of authority across judicial circuits.

The Federal Circuit's opinion below also conflicts with the First Circuit's opinion in *Fresenius Med. Care Holdings, Inc. v. United States*, 763 F.3d 64 (1st Cir. 2014), which holds, as a fundamental premise of tax law, that deductibility must be determined based upon "the economic realities of the

transaction." The economic reality of Mr. Nacchio's forfeiture is that the forfeited funds were remitted to victims as compensation, exactly as Congress intended when it amended the forfeiture statutes in the Civil Asset Forfeiture Reform Act of 2000.

As such, the opinion of the Federal Circuit below stands alone in its holding that *all* forfeitures (regardless of remission) are non-deductible.

The petition sets forth in detail the unique dangers of forum shopping, and of attorneys' structuring compensatory payments to bring about desired tax results, that the Federal Circuit's opinion – and the resulting circuit split – creates. This Court should grant the petition both to prevent these dangers from coming to pass, and to bring about uniformity in this important area of law.

I.

EACH AND EVERY CASE THAT THE GOVERNMENT CITES IS INAPPLICABLE, BECAUSE NOT ONE OF THOSE CASES INVOLVED THE REMISSION OF FORFEITED FUNDS AS COMPENSATION TO VICTIMS.

The Government cites a litany of cases in an attempt to cast as settled law its notion that forfeitures "are not deductible because they are punitive." Opp. 13-14. This attempt fails, however, because each of the cases that the Government cites in support of this proposition is wholly distinguishable from Mr. Nacchio's case. Here again, the Government makes the same error that

the Federal Circuit made below: focusing exclusively on the mechanism employed to extract funds from the defendant (here, forfeiture), rather than on whether the defendant's payment served a compensatory purpose. Not one of the cases that the Government cites involved the distinguishing characteristic of Mr. Nacchio's case, which is that *forfeited funds were earmarked and used to compensate victims*. As such, the Government could not be more wrong in its assertion that the forfeitures at issue in the cases upon which it relies are "similar to the one at issue here." *Id.* at 13.

Consider in turn each of the cases upon which the Government relies for its contention that forfeitures are necessarily punitive. In *King v. United States*, 152 F.3d 1200 (9th Cir. 1998), the Ninth Circuit disallowed a deduction for forfeited funds that a farmer had been paid in exchange for allowing others to grow marijuana on his ranch. The situation in *King* is distinguishable from Mr. Nacchio's case, because the crime in *King* involved no victims to whom a compensatory payment could possibly have been made. The Ninth Circuit in *King* itself recognized this distinction. Explicitly contrasting the situation in *King* with the embezzlement case of *James v. United States*, 366 U.S. 213, 220 (1961) ("[i]f, when, and to the extent that the victim recovers back the misappropriated funds, there is, of course, a reduction in the embezzler's income"), the Ninth Circuit in *King* distinguished the two cases "because *James* is a three-party relationship, where the restitution is to the third party victim of the embezzlement[,] while drug money is forfeited to the same entity that levies

the taxes." *King*, 152 F.3d at 1202. The crucial distinction between *King* and *James* is not that the mechanism used in *King* was forfeiture. Rather, these two cases are distinguishable precisely because *James* involved a payment made in compensation to victims, whereas *King* did not.[1]

Similarly, in *Wood v. United States*, 863 F.2d 417 (5th Cir. 1989), the Fifth Circuit denied a deduction for the value of forfeited real estate whose acquisition was directly traceable to profits from drug smuggling. Just like *King*, *Wood* is distinguishable from Mr. Nacchio's case because *Wood* involved no compensatory payment made to victims from the proceeds of the forfeiture.[2] The

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[1] This crucial distinction – which underlies this entire case – also explains why the Government is wrong in its assertion that 18 U.S.C. § 981(a)(2)(B) is applicable to this case. That statute, which states that a forfeiture amount is not to be reduced by "any part of the income taxes paid," was certainly followed in Mr. Nacchio's criminal case, as the amount that he forfeited was not reduced at sentencing by any amount of taxes. Had Mr. Nacchio's forfeiture *not* been remitted as compensation to victims (as in every case forfeiture that the Government cites in its opposition brief), Mr. Nacchio would have no claim for a tax refund. Mr. Nacchio seeks a deduction on funds forfeited *and then remitted*, which in this case just so happens to equal the entirety of the amount of the forfeiture.

