Final Regulations Clarify Rules Denying Deductions for Judgments and Settlement Payments in Disputes With a Government

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On January 12, 2021, the Treasury Department (Treasury) and the IRS released final regulations under Section 162(f) and Section 6050X of Title 26 of the U.S. Code. Section 162(f), as amended by the Tax Cuts and Jobs Act of 2017 (TCJA), generally prohibits a deduction for any amount paid or incurred — whether by suit, agreement or otherwise — to or at the direction of a government or governmental entity in relation to the violation of law, or the investigation or inquiry by such government or governmental entity into the potential violation of any law. Section 6050X, enacted by the TCJA, imposes an information reporting regime in connection with payments to which Section 162(f) applies. The final regulations address many of the outstanding issues related to proposed regulations that were issued in May 2020. In some important ways, the final regulations may help ease the burden on taxpayers seeking to qualify for Section 162(f)'s exceptions that allow deductions for amounts paid as restitution, remediation or to come into compliance with a law. Taxpayers should review the regulations carefully and be mindful of the requirements for exceptions when drafting and reviewing court orders and settlement agreements. Failure to do so may cost a taxpayer a deduction to which it otherwise would have been entitled.

The amended Section 162(f) generally makes deducting judgment and settlement payments in government disputes harder for taxpayers than was the case under the pre-TCJA statute. Like the former Section 162(f), the amended Section 162(f) allows a taxpayer to deduct compensatory-type damages (specifically termed under the amended law "restitution, remediation, or amounts paid to come into compliance with the law"). However, the amended Section 162(f) makes the exception harder to meet because, in addition to having to show that the payments are, in substance, restitution, remediation or made to come into compliance with the law (the "establishment requirement"), the new Section 162(f) provisions also impose an "identification requirement" on a deduction. That new requirement is met only if a court order or agreement specifically states the amount of the payment is for restitution or remediation or made to bring a taxpayer into compliance with the law.

The Identification Requirement

In interim guidance (Notice 2018-23) issued in 2018, as well as in the proposed regulations, the IRS and the Treasury took a hard line on the identification requirement. Again, if this requirement is not satisfied, no deduction is permitted, regardless of any other facts or circumstances. Notice 2018-23 initially required taxpayers to use the specific words "restitution," "remediation," or "paid to come into compliance with the law" in the text of a court order or agreement to satisfy this requirement. The proposed regulations then relaxed this rule a bit by allowing the use of derivative words, such as "remediate" or "comply with law," to describe a payment eligible for deduction. Now the final regulations appear to further relax this rule. Under the final regulations, taxpayers can satisfy the identification requirement if the order or agreement specifically states that a payment constitutes restitution, remediation or an amount paid to come into compliance with the law (or uses variations of those terms). Also under the final regulations, a taxpayer can meet the identification requirement even without the use of those words, as long as the order or agreement clearly and unambiguously describes the nature and purpose of the payment to restore an injured party or property, or to correct noncompliance with the law. Given that whether a description is "clear and unambiguous" may be subjective, taxpayers would be best served to include the "magic words" in court orders or agreements, if possible.

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The final regulations also remove a controversial rule in the proposed regulations under which a taxpayer's description of a payment as "restitution" or "remediation," or used "to come into compliance with the law," would have created a rebuttable presumption of meeting the identification requirement. Commentators questioned whether a rebuttable presumption was appropriate for a form-driven requirement (*i.e.*, the requirement that the order or the agreement contains certain descriptive language). Further, commentators perceived the presumption as unnecessary given the statute's separate establishment requirement. Elimination of the rebuttable presumption in the final regulations now is a welcome development for taxpayers.

Lastly, the final regulations make clear that the identification requirement can be met in respect of a lump sum payment or multiple damage awards that are identified in an order or agreement as "restitution, remediation, or coming into compliance" even if in the order or agreement does not split such payments and awards into specific buckets, *i.e.*, $X for "restitution," $Y for "remediation," and $Z to "come into compliance with a law." The order or agreement in that case must instead specify the damage done, harm suffered or manner of noncompliance, and describe the action required by the taxpayer, such as paying or incurring costs to provide services or property.

The Establishment Requirement

Although lump sum payments and multiple damage awards need not be specifically divided between restitution, remediation or compliance payments in the body of an order or agreement, the final regulations make clear that the establishment requirement is not satisfied unless the taxpayer establishes the exact amount paid or incurred for each purpose. Further, in the case of multiple taxpayers, each taxpayer must establish the amount that it paid or incurred as restitution, remediation or to comply with law, respectively.

Restitution and Remediation

The final regulations retain the general definition of restitution and remediation as amounts that restore, in whole or in part, the government, governmental entity, or another person or property harmed by the violation of law. However, in the case of certain environmental damage, the final regulations expand the definition of "restitution, remediation of property, and amounts paid to come into compliance with a law" to include amounts that are not necessarily restorative. The preamble to the rules notes that in some cases environmental damage cannot be restored. Accordingly, under the final regulations, amounts paid, for example, for the purpose of conserving soil, air or water resources; for improving forests; or for providing a habitat for fish, wildlife or plants can also qualify for the statute's exception, provided the amounts bear a nexus to the harm that the taxpayer has caused or is alleged to have caused.

