

# Highlights From the Recently Issued Proposed Regulations Under Sections 162(f) and 6050X

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On May 13, 2020, the U.S. Treasury Department and Internal Revenue Service issued proposed regulations under Sections 162(f) and 6050X of the Internal Revenue Code regarding the disallowance of deductions for certain amounts paid as judgments or settlements in disputes with a government entity. The new proposed regulations and accompanying preamble provide taxpayers and government entities with additional guidance while also offering affected parties an opportunity to submit comments on a number of open issues. Although the proposed regulations are not binding until they are finalized, taxpayers that are, or may in the future be, parties with a governmental entity to a settlement or court order should be aware that the proposed rules, if finalized, could produce unfavorable results.

## Background

On December 22, 2017, Congress passed the Tax Cuts and Jobs Act (TCJA), which amended Section 162(f). Prior to the TCJA's enactment, Section 162(f) disallowed a deduction for "any fine or similar penalty paid to a government for the violation of any law," but allowed a deduction for payments that the taxpayer could show, based on all the facts, were compensatory. Under the TCJA, 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 entity into potential violation of any law" cannot be deducted, even when the payments are compensatory in nature (or paid to come into compliance with the law), unless: (1) the taxpayer is able to establish that the payment is in fact restitution, remediation or an amount paid to come into compliance with the law (establishment requirement); and (2) the payment is identified as such in either a court order or a settlement agreement (identification requirement).<sup>1</sup> The TCJA also enacted new Section 6050X, which requires the government entity to file an information return with the IRS.<sup>2</sup>

In March 2018, the IRS issued Notice 2018-23<sup>3</sup> to provide interim guidance pending the issuance of the proposed regulations. The notice provides that the identification requirement will be treated as satisfied if the settlement agreement or court order specifically states on its face that an amount is restitution, remediation or paid to come into compliance with the law. In addition, the notice suspended any reporting requirement under Section 6050X until the date specified in the proposed regulations.

## Proposed Regulations

**Restitution, Remediation and Amounts Paid To Come Into Compliance With the Law.** The proposed regulations provide that an amount is paid or incurred for restitution, remediation of property or to come into compliance with the law if the amount is paid or incurred to restore, in whole or in part, the person, governmental entity or property harmed by the violation or potential violation. Also, amounts paid or incurred to come into compliance with a law may include amounts paid or incurred to perform services, take action, modify equipment or provide property. However, amounts paid or incurred pursuant to forfeiture and disgorgement provisions do not qualify as restitution. The preamble to the proposed regulation explains that whereas "the purpose of restitution or remediation is to restore the person or property, in whole or in part, to the same or substantially similar position or condition as before the harm," forfeiture and disgorgement are centered on the "unjust enrichment of the wrongdoer." The position taken in

<sup>1</sup> Section 162(f) (2017).

<sup>2</sup> Section 6050X(a)(1) (2017).

<sup>3</sup> Notice 2018-23, 2018-15 IRB 474 (Mar. 27, 2018).

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the proposed regulations, however, is premised on a U.S. Supreme Court case that addressed the purpose of disgorgement or forfeitures under certain federal securities statutes; the case did not address all disgorgement or forfeiture provisions, some of which may have compensatory purposes. Accordingly, the position taken in the proposed regulations that amounts paid pursuant to any disgorgement provision is not restitution is arguably too restrictive.

**Establishment Requirement.** The proposed regulations provide that taxpayers can satisfy the establishment requirement by maintaining documentary evidence supporting the following: (1) that the taxpayer was legally obligated to pay the amount the order or agreement identified as restitution, remediation or to come into compliance with a law; (2) the amount paid or incurred; and (3) the date on which the amount was paid or incurred.<sup>4</sup> Notably, information reports submitted by the government pursuant to Section 6050X will not satisfy the establishment requirement.

**Identification Requirement.** The preamble to the proposed regulations highlights two concerns about the identification requirement raised by interested parties: (1) how to satisfy the identification requirement in the case of lump-sum payments, multiple damage awards and multiple taxpayers; and (2) what happens if the taxpayer ultimately pays more as restitution, remediation or to come into compliance with a law than the order or agreement identified as such. Rather than addressing these concerns in the proposed regulations, the preamble calls upon the public to submit comments on both topics. The proposed regulations do, however, provide guidance on how to satisfy the identification requirement when the restitution, remediation or an amount paid to come into compliance with a law is paid through in-kind “payments.” In those cases, “the order or agreement must describe the damage done, harm suffered, or manner of noncompliance with a law, and describe the action required by the taxpayer (such as incurring costs to provide services or to provide property) with respect to the damage, harm, or noncompliance.”<sup>5</sup>

**Time for Filing Information Return.** The proposed regulations provide that the information return (Form 1098-F) must be filed with the IRS on or before January 31 of the year following the calendar year in which the order or agreement becomes binding under applicable law.<sup>6</sup>

<sup>4</sup> Prop. Reg. § 1.162-21(b)(3)(i).

<sup>5</sup> Prop. Reg. § 1.162-21(b)(2)(iii).

<sup>6</sup> Prop. Reg. § 1.6050X-1(b)(2).

**Material Change.** For agreements or orders in effect before the enactment of the TCJA, Congress included a “grandfather provision” providing that Section 162(f), as amended, “shall not apply to amounts paid or incurred under any binding order or agreement entered into before [December 22, 2017].” The proposed regulations attempt to clarify the application of the grandfather provision where parties to a binding order or agreement entered into before December 22, 2017, seek to amend their existing order or agreement. According to the proposed regulations, if the parties make a “material change to the terms of that order or agreement,” then amended Section 162(f) will apply.<sup>7</sup> The proposed regulations provide that a material change may 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.”<sup>8</sup> The proposed regulations further provide that a material change does not include “changing a payment date or changing the address of a party to the order or agreement.”<sup>9</sup> As the material change provision includes “changing, adding to, or removing a payment obligation,” the scope of a material change is excessively broad (*i.e.*, seemingly any change other than a change in payment date or address could be a material change). Thus, this definition likely will be a source of uncertainty and potentially controversy.

**Effective Date.** The rules set forth under the Section 162(f) proposed regulations are proposed to apply to taxable years beginning on or after the date the regulations are finalized and published in the Federal Register. Taxpayers have the option of relying on the proposed regulations in the meantime, but must do so consistently. The rules in the Section 6050X proposed regulations are proposed to apply only to orders and agreements that become binding under applicable law on or after January 1, 2022.

## Conclusion

Although the proposed regulations do offer some clarity to taxpayers and government entities seeking to comply with the new regime, the preamble makes clear that Treasury and the IRS are very interested in hearing from affected parties. Comments are requested to be submitted by July 13, 2020 (60 days from the May 13, 2020, issuance date of the proposed regulations).

<sup>7</sup> Prop. Reg. § 1.162-21(e)(1).

<sup>8</sup> Prop. Reg. § 1.162-21(e)(2).

<sup>9</sup> *Id.*