[2] Meanwhile, *Wood* is perhaps most noteworthy because the Fifth Circuit inserted into its opinion in *Wood* statements of pure *dicta* positing questions very similar to those that Mr. Nacchio's case presents. In *dicta*, the Fifth Circuit in *Wood* contemplated whether "a sharply defined public policy enforced by fines or penalties would prohibit deductions for losses attributed to restitution payments." 863 F.2d at 421. The Fifth Circuit in *Wood* even pondered (again, in *dicta*) whether it makes a difference, as to deductibility, whether a compensatory

same is true with regard to *Fuller v. Commissioner*, 213 F.2d 102 (10th Cir. 1954). In *Fuller*, a taxpayer who illegally sold in Oklahoma liquor that he had purchased outside Oklahoma sought to deduct the value of the whiskey that the authorities had confiscated. The Tenth Circuit denied the deduction. Again, this result is distinguishable from Mr. Nacchio's case because the confiscation of the whiskey brought about no compensatory payments to any possible victims.

Another inapposite case upon which the Government relies is *United States v. Algemene Kunstzijde Unie, N.V.*, 226 F.2d. 115 (4th Cir. 1955), *cert. denied*, 350 U.S. 969 (1956). In that case, assets situated in the United States that were owned by a Netherlands corporation became vested in the Attorney General under the Trading With The Enemy Act, because a portion of that Netherlands corporation's equity had been owned by nationals of Nazi Germany. The Fourth Circuit ruled that the assets vested in the Attorney General were not deductible as a loss by the Netherlands corporation (as a U.S. taxpayer). This result is distinguishable from Mr. Nacchio's case, because the assets appropriated from the Netherlands corporation (unlike the assets that Mr. Nacchio forfeited) were not distributed to any victims. Indeed, as a hypothetical, the result as to the Netherlands corporation might very well have been different had

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payment is "voluntary or forced." *Id.*; *see* n.5, *infra*. Of course, the Fifth Circuit in *Wood* did not answer these questions, because *Wood* did not present these questions. Yet the fact that these questions are raised in *dicta* by a federal court of appeals demonstrates both the importance of these questions, and why the petition for *certiorari* should be granted.

the assets vested in the Attorney General ultimately been redistributed to nationals of the Netherlands.

United States v. Bajakajian, 524 U.S. 321 (1998), is similarly distinguishable because *Bajakajian* did not involve forfeited funds being used to compensate persons who suffered losses due to the underlying offense. At issue in *Bajakajian* was a forfeiture of $357,144 that was imposed for attempting to carry that amount of cash outside of the country without reporting it to Customs, as required by federal law when carrying more than $10,000.00. The fact pattern of *Bajakajian* thus raised no issues of the forfeited funds being used to compensate victims, so the forfeiture in *Bajakajian* obviously could only have been punitive in nature.[3]

Finally, the Government also references four cases that the Federal Circuit cited below for the notion that "criminal forfeiture under 28 U.S.C. 2461(C) and 18 U.S.C. 981(a)(1)(C) serves a distinct, punitive purpose." *Id.* at 13. Yet all four of those

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[3] *Bajakajian* is further distinguishable from Mr. Nacchio's situation because this Court's determination in *Bajakajian* that a forfeiture was punitive came in the specific context of considering whether that forfeiture violated the Excessive Fines Clause of the Eighth Amendment, which is a radically different inquiry from the question of tax law that this case presents. *See Bajakajian*, 524 U.S. at 331. For this same reason, it matters not that Mr. Nacchio argued during his criminal appeal that his forfeiture was a "penalty" that raised "a serious Eighth Amendment question." Opp. At 14. Mr. Nacchio is certainly free to argue that his forfeiture constitutes a "penalty" under the definition applicable under Eighth Amendment, but that it does not constitute a "penalty" under the very different definition applicable under Section 162(f) of the Internal Revenue Code.

