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

On January 14, 2021, the IRS released final regulations (T.D. 9946) (the “Final Regulations”) interpreting Sections 162(f) and 6050X of the Internal Revenue Code of 1986 (the “Code”), as amended and drafted by the Tax Cuts and Jobs Act (“TCJA”), respectively. As described below, the Final Regulations deviate from and clarify proposed regulations that the IRS issued in May of 2020 (the “Proposed Regulations”) in several important ways. The Final Regulations will apply to taxable years beginning on or after January 14, 2021.

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”). Likewise, 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 agreement, and separately identifying any portions constituting restitution, remediation, or payments to comply with a law. The Final Regulations under Section 6050X confirm the Proposed Regulations’ position that reporting requirements do not apply to foreign, territorial and tribal governments, and they maintain the \$50,000 payment reporting threshold included in the Proposed Regulations.

The remainder of this alert focuses on the changes to the Proposed Regulations made by the Final Regulations under Section 162(f):

1. **Scope:** The Final Regulations clarify certain circumstances to which Section 162(f) does and does not apply.
2. **Disgorgement and Forfeiture:** The Final Regulations remove the Proposed Regulations’ *per se* prohibition on deductions for disgorgement or forfeiture payments, and include a facts and circumstances test that must be met for disgorgement or forfeiture payments to be deductible.
3. **Environmental Remediation:** The Final Regulations provide that payments for remediation or restitution of environment, wildlife, or natural resources may be deductible.
4. **Governmental Account Where Payments Made Matters:** The Final Regulations prohibit the deduction of amounts paid to the general account of a governmental or governmental entity for general enforcement purposes, but explains that payments may be deductible as restitution or remediation if they are paid to a segregated fund, even if a portion reverts to the government or governmental entity’s general account if the fund is not exhausted.
5. **Clarifications to the Identification Requirement:** The Final Regulations clarify how a taxpayer may meet the Identification Requirement if the precise amount of the payment or its division amongst multiple taxpayers is unknown at the time an agreement is signed or order is entered. They further clarify the language that an agreement or order must use to meet the Identification Requirement.
6. **Clarifications to the Establishment Requirement:** The Final Regulations clarify the Establishment Requirement, adding to the non-exhaustive list of documents that can be used to fulfill the Establishment Requirement that was contained in the Proposed Regulations.

7. **Deletion of Material Change Rule:** The Final Regulations remove the Proposed Regulations' material change rule, explaining that Section 162(f), as amended by the TCJA, does not apply to any pre-December 22, 2017 binding order or agreement, even if it is modified after that date.

1. Scope of Section 162(f)

The Final Regulations and their Preamble clarify that Section 162(f) does not apply in certain circumstances, meaning that payments may be deductible if other requirements are met. Specifically, Section 162(f) does not apply to:

- Reimbursements to a government or governmental entity for legal fees and expenses paid or incurred in the defense of a prosecution, civil action, or investigation arising from the alleged violation of a law.
- Amounts paid or incurred for routine investigations or inquiries (*e.g.*, audits or inspections) required to ensure compliance with rules or regulations applicable to the business or industry where there is no evidence of wrongdoing or suspected wrongdoing.
- Payments made under any order or agreement in a suit in which a government or governmental entity enforces its rights as a private party. This would include a government's recovery of vendor overcharge errors.
- Amounts paid in connection with the cleanup requirements and reimbursement provisions of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) where there is no violation of the law.
- The excess of amounts paid or incurred to upgrade equipment or property to a higher standard than that required to come into compliance with the law (*e.g.*, if it cost \$12 to come into compliance with the law, and the taxpayer chooses to spend \$15 to upgrade the property to a higher standard, the \$3 difference would not be subject to Section 162(f)).

The Preamble to the Final Regulations also explains that they do not include a single rule concerning qui tam cases brought by private citizens on behalf of a government or governmental entity. However, the Preamble notes that a government or governmental entity is the real party in interest in qui tam cases, and Section 162(f) likely applies to any amount paid, including any share ultimately paid by the government or governmental entity to the relator, whether or not the government or governmental entity intervenes in the suit.

2. Disgorgement and Forfeiture Payments Are Deductible in Certain Circumstances

The Final Regulations remove the Proposed Regulations' *per se* prohibition on deductions for disgorgement or forfeiture payments, and include a facts and circumstances test that must be met for disgorgement or forfeiture payments to be deductible. Under the Final Regulations, such payments are deductible if:

1. the amount is otherwise deductible under chapter 1;
2. the order or agreement otherwise identifies the payments, not in excess of net profits, as restitution, remediation, or an amount paid to come into compliance with a law (*i.e.*, the Identification Requirement is met);
3. the taxpayer establishes the amount was paid as restitution, remediation, or to come into compliance with the law (*i.e.*, the Establishment Requirement is met);
4. the origin of the taxpayer's liability is restitution, remediation, or an amount paid to come into compliance with the law; and

5. the amount is *not* disbursed to the *general account* of the government or governmental entity for general enforcement purposes.

3. Payments for Remediation or Restitution of Environment, Wildlife, or Natural Resources Are Deductible in Certain Circumstances

The Final Regulations provide that payments to a government or governmental entity may be deductible if they are made for restitution or remediation of the environment, wildlife, or natural resources or include amounts paid to conserve soil, air, or water resources; to protect or to restore the environment or ecosystem; to improve forests; or to provide a habitat for fish, wildlife or plants. To be deductible as restitution or remediation, such amounts must be paid or incurred at the government's or governmental entity's direction, and used exclusively for the restitution or remediation of a harm to the environment, wildlife or natural resources. Moreover, the payments must be made to a segregated fund or account established by (or at the direction of) a government or governmental entity, and pursuant to the terms of the order or agreement, the amounts must not be disbursed to the general account of the government or governmental entity for general enforcement or other discretionary purposes. Further, there must be a strong nexus between the payment's purpose and the harm to the environment, natural resource, or wildlife that the taxpayer is alleged to have caused.