Also of interest to taxpayers with liabilities related to environmental matters is a clarification in the preamble of Section 162(f) that the section does not apply to amounts paid by a taxpayer pursuant to the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) cleanup requirements and reimbursement requirements that apply without regard to whether there is a violation of law, although the section does apply to penalties under CERCLA.

The proposed regulations would have defined "restitution" to *per se* exclude disgorgement and forfeiture damages. This position was based largely on the U.S. Supreme Court's decision in *Kokesh v. Securities and Exchange Commission*, 137 S. Ct. 1635 (2017). However, following release of the proposed regulations, the Court issued another disgorgement-related opinion — *Liu v. Securities and Exchange Commission*, 140 S. Ct. 1936 (2020). In that case, the Court acknowledged that disgorgement is traditionally an equitable remedy that typically is not intended to be punitive. In the wake of *Liu*, the final regulations have removed the *per se* exclusion of disgorgement and forfeiture from the definition of restitution. Thus, it is possible for taxpayers to claim deductions for disgorgement and/or forfeiture damages. However, to be deductible, these amounts still must satisfy the identification requirement (*i.e.*, they must be described as restitution or remediation in an order or agreement) and the establishment requirement (*i.e.*, the taxpayer must establish that they are in fact for restitution or remediation, rather than for punishment or deterrence). Further, a deduction will be disallowed if the disgorgement or forfeiture damages are paid to the general account of a government or government entity for general enforcement or other discretionary purposes.

The proposed regulations also would have prohibited any deduction for amounts paid to an entity, such as a fund, to the extent the entity itself was not harmed (actually or allegedly) by the taxpayer's conduct. This proposed rule called into question whether, for example, payments to a qualified settlement fund (QSF) for the benefit of harmed parties qualified for the restitution or remediation exceptions. The final regulations remove that rule. Thus, payments to a fund such as a QSF can qualify as restitution or remediation if the identification and establishment requirements are met.

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Related Amounts

In response to comments, the final regulations make clear that even if Section 162(f) applies to deny a deduction for damages and settlement amounts, it does not disallow a deduction for expenses, such as legal fees, that a taxpayer incurs in defending against a claim or investigation by the government. Also, the final regulations provide that deductions for prejudgment and post-judgment interest may be subject to disallowance under Section 162(f). However, prejudgment interest can qualify for the restitution, remediation and compliance exception if the identification and establishment requirements are satisfied. The treatment of post-judgment interest piggybacks on the treatment of the underlying amount, so if the post-judgment interest is calculated on an amount that is not deductible, the post-judgment interest is not deductible; whereas if the post-judgment interest is calculated on an amount that satisfies the exception, the post-judgment interest is deductible pursuant to the exception.

The Grandfather Rule

The amendments to Section 162(f) are applicable to orders and agreements that become binding on or after December 22, 2017, the date on which the TCJA was enacted. Thus, orders and agreements that are effective prior to that date remain subject to the more lenient former Section 162(f). One open question is whether pre-TCJA orders or agreements that are modified after the statute's effective date continue to be grandfathered. The proposed regulations contained a rule that, read literally, could have resulted in any change at all to such an order or agreement disqualifying it from the grandfather rule. Instead of clarifying that rule in the final regulations, the IRS and the Treasury removed it entirely and declined to provide any rule at all in the final regulations regarding grandfather clause eligibility in the face of amendments. The preamble to the regulations contains a rather cryptic explanation to the effect that pre-TCJA agreements will be grandfathered even if they are modified on or after December 22, 2017, but that a "material change" to such an agreement will likely result in a "new agreement," which would not be grandfathered. Thus, exactly where the line will be drawn with regard to pre-TCJA agreements that undergo a change after the effective date of the statutory amendments is not clear. The distinction will turn on how radical the change is, but neither the final regulations nor the preamble provide any bright lines. Also somewhat unclear is whether a requirement that the changed agreement receive court approval bears at all on the question.

Information Reporting Under Section 6050X

The final regulations confirm what was stated in the proposed regulations: No information reporting is required under section 6050X with respect to any order or agreement that becomes effective prior to January 1, 2022. Thus, no information returns are required for orders or settlement agreements that become binding in 2021.

Once information reporting requirements kick in, the government will have until January 31 of the year following the year the order or settlement becomes binding to provide the payor with the information statement that Section 6050X requires, and an additional month (*i.e.*, until February 28 of that year) to file a Form 1098-F with the IRS. This is welcome relief for government entity filers, as Section 6050X itself says that the filer must file a return at the time it enters into the agreement.

The final regulations do not clarify whether a new information reporting obligation will arise if an existing order or agreement is modified or amended. Consistent with the comments of the IRS and the Treasury in regard to the grandfather rule, such an obligation presumably would arise only when the modification is so significant as to give rise to a "new" order or agreement.

Finally, although the statute provides that information reporting is required for any amounts in excess of $600, the final regulations raise that threshold to $50,000. Commentators on the proposed regulations had urged the IRS and the Treasury to raise the threshold even higher, but the authorities declined to do so, citing the fact that none of feedback had provided data to support a higher amount.