

CLIENT ALERT

Top Questions Answered by New Section 162(f) Regulations

May.13.2020

The IRS recently issued proposed regulations regarding taxpayers' ability to deduct settlement and court ordered payments made to governments, government entities and certain non-governmental entities. Under the proposed regulations, if a settlement agreement or court order does not identify payments as deductible in the manner prescribed by the proposed regulations, taxpayers will be precluded from deducting payments made under the settlement or court order, even if those payments would normally be deductible. Governments will report the payments and whether or not those payments are deductible to the IRS. Taxpayers should take action to ensure that their in-house and outside counsel handling government investigations and litigation involving civil or criminal law violations are thoroughly familiar with the requirements for deduction under Section 162(f). Moreover, taxpayers with significant deductions at stake should consider submitting comments on the proposed regulations.

As part of the Tax Cuts and Jobs Act, Congress amended Section 162(f) and introduced new hurdles for companies seeking to deduct payments related to government investigations and litigation against the government. Although the "new" Section 162(f) rule has been in effect for a couple of years, the statute left many open questions. In 2018, the IRS issued [Notice 2018-23](#), which gave preliminary guidance under Section 162(f). On May 12, 2020, the IRS released [proposed regulations](#) implementing new Section 162(f) and the related Section 6050X. To help taxpayers ensure their payments are deductible, below are answers to questions taxpayers may have about Section 162(f) and the new regulations.

When does Section 162(f) apply?

Section 162(f) applies to payments made to or at the direction of the government in relation to the violation of any law or investigation into potential violation of law. The rule also applies to governmental entities and certain nongovernmental entities which exercise self-regulatory powers or are part of performing essential governmental functions. The rule does not apply to suits between private parties in which no government or governmental entity is a party.

Generally, Section 162(f) disallows all deductions for payments made to or at the direction of the government in relation to a violation or potential violation of law. It can include not only traditional fines or penalties paid to a government, but also other types of payments commonly made as part of a settlement (e.g., agreement to fund building a nature center).

Significantly, there is an exception to disallowance under Section 162(f) if a payment is for restitution, remediation or to come into compliance with a law. However, the exception applies only if a taxpayer meets (1) the establishment requirement and (2) the identification requirement. Accordingly, it will be critical for taxpayers with controversies involving governments, and their counsel, to be aware of the establishment and identification requirements and include the necessary language in their settlement agreements and draft orders submitted to a court, government, government entity, or applicable nongovernment entity.

What is the establishment requirement?

The first requirement for meeting the exception to Section 162(f) is the establishment requirement. To meet this requirement, the taxpayer must establish that the amount paid or incurred was restitution, remediation, or paid or incurred to come into compliance with a law.

The proposed regulations provide that a taxpayer satisfies the establishment requirement by providing documentary evidence of the following:

- that the taxpayer was legally obligated to pay the amount identified as restitution, remediation, or as a coming into compliance payment
- the amount paid or incurred, and
- the date on which the amount was paid or incurred.

The proposed regulations include the following examples of documentary evidence that may be used to satisfy the establishment requirement: receipts; the legal or regulatory provision related to the violation or potential violation of a law; documents issued by the government or governmental entity relating to the investigation or inquiry; documents describing how the amount to be paid was determined; and correspondence exchanged between the taxpayer and the government or governmental entity before the order or agreement became binding under applicable law.

The proposed regulations explicitly state that a taxpayer does not satisfy the establishment requirement simply by establishing the identification requirement (discussed below).

What constitutes restitution?

An amount is paid or incurred for restitution or remediation if it restores, in whole or part, the person, government or governmental entity, or property harmed by the violation or potential violation of law.

The proposed regulations exclude forfeiture and disgorgement from the definition of restitution. The IRS said forfeiture and disgorgement are not restitution because they focus on unjust enrichment of the wrongdoer, not the harm to the victim. As explained below, they also exclude other payments made pursuant to a settlement or court order, such as a commitment to fund improvements to a park, that are not remediation, restitution, or to come into compliance with law.

What constitutes coming into compliance with the law?

The proposed regulations emphasize the importance of the purpose of a payment, which should be spelled out in the settlement agreement or court order. A payment for the purpose of taking a specific corrective action, or providing specific property for purpose of coming into compliance, is treated as an amount paid to come into compliance with a law.

The proposed regulations specifically provide that the following are not payments to come into compliance with a law:

- payments to reimburse the government or government entity for investigation or litigation costs,
- a payment made in lieu of fine or penalty at the payor's election, or

- forfeiture or disgorgement.

What is the identification requirement?

The second requirement for meeting the exception to Section 162(f) is the identification requirement. The identification requirement requires the settlement agreement or court order to specifically identify the amount paid or incurred as restitution, remediation, or to come into compliance with a law. The proposed regulations provide that an order or agreement identifies a payment by (1) stating the nature, or purpose for, each payment each taxpayer is obligated to pay and (2) the amount of each payment identified.

Does the IRS have to accept the parties' classifications?