4. Payments to a Governmental or Governmental Entity's General Account and Reversion of Excess Amounts

The Final Regulations prohibit the deduction of amounts paid to the general account of a governmental or governmental entity for general enforcement purposes.

However, the Preamble explains that certain payments may be deductible as restitution or remediation if they are paid to a segregated fund of (or established at the direction of) the government or governmental entity, even if a portion reverts to the government or governmental entity's general account if the fund is not exhausted (*e.g.*, due to amounts going unclaimed). The taxpayer must have reasonably expected at the time it made the payment that the amount would be used for restitution to harmed persons, and must establish that it made the payment for the identified purpose (*e.g.*, by showing a cancelled check).

Finally, if a portion of the payment reverts to the taxpayer for the taxpayer's benefit, then that portion is not deductible, and the taxpayer will be required to include those amounts in income under the tax benefit rule.

5. Clarifications to the 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. One way to meet this requirement is for the agreement or order to state that the amounts paid constitute "restitution," "remediation" or "an amount paid to come into compliance with law" or to use a different form of those words (*e.g.*, "remediate" or "comply with a law"). The Final Regulations provide that this requirement may also be met if the agreement or order specifically describes the damage done, harm suffered, or manner of non-compliance with the law *and* describes the action required of the taxpayer to provide restitution, remediation, or to come into compliance with the law.

The Final Regulations recognize that the precise amount of a payment that relates to restitution, remediation, or coming into compliance with the law may not be known upon entering into a settlement or the issuance of an order, including when the applicable agreement or order specifies only a lump sum payment. Further, a settlement agreement or order may apply to multiple taxpayers and not allocate the payment amongst them. The Final Regulations provide that the Identification Requirement may be met if (1) the order or agreement does not allocate the total lump-sum payment amount or multiple damage award among restitution, remediation, or to come into compliance or (2) is among multiple taxpayers. Further, the Final Regulations clarify that the Identification Requirement may be met *even if* the order or agreement does not provide an estimated payment amount. To meet the Identification Requirement in such circumstances, the agreement or order must contain language specifically stating or describing that the amount will be paid or incurred as restitution, remediation, or to come into compliance with the law.

The Final Regulations remove the Proposed Regulations' provision allowing the IRS to challenge the characterization of an amount identified in an order or agreement as paid for restitution, remediation, or to come into compliance with the law.

6. Clarifications to the 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 Final Regulations add to the non-exhaustive list of documents that can be used to fulfill the Establishment Requirement that was contained in the Proposed Regulations. The full list of example documents included in the Final Regulations comprises:

- receipts;
- the legal or regulatory provision related to the violation or potential violation of any law;
- documents issued by the government or governmental entity relating to the investigation or inquiry, including court pleadings filed by the government or governmental entity requesting restitution, remediation, or demanding that defendant take action to come into compliance with the law;
- judgment;
- decree;
- 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, determined without regard to whether all appeals have been exhausted or the time for filing an appeal has expired.

The Preamble to the Final Regulations also clarifies that the taxpayer may use documentary evidence in a foreign language if it provides a complete and accurate certified English translation of the documentary evidence. The Preamble further provides that a report filed by a government or governmental entity in compliance with Section 6050X is insufficient documentation to satisfy both the establishment and identification requirements.

The Final Regulations further clarify that the Establishment Requirement may be met if the amount is paid to a segregated fund or account established by or at the direction of a government or governmental entity to restore a person, government, governmental entity, property, environment, or natural resource harmed, injured or damaged by an actual or potential legal violation, *even if* the ultimate recipient, or each ultimate use, of the payment is not designated or is unknown.

In the case of a lump sum payment or multiple damage award that includes a combination of restitution, remediation, and coming into compliance with the law, the taxpayer must establish the exact amount paid or incurred for each purpose to meet the Establishment Requirement. Likewise, if an order or agreement involves multiple taxpayers, each taxpayer must establish the amount it paid or incurred as restitution, remediation, or to come into compliance with the law.

7. Material Change to Order or Agreement

The Final Regulations remove the Proposed Regulations' material change rule. The Preamble explains that Section 162(f) as amended by the TCJA does not apply to any pre-December 22, 2017 binding order or agreement, even if it is modified after that date. However, it notes that "material changes to an order or agreement will generally result in a new

order or agreement subject to section 162(f).” The Final Regulations do not define what constitutes a “material change,” although the Proposed Regulations listed the following as material changes: “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, the Proposed Regulations provided that a material change does not include “changing a payment date or changing the address of a party to the order or agreement.” *Id.*

Key Implications

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

- Ensure that orders and settlement agreements are clear, either explicitly that amounts are paid as restitution (or other deductible payment), or describe the alleged harm and actions required to provide restitution.
- Include the specific amount paid as restitution (or other deductible payment) in an order or settlement agreement, or maintain documentation containing enough facts to determine such amount.
- Ensure that payments under a settlement or order are not made to the general account of the government or governmental entity used for general enforcement purposes.
- Review the record of negotiations to confirm there are no inconsistencies with the language in the order or settlement agreement.
- Maintain contemporaneous files of substantiation and other records that may be necessary to defend deductions if later reviewed by the IRS.
- Review the potential impact of the Final Regulations on any historic settlement agreement that is being materially amended to determine whether the prior tax treatment will be affected.