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Legal Update
December 29, 2017

Tax Reform's Effects on Settling Non-Tax Government Disputes—New Deductibility Restrictions to Consider During Settlement Negotiations

H.R. 1, the "Tax Cuts and Jobs Act" (the "Tax Act"), makes several changes affecting the deductibility of settlement payments to governments and certain non-government entities. These changes affect how taxpayers should approach settlement negotiations with the government.

The Tax Act makes three major sets of changes related to deducting settlement payments:

1. It places additional restrictions on a taxpayer's ability to deduct settlement payments to governments, including limitations on payments made at the direction of a government, and it adds substantiation requirements for the settlement agreement itself.
2. It furthers the scope of those restrictions by expanding the definition of "government or government entities."
3. It adds government reporting requirements.

The effect of these changes on a few key settlement deductibility questions is summarized in the following chart. These and other changes are discussed in more detail below.

Issue	Prior Law	New Law
Recipients of Payments	Paid to a government	Paid to—*or at the direction of*—a government
Definition of "Government"	Government, agency or "instrumentality"	Government or "governmental entity"
Types of Non-Deductible Payments	Only punitive fines and civil penalties	All payments except amounts paid as restitution or to remedy a violation of law
Identification of Deductible Amounts in Settlement Agreements	Not Required	Required
False Claims Act Whistleblower (Relator) Payments	Deductible	Unclear
Payments Compensating Investigation Costs	Deductible	Not deductible

Prior Law

Until the Tax Act, settlement payments to a government were deductible so long as they were not fines or similar penalties.

Section 162(a) of the Internal Revenue Code allows deductions for ordinary and necessary business expenses. Until now, section 162(f) has disallowed deductions for "fine[s] or similar penalt[ies] paid to a government for the violation of any law." The regulations provided that the term "government" included US federal and state governments, foreign governments, and political subdivisions.[1] In addition, they included entities serving as "agencies or instrumentalities" of governments in the definition of "government."Although the regulations did not define "instrumentality,"[2] the Tax Court laid out a three-part test for whether an entity is an agency or "instrumentality," examining whether: (i) the entity had been delegated the right to exercise part of the sovereign power, (ii) the entity performed an important governmental function, and (iii) the entity had the authority to act with the sanction of government behind it.[3]

Regulations extended the scope of section 162(f) to settlements by providing that payments to settle "actual or potential liability for a fine or penalty (civil or criminal)" were fines or similar penalties as well.[4] In addition, they clarified that payments of compensatory damages were not.[5] Because deductions are a "matter of legislative grace," taxpayers bore the burden of proving that settlements were compensatory and thus deductible.

Under these rules, disputes with the IRS often focused on a few types of questions. First, were payments under certain statutes "fines or similar penalties"? [6] Second, where a settlement agreement was unclear and a payment under a particular statute could be either punitive or compensatory, was the settlement payment deductible in whole or in part?[7] And third, were payments made to a government, an agency of the government, or an instrumentality of the government. [8]

Tax Reform

On December 20, 2017, the House of Representatives passed the Tax Act, which the president signed into law two days later. Among the changes the Tax Act implemented were the replacement of section 162(f) and the addition of new reporting requirements under new section 6050X.

NEW REQUIREMENTS AND SUBSTANTIATION

Section 13306 of the Tax Act begins by amending section 162 to replace existing section 162(f) with a new, expanded restriction.

While prior section 162(f) applied to only fines or similar penalties, new section 162(f)(1) denies deductions for *any* amount paid in relation to either "the violation of any law" or even "the investigation or inquiry" into the *potential* violation of law (unless certain exceptions, discussed below, apply). Deductions are denied regardless of whether they are "fines or similar penalties." In addition, while prior section 162(f) applied to only payments *to* governments (or agencies or instrumentalities),[9] new section 162(f)(1) also applies to payments "*at the direction of*" a government or governmental entity. Beyond that, as discussed below, new section 162(f)(5) expands the definition of "government or governmental entity" as well.

If a payment is covered by new section 162(f)(1), it is not deductible unless it fits into one of three exceptions. Of those exceptions, the first—found in new section 162(f)(2)—will require attention in most government settlement negotiations.[10] New section 162(f)(2) provides an exception for "restitution" and amounts paid "to come into compliance with law."

As noted above, under prior law, compensatory amounts were not "fines or similar penalties" and were therefore deductible.[11] New section 162(f)(2), however, replaces "compensatory"

with two options.[12] The taxpayer must establish either (i) that an amount was restitution for damage or harm that was or may have been caused by the violation (or potential violation) of any law or (ii) that an amount was paid to come into compliance with any law that was either violated or "otherwise involved" in the "investigation or inquiry" mentioned in new section 162(f)(1). While new section 162(f) does not define "restitution," it clarifies that, in a change from prior law, "restitution" will not include amounts that reimburse "the costs of any investigation or litigation."[13]

Beyond requiring the taxpayer to establish that an amount is potentially deductible, new section 162(f) also requires that the settlement agreement itself must identify the payment as restitution or a payment to come into compliance with law.[14] If the settlement agreement fails to do so, the amount is not deductible, regardless of whether the taxpayer establishes that it was restitution or an amount paid to come into compliance with law.

Yet new section 162(f) also provides that identification in the settlement agreement "alone shall not be sufficient" to establish that an amount is deductible as restitution or an amount paid to come into compliance with law.[15] As a result, taxpayers will need to gather additional documentation supporting deductibility (e.g., settlement communications, damages estimates).