No. The IRS can challenge the parties' classification of payments as restitution, remediation, or to come into compliance with the law. However, the identification requirement is presumed met if order or agreement states that the payment, and the amount of the payment, constitutes restitution, remediation, or an amount paid to come into compliance with the law. To rebut that presumption, the IRS must develop sufficient contrary evidence that the amount paid or incurred was not for the purpose identified in the order or agreement. The regulations do not specify how this presumption would apply in the context of litigation over the tax deduction (e.g., whether the rule shifts the burden of production or proof on the identification requirement to the IRS). Nevertheless, the presumption should be useful in the context of a tax controversy.

What if the parties do not know the amount of the payment to be made?

The identification requirement can be met even if the exact amount of the payment is not specified. In that case, the order or agreement must (1) identify the payment as restitution, remediation, or to come into compliance with the law, (2) describe the damage done, harm suffered, or manner of noncompliance with a law, and (3) describe the action required of the taxpayer (e.g., paying costs to provide services or property).

What is the government's reporting requirement?

Under Section 6050X, if a government (or government entity) receives a payment exceeding a threshold amount pursuant to a court order or settlement agreement, the government's "Appropriate Official" must report the amount to the IRS and the taxpayer. The report also must separately identify any amounts that are for restitution, remediation of property, or correction of noncompliance.

The proposed regulations attempt to minimize the reporting burden on governments. Specifically,

- Treasury used its discretion under the regulatory delegation in the statute to increase the threshold reporting requirement from \$600, the threshold in the statute, to \$50,000.
- Section 6050X provides that the "Appropriate Official" is responsible for filing the information returns. The statute defines the Appropriate Official as the officer or employee having control of the suit or investigation as the party responsible for filing the information return with the IRS. The proposed regulations provide that the Appropriate Official may instead be an officer or employee assigned to comply with the information reporting requirement of Section 6050X.

- Section 6050X requires the Appropriate Official to file the information return at the time agreement is entered into, but the proposed regulations instead provide that the Appropriate Official must file information returns on or before January 31 of the year following the calendar year in which the order or agreement becomes binding under applicable law, even if all appeals have not yet been exhausted.
- If more than one government or government entity is party to an order or agreement, the government or entity listed first (e.g. first signatory) has the reporting requirement. In addition, the governments and government entities have the flexibility to appoint which is responsible for complying with the reporting requirements. The other governments or entities do not need to file the information return.
- Even if a payment is to be paid over several years, the Appropriate Official has to file only one information return for the aggregate amount identified in the order or agreement.

The proposed regulations require that the government report the payment on Form 1098-F, Fines, Penalties, and Other Amounts, and on Form 1096, Annual Summary and Transmittal of U.S. Information Returns. Taxpayers entering into settlement agreements or drafting proposed court orders should discuss with the governmental party how the payments will be reported on the Form 6050X.

What is the government's reporting requirement if there are multiple payors?

If multiple payors are individually liable for the amount, the Appropriate Official must file an information return for the separate amount that each individually liable payor is required to pay, even if a payor's payment liability is less than the threshold amount.

If multiple payors are jointly and severally liable, the Appropriate Official must file an information return for each payor reporting the aggregate amount to be paid by all jointly and severally liable payors.

Are these regulations in effect?

Not yet, but taxpayers can rely on the proposed regulations pending the issuance of final regulations. The Section 162(f) regulations will be effective when the final regulations are published in the Federal Register. The Section 6050X regulations regarding the government's reporting requirement are proposed to apply only to orders and agreements that become binding after January 1, 2022. In the meantime, taxpayers have the option of following the rules set forth in the proposed regulations or those prescribed in Notice 2018-23, which generally states that the identification requirement is satisfied if a settlement agreement or court order specifically states on its face that an amount is paid or incurred as restitution, remediation, or to come into compliance with a law.

Who should consider commenting on the proposed regulations?

Taxpayers with significant amounts at stake in controversies involving a government, government entity, or applicable nongovernmental entity should review the proposed regulations and consider submitting comments. Comments are due July 13, 2020. Potential areas for comment include the following:

- Definition of restitution, the exclusion of disgorgement and forfeiture from the definition of restitution, and the classification of other payments required by a settlement agreement or court order (e.g., agreement to fund building a nature center).
- Examples of audits, inspections, or reviews conducted in the ordinary course of business that are not investigations or inquiries of potential violations of law intended to fall within the ambit of section 162(f).
- How taxpayers may meet the identification requirement with respect to lump-sum payments, multiple damage awards, and multiple taxpayers.
- How orders or agreements meet the identification requirement, including when an order or agreement identifies a payment which is less than the amount the taxpayer establishes was paid as restitution, remediation, or to come into compliance with a law.
- Whether parties can satisfy the identification requirement by amending agreements that failed to include the identification language.
- Taxpayers' recourse if government refuses include identification language even though the payment is for restitution, remediation, or to come into compliance with the law.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

David B. Blair

Partner – Washington, D.C.

Phone: +1 202.624.2765

Email: dblair@crowell.com

S. Starling Marshall

Partner – New York

Phone: +1 212.895.4263

Email: smarshall@crowell.com

Teresa Abney

Counsel – Washington, D.C.

Phone: +1 202.624.2667

Email: tabney@crowell.com