cases are necessarily inapposite, because each of those cases involved *both* forfeitures and restitution payments. In such cases, the purpose of the forfeiture was of course necessarily punitive, as any and all compensatory purpose was completely fulfilled by the separate payment of restitution. None of these four cases posed the question that Mr. Nacchio's case presents, which is whether forfeited funds that were paid to victims as compensation are deductible. Consider, for example, *United States v. Venturella*, 585 F.3d 1013 (7th Cir. 2009), *cert. denied*, 559 U.S. 955 (2010). The Seventh Circuit in *Venturella* held that it was permissible for a defendant to be subject both to forfeiture and restitution, explaining that "forfeiture seeks to punish a defendant for his ill-gotten gains *by transferring those gains to the United States Department of Justice* while restitution seeks to make the victim whole." *Id.* at 1019-20 (emphasis added, internal punctuation and citation omitted). This suggests that a forfeiture such as Mr. Nacchio's – whose proceeds were used to compensate victims (rather than residing permanently in the government's coffers) – is compensatory. *See also United States v. Joseph*, 743 F.3d 1350 (11th Cir. 2014) (an inmate who fraudulently obtained tax refunds from the IRS under other inmates' names was made *both* to forfeit his ill-gotten gains and make restitution to the IRS); *United States v. Blackman*, 746 F.3d 137 (4th Cir. 2014) (a defendant who received stolen goods from armed robberies was ordered *both* to forfeit the proceeds of the heists and make restitution to the victims); *United States v. Taylor*, 582 F.3d 558 (5th Cir. 2009), *cert. denied*, 558 U.S. 1136 (2010) (a defendant who obtained disaster

relief benefits by submitting fraudulent applications to FEMA was made *both* to forfeit the remainder of the funds he had fraudulently obtained and make restitution to FEMA and other authorities).[4]

II.

THE OPINION BELOW CONFLICTS WITH *STEPHENS* AND *FRESENIUS*.

The inapplicability of each of the cases upon which the Government relies, *see* Section I, *supra*, underscores the conflict between the opinion of the Federal Circuit below and both the Second Circuit's opinion in *Stephens* and the First Circuit's opinion in *Fresenius*. Whereas the opinion of the Federal Circuit below holds that all forfeitures are necessarily deductible (a proposition *not* supported by the cases that the Government cites), *Stephens* and *Fresenius* hold that deductibility turns on the economic reality of whether funds were used for a compensatory purpose. This circuit split presents serious and undesirable consequences (as detailed in the petition) that warrant granting *certiorari*.

The Government's primary ground of supposed distinction between this case and *Stephens* is that this case involves forfeiture, whereas *Stephens* involved restitution. *See* Opp. At 15. Again, this supposed distinction hinges on the notion

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[4] Last of all, *Libretti v. United States*, 516 U.S. 29 (1995) is wildly inapposite, having addressed whether forfeitures are punitive only in the wholly unrelated context of whether Federal Rule of Criminal Procedure 11(f) requires a sentencing court to ascertain a factual basis for a stipulated forfeiture.

that all forfeitures are necessarily punitive. That is the very notion that the Government fails to establish by citing a long list of cases that are wholly inapplicable, due to those cases' not involving forfeited funds being used to compensate victims. *See* Section I, *supra*. To the contrary, Mr. Nacchio's forfeiture (coupled with the remission process) is deductible because it was compensatory.

It matters not that Mr. Nacchio's forfeiture arose in a criminal case, as *Stephens* itself was a criminal case.[5] *See Cavaretta v. Comm'r.*, T.C. Memo 2010-4, 99 T.C.M. (CCH) 1028 (Tax Ct. 2010), (explaining that the Second Circuit in *Stephens* had "carefully distinguished punitive from compensatory restitution, *even in criminal cases*, and reasoned that Stephens' restitution payment had both law-enforcement [punitive] and compensatory purposes, but that it was primarily a remedial measure to compensate another party") (emphasis added). Again, what matters is that the payment to victims (by whatever mechanism) was compensatory in nature. This was aptly explained by Professor F. Philp Manns, Jr., as follows:

> Restitution normally does not serve the same purpose as a fine exacted under a criminal statute. Rather, it serves the same purpose as damages exacted

[5] It also matters not that Mr. Nacchio's forfeiture was "mandatory." Opp. At 15. The Second Circuit in *Stephens* found deductibility because Stephens' "restitution payment is primarily a remedial measure to compensate another party, not a 'fine or similar penalty,' even though Stephens repaid the embezzled funds *as a condition of his probation.*" *Stephens,* at 672-73 (emphasis added).