EXPANDED DEFINITION OF "GOVERNMENT"

New section 162(f) also expands on the concept of what qualifies as a "government."

New section 162(f)(5)(A) provides that "[a]ny nongovernmental entity which exercises self-regulatory powers (including imposing sanctions) in connection with a qualified board or exchange"[16] is treated as a "governmental entity" for section 162(f) purposes. Beyond that, new section 162(f)(5)(B) authorizes the IRS to issue regulations defining any nongovernmental entity that "exercises self-regulatory powers (including imposing sanctions) as part of performing an essential government function."

NEW REPORTING REQUIREMENTS

Despite the requirement that the settlement agreement identify all potentially deductible amounts, the Tax Act also adds a reporting requirement for the governments and governmental entities involved.

Section 13306(b) of the Tax Act adds a new section, section 6050X, to the Code. Under new section 6050X, the "appropriate [government] official" must make a return regarding the settlement. The "appropriate official" means "the officer or employee having control of the suit, investigation, or inquiry or the person appropriately designated for purposes of [new section 6050X]."[17] That return must report (i) the amount required to be paid under the suit or agreement at issue, (ii) any part "which constitutes restitution or remediation of property" and (iii) any part paid "for the purpose of coming into compliance with any law . . . ." In addition, the return must be made contemporaneously with the settlement agreement and a written statement with the information must be provided to each party to the settlement.

Importantly, new section 162(f) does not provide that the return required by section 6050X can satisfy the requirement to identify potentially deductible amounts in the settlement agreement.

Lessons Learned and Best Practices

The new sections 162(f) and 6050X raise a number of issues for taxpayers. How far will the government go in declaring non-governmental entities as "government entities" in any future regulations? Will the government attempt to claim that a payment to a whistleblower under the False Claims Act is no longer deductible? (Unlike the current version, the legislative history for the earlier proposals indicated that the members making those proposals may have

intended to deny deductions for whistleblower payments.) And how aggressively will the IRS challenge settlements in which the agreements specified amounts as restitution?

In this environment, taxpayers should consider a few best practices to minimize their risks:

- **Identify.** Taxpayers should ensure that the agreement characterizes the payment to be deductible. The reporting requirements imposed on the government do not appear to cure the failure to identify in the settlement.
- **Negotiate.** Taxpayers should be cautious in their negotiations to ensure that the substance of their agreement is aligned with any amounts identified as deductible in the settlement agreement. New section 162(f) specifies that the IRS can still challenge deductibility even if the agreement identifies the payment as a deductible amount.
- **Document.** Taxpayers should preserve documents demonstrating that the parties actually negotiated over the amount required for restitution and how the government determined damages before entering the settlement agreement. Regardless of the settlement agreement and government information return, new section 162(f) places the burden on the taxpayer to establish that payments are actually restitution and therefore deductible.
- **Prepare.** Taxpayers should be prepared for the IRS to take narrow positions as to what amounts are in substance restitution, even if the settlement agreement states otherwise.

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Endnotes

[1] Treas. Reg. § 1.162-21(a)(3).

[2] *Id.*

[3] *Guardian Industries*, 143 T.C. 1 (2014).

[4] Treas. Reg. § 1.162-21(b)(1)(iii).

[5] Treas. Reg. § 1.162-21(b)(2).

[6] *See, e.g.*, *Nacchio v. United States*, Dkt. No. 15-5114, Index No. 54 (Fed. Cir. 2016) (addressing whether a forfeiture under 18 U.S.C. § 981(a)(1)(C) and 2641(c) a "fine or similar penalty").

[7] *See, e.g.*, *Fresenius Med. Care Holdings, Inc. v. United States*, 763 F.3d 64 (1st Cir. 2014) *aff'g* 2013 WL 1946216 (D. Mass. 2013).

[8] *See, e.g.*, *Guardian Industries Corp. v. Commissioner*, 143 T.C. 1 (2014) (addressing whether the European Commission was a government or an agency or instrumentality of a government).

[9] *Compare* 26 U.S.C. § 162(f)(1) (" . . . any amount paid or incurred (whether by suit, agreement, or otherwise, to *or at the direction of* a government or . . . .") (emphasis added) *with* Treas. Reg. § 1.162-21(a) ("fine or similar penalty paid *to* (1) The government . . . .") (emphasis added).

[10] The other two exceptions are found in new sections 162(f)(3) and (f)(4). New section 162(f) does not apply in cases where no government or governmental entity is a party. 26 U.S.C. § 162(f)(3). And new section 162(f) does not apply to amounts paid as taxes due. 26 U.S.C. § 162(f)(4).

[11] Treas. Reg. § 1.162-21(b)(2).

[12] For restitution related to US tax, there is a third requirement not discussed here. *See* 26 U.S.C. § 162(f)(2)(iii).

[13] 26 U.S.C. § 162(f)(2)(B).

[14] 26 U.S.C. § 162(f)(2)(A)(i)(II).

[15] See 26 U.S.C. § 162(f)(2)(A).

[16] "[Q]ualified board or exchange" is defined in section 1256(g)(7). Section 1256(g)(7) provides that "the term 'qualified board or exchange' means—(A) a national securities exchange which is registered with the Securities and Exchange Commission, (B) a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission, or (C) any other exchange, board of trade, or other market which the Secretary determines has rules adequate to carry out the purposes of this section."

[17] *See* New Section 6050X(c).

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