

June 16, 2020

IRS Issues Proposed Regulations on Deductions of Certain Settlement Payments to Governments

On May 12, 2020, the IRS released proposed regulations (REG-104591) affecting the deductibility of payments made to governments in settlement of alleged violations of law. The proposed regulations interpret Sections 162(f) and 6050X of the Internal Revenue Code of 1986 (the Code), as amended and introduced by the Tax Cuts and Jobs Act (TCJA), respectively. On June 11, 2020, the IRS released minor corrections to the proposed regulations. Sections 162(f) and 6050X changed the requirements for taxpayers to deduct amounts paid to the government pursuant to court-ordered judgments, settlement agreements, non-prosecution agreements, deferred prosecution agreements, and decisions by certain boards/commissions. At a high level, under Section 162(f), to be deductible, such payments must be restitution, remediation, or an amount paid to come into compliance with the laws, and must be identified as such in either the order or agreement (the “identification requirement”). In addition, taxpayers must maintain records substantiating the nature of their payments (the “establishment requirement”).

Section 6050X requires governments to file information returns (Form 1098-F) with the IRS to report payments received from taxpayers pursuant to an order or an agreement, and separately identify any portions constituting restitution, remediation, or payments to comply with a law. The proposed regulations under Section 6050X clarify that reporting requirements do not apply to foreign, territorial and tribal governments, and reporting by covered governments and entities is only required for payments above a \$50,000 threshold.

The remainder of this alert focuses on the proposed regulations under Section 162(f) elaborating on key definitions and the identification and establishment requirements.

Proposed Regulation 1.162-21

The proposed regulations contain several important definitions, including definitions of deductible amounts (restitution, remediation, and compliance with law), government or governmental entity, and suit or agreement:

- **Restitution, Remediation, and Compliance with Law:** Taxpayers can deduct amounts paid for restitution, remediation, or to come into compliance with a law.
 - The proposed definition of restitution or remediation is an amount that “restores, in whole or in part, the person . . . ; the government; the governmental entity; or property harmed by the violation or potential violation of a law” Prop. Reg. § 1.162-21(f)(3)(i).
 - The proposed definition of an amount paid or incurred to come into compliance with a law is “[a]n amount paid or incurred to come into compliance with a law that the taxpayer has violated, or is alleged to have violated, by performing services; taking action, such as modifying equipment; providing property; or doing any combination thereof.” Prop. Reg. § 1.162-21(f)(3)(ii). This list of actions within the definition is an exhaustive list, not simply a list of examples. Additionally, these amounts can only be deducted if the payments would otherwise be deductible under Chapter 1 of the Code.
 - In addition to defining what is included within restitution, remediation, and amounts paid to come into compliance, the proposed regulations also specifically exclude certain payments from these defined terms; these terms do not include amounts paid to reimburse governments or governmental entities for investigation or litigation costs, nor do they include forfeiture and disgorgement. Additionally, they do not include any amount paid at the payor’s election, in lieu of a fine or a penalty.

- *Government or governmental entity:* Taxpayers can deduct certain payments made to a government or governmental entity. The proposed definition of “government or governmental entity” includes Indian tribal and foreign governments. Also, certain non-governmental entities are treated as governmental entities. These are entities that “[e]xercise[] self-regulatory powers (including imposing sanctions) in connection with a qualified board or exchange . . . ; or exercises self-regulatory powers, including adopting; administering; or enforcing laws and imposing sanctions, as part of performing an essential governmental function.” Prop. Reg. § 1.162-21(f)(2). However, Indian tribal governments and foreign governments are exempted from Section 6050X’s reporting requirements.
- *Suit, agreement, or otherwise:* Taxpayers can deduct certain payments to a government or governmental entity that are made by a suit, agreement, or otherwise. The proposed definition of suit or agreement is, “suit, agreement agreements; non-prosecution agreements; deferred prosecution agreements; judicial proceedings; administrative adjudications; decisions issued by officials, committees, commissions, boards of a government or a governmental entity; and any legal actions or hearings which impose a liability on the taxpayer or pursuant to which the taxpayer assumes liability.” Prop. Reg. § 1.162-21(f)(4). The June 11 corrections changed the definition to make the list exhaustive, and also excluded the word “settlement,” which may be an inadvertent mistake.

Identification Requirement

Section 162(f) contains an “identification requirement” that the order or agreement identify the amounts paid that are restitution-, remediation-, or compliance-based. Importantly, the proposed regulations establish a presumption for this requirement. It is presumed to be met if the order or agreement specifically states what the payment constitutes (restitution, remediation, or compliance), even if the document uses a different form of the required words (*e.g.*, “remediate” or “comply with a law”). To rebut this presumption, the IRS must “develop sufficient contrary evidence that the amount . . . was not for the purpose identified in the [document].” Prop. Reg. § 1.162-21(b)(2)(iv).

If the precise amount that relates to restitution, remediation, or compliance is not known, the identification requirement can be met if the order/agreement “describes the damage done, harm suffered, or manner of noncompliance with a law, and describes the action required of the taxpayer, such as paying or incurring costs to provide services or to provide property.” Prop. Reg. § 1.162-21(b)(2)(iii). The IRS has requested comments as to how taxpayers could meet the identification requirement for lump-sum payments, multiple damage awards, and multiple taxpayers.

Establishment Requirement

Section 162(f) contains an “establishment requirement” that the taxpayer must substantiate, with documentary evidence, the legal obligation to pay, the amount, the amount paid, and the date the amount was paid. The regulations contain a non-exhaustive list of documents that can be used to fulfill the establishment requirement, including:

- 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.

Prop. Reg. § 1.162-21(b)(3)(i).

The IRS specifically requested that comments be submitted detailing other evidence and supporting documentation that taxpayers could use to meet the establishment requirement.

Material Change in Order or Agreement

One especially noteworthy manner in which the proposed regulations depart from prior guidance is the applicability to orders and agreements entered before December 22, 2017. The proposed regulations state that, if there is a material change to the terms of the order or agreement, Section 162(f) applies to payments made after that material change. Examples of material changes with the proposed regulations include “changing the nature or purpose of a payment obligation; or changing, adding to, or removing a payment obligation, an obligation to provide services, or an obligation to provide property.” Prop. Reg. § 1.162-21(e)(2). On the other hand, a material change does not include “changing a payment date or changing the address of a party to the order or agreement.” *Id.*

Effective Date

When finalized, the regulations would apply to taxable years beginning on or after the date the final regulations are published in the Federal Register. Until the regulations are final, taxpayers can either rely on the previously released IRS Notice 2018-23 or on the proposed regulations; if relying on the proposed regulations, taxpayers must apply the proposed regulations entirely and consistently.

Key Implications

Taxpayers making payments in connection with pending governmental investigations and litigation, including False Claims Act and Foreign Corrupt Practices Act investigations by the Department of Justice (DOJ) or the Securities and Exchange Commission (SEC) should consider whether these proposed regulations impact their approach to substantiating and documenting a settlement or payment. Some key steps:

- Ensure that orders and agreements are clear, either explicitly as to the amount of restitution (or other deductible payment) or contain enough facts to determine such amount.
- Review the record of negotiations to confirm there are no inconsistencies with the language in the order or agreement.
- Prepare contemporaneous files to maintain substantiation and other records that may be necessary to defend deductions if later reviewed by the IRS.
- Review the potential impact of the regulation on any historic settlement agreement that is being materially amended to determine whether the prior tax treatment will be affected.