

December 21, 2017

Tax Reform: Deductibility of Government Payments Materially Limited

On Wednesday, December 20, 2017, the House of Representatives and Senate passed comprehensive tax reform legislation. The bill, which is expected to be signed by President Trump in the coming weeks, amends the tax treatment of payments made to (or at the direction of) a government, including payments under the False Claims Act and Foreign Corrupt Practices Act. The provisions of the legislation effectively limit the deductibility of those payments to situations where either (a) a court has ordered amounts be paid as restitution, or (b) defendants and the government agree, in settlement agreements, amounts constitute restitution.

Existing Law

Currently, Section 162(a) of the Internal Revenue Code (the “Code”) permits the deduction of ordinary and necessary business expenses. However, Section 162(f) denies deductions for fines or penalties. Historically, payments made to governments, including those under the False Claims Act, pursuant to a court order or a settlement agreement are treated as deductible to the extent that they are compensatory or remedial in nature. *See Fresenius Medical Care Holdings, Inc. v. United States*, 763 F.3d 64 (1st Cir. 2014). Generally this means that only the “single damages” portion of any agreed settlement or court-ordered payment is clearly deductible. Statutory penalties or “multiple” damages imposed in excess of the single damages amount, depending upon the particular facts and circumstances of the individual case, are often viewed by the Internal Revenue Service (“IRS”) as fines or penalties. In recent years, audit activity by the IRS over the deductibility of payments to governments has dramatically increased, including challenges by the IRS over the deductibility of disgorgement payments made under the Foreign Corrupt Practices Act.

New Provisions

The tax reform bill passed by Congress provides that payments to (or at the direction of) any government “in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law” are non-deductible. The legislation does allow a carve-out for restitution payments and payments to “come into compliance with any law,” provided that (i) the taxpayer is able to establish the nature of the payment and (ii) the payment is identified as restitution or an amount paid to come into compliance in either a court order or settlement agreement. The legislation further clarifies that the payment of restitution is deductible in the same manner as the underlying payment would have been deductible. Furthermore, amounts paid as reimbursement for governmental investigatory expenses will no longer be deductible.

New Section 6050X will require government agencies (or entities treated as such) to file information returns with the IRS to report payments under a settlement agreement or order (with exceptions for certain *de minimis* amounts), and identify separately any portions constituting restitution, remediation of property, or payments for correction of noncompliance. Copies of the returns must also be furnished to parties to the suit or agreement.

Effective Date

The new rules described above will apply to amounts paid or incurred on or after the enactment date of the tax reform legislation, provided that the rules will not apply to amounts paid or incurred under any binding order or

agreement entered into before the law's enactment. This exception does not apply to an order or agreement requiring court approval unless the approval was obtained before enactment.

Key Implications

The implications of these changes are potentially significant for defendants in pending litigation or investigation by governments, including False Claims Act and Foreign Corrupt Practices Act investigations by the Department of Justice ("DOJ") or the Securities and Exchange Commission ("SEC"). Parties with pending settlements should evaluate whether an existing settlement or order will be binding prior to the enactment of the tax reform legislation. Additionally, while it appears to be clear under the legislation's provisions that certain types of payments (e.g., equitable disgorgement to either the SEC or DOJ as part of a Foreign Corrupt Practice Act investigation and any amount in excess of "single damages") will no longer be deductible, parties to settlement agreements and court orders will want to pay particular attention to documenting restitution payments in settlement agreements and orders wherever possible.

Our previous coverage of tax reform can be found on our [Capital Insights](#) page. Please contact any member of the [Tax Controversy](#) or [Government Enforcement](#) Groups with any questions you may have.