> under a tort claim. Section 162(f) of the Code assumes that punishment can occur in a civil suit; it should also recognize that reparation of damage can occur in a criminal suit.

F. Philp Manns, Jr., *Internal Revenue Code Section 162(f): When Does the Payment of Damages to a Government Punish the Payor?*, 13 Va. Tax Rev. 271, 319 (1993). As such, Mr. Nacchio's forfeiture payment is compensatory (and thus deductible) because the remission payments were made to identifiable persons who would have a civil cause of action against Mr. Nacchio to recover those funds.[6]

The Government argues that the compensatory remission of Mr. Nacchio's forfeited funds to victims is of no matter, citing *Bailey v. Comm'r*,

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[6] The Government is incorrect when it contends that Section 162(f) and 26 C.F.R. § 1.162-21(b)(2) are inapplicable to this case. The Government argues that 26 C.F.R. § 1.162-21(b)(2), which provides that "[c]ompensatory damages . . . paid to a government do not constitute a fine or penalty," does not apply because the remission of Mr. Nacchio's forfeited funds "did not compensate *the government* for damages that it sustained" (emphasis in original). Opp. at 16-17. To the contrary, both Section 162(f) and that regulation allow a deduction for payments meant to compensate *any party*, even though such a payment might be made to the government in the first instance. *See, e.g., Colt Indus., Inc. v. United States*, 11 Cl. Ct. 140, 144 (Cl. Ct. 1986) (if a "civil penalty is imposed . . . as a remedial measure *to compensate another party* for expenses incurred as a result of the violation, it is not "similar" to a fine under I.R.C. § 162(f) and therefore deductible") (emphasis added); *Huff v. Comm'r*, 80 T.C. 804, 824 (T.C. 1983) (penalties imposed "as a remedial measure to compensate *another party* for expenses incurred as a result of the violation" are not "similar penalties" under I.R.C. § 162(f)) (emphasis added).

756 F.2d 44, 47 (6th Cir. 1985), for the proposition that "[t]he characterization of a payment for purposes of § 162(f) turns on the origin of the liability giving rise to it." Here the Government ignores the deeply compensatory nature of the forfeiture regime, as amended by the Civil Asset Forfeiture Reform Act, P.L. 106-185 (2000) ("CAFRA"). The very purpose of CAFRA was to ensure that forfeited funds are returned to the victims of the crime giving rise to the forfeiture. Indeed, Section 6 of CAFRA was revolutionary in that it created a statutory mechanism for returning forfeited assets to victims of the offense that gave rise to the forfeiture, where none had existed before. *See, e.g., United States v. Approx. $133,803.53 in U.S. Currency*, 683 F. Supp. 2d 1090, 1095 (E.D. Cal. 2010) ("In April 2000, Congress amended 18 U.S.C. § 981 to provide that forfeited assets could be restored to crime victims of the offense giving rise to the forfeiture"). The statutory origin of the liability giving rise to Mr. Nacchio's forfeiture thus includes a strong compensatory purpose.

All of this is underscored by the First Circuit's opinion in *Fresenius*, with which the Federal Circuit's opinion below existentially conflicts. The First Circuit in *Fresenius* held that "[u]nder generally accepted principles of tax law," a court should determine deductibility by inquiring as "to the economic realities of the transaction," because "[s]ubstance matters." 763 F.3d at 70. The Federal Circuit's opinion below breaks from these fundamental premises of tax law. This Court should grant the petition for a writ of *certiorari* because the

economic reality of Mr. Nacchio's forfeiture and remission is solidly compensatory in nature.

CONCLUSION

For the foregoing reasons, the petition for a writ of *certiorari* to the United States Court of Appeals for the Federal Circuit should be granted.

Dated: April 26, 2017

Respectfully submitted,

WILSON ELSER MOSKOWITZ EDELMAN & DICKER LLP

By: /s/ Andrew M. Epstein

ANDREW M. EPSTEIN
WILLIAM D. LIPKIND
THOMAS A. GENTILE
200 Campus Drive, 4th Floor
Florham Park, New Jersey 07932
Phone: (973) 735-5785
Fax: (973) 624-0808
andrew.epstein@wilsonelser.com
william.lipkind@wilsonelser.com
thomas.gentile@wilsonelser.com

Counsel for Petitioners

JOSEPH P. NACCHIO and
ANNE M. ESKER