

New Restrictions on Deductibility of Settlement Payments

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Tax

New restrictions on the deductibility of certain payments will require companies facing government investigations to pay close attention to the tax treatment of any settlement or court judgment, and to address this treatment in their negotiations with regulatory agencies. There is a risk under new tax rules that the amount paid to resolve these disputes may be nondeductible, substantially increasing the economic cost of the resolution.

Any company subject to government regulation may face this issue. Government investigations, and payments to resolve them, are particularly common in highly regulated industries such as healthcare (investigations/actions brought under the False Claims Act), energy production and manufacturing (EPA enforcement actions), and finance (SEC enforcement actions), though they are by no means limited to these arenas. Under prior law, payments to resolve such investigations, under either a settlement agreement or a court judgment, were deductible for federal tax purposes unless they were a “fine or similar penalty paid to a government for the violation of any law.”¹

Substantial controversy developed as a result of this formulation, however, focused primarily on whether a payment to a government should be characterized as a fine or penalty (nondeductible) or as restitution or a similar payment (deductible).

In an attempt to reduce these controversies, the TCJA tightened the restrictions on deductibility under section 162(f), now requiring taxpayers to satisfy several criteria before they are permitted to deduct a payment made to a government pursuant to a court order or settlement agreement. Moreover, the TCJA enacted new section 6050X of the Internal Revenue Code, which requires federal and state governments to report to the IRS the amount and characterization of government settlement payments. The operation and practical impact of these new provisions are discussed below.

New Deductibility Restrictions Under Section 162(f)

Section 162(f)(1) now provides that, subject to the exceptions described below, no deduction is allowed for an amount paid “to, or at the direction of, a government or governmental entity in relation to the violation of any law or the investigation or inquiry by such government or entity

¹ Section 162(f) (prior to amendment by the Tax Cuts and Jobs Act of 2017 (the “TCJA”).

into the potential violation of any law.” This formulation expands the scope of section 162(f) in three critical ways.

- First, it makes clear that a deduction may be disallowed not only where an amount is paid *to* a government, but also where a payment is made *at the government’s direction*.
- Second, it provides that investigations into *potential* violations, rather than the resolution of actual violations, are swept up by section 162(f). Thus, even if a taxpayer disclaims legal liability in a settlement agreement and thus could argue no violation of the law had occurred, that would no longer preserve the deductibility of the payment.
- Third, in conjunction with its broader focus on actual or potential legal violations, the statute’s new formulation removes the “fine or similar penalty” language of prior law. Thus, any payment to resolve an investigation would be subject to the rule, even if it is clearly not a fine or penalty, unless one of the exceptions described below applies.

Exceptions to the general rule denying deductibility apply to amounts paid “as restitution” and payments “to come into compliance with” a law (“compliance payments”). But to qualify for these exceptions, companies must satisfy three new requirements.

- First, the settlement agreement or court judgment must expressly identify the payment as restitution or as a compliance payment. Section 162(f)(2)(A)(ii).
- Second, notwithstanding any language in the settlement agreement or judgment, the taxpayer must independently “establish” that the payment “constitutes restitution (including remediation of property) for damage or harm which was or may be caused by the violation of any law or the potential violation of any law,” or is a compliance payment. Section 162(f)(2)(A)(i).
- Third, the taxpayer must establish that the amount paid did not reimburse “the government or entity for the costs of any investigation or litigation.” Section 162(f)(2)(B).

These requirements are generally effective for amounts “paid or incurred on or after” December 22, 2017. Payments made pursuant to agreements and court judgments entered into before December 22, 2017, however, are exempt from the new provisions. P.L. 115-97, Sec. 13306(a)(2).

Enactment of Section 6050X

In addition to amending section 162(f), the TCJA also adopts new section 6050X. That provision requires governments entering into a settlement agreement or receiving a payment pursuant to a court order to report to the IRS, at the time the agreement is entered into or the judgment issues, the amount paid as a result of the agreement and any portion of that amount that (i) is for “restitution or remediation of property” or (ii) is a compliance payment. Section 6050X(a)(1). The government must also provide to the other parties involved in the settlement agreement or suit a copy of the report filed with the IRS. Section 6050X(b).

By enacting section 6050X, Congress forces governments receiving these types of payments to take an affirmative position regarding the character of the payment. Although not explicit in sections 162(f) or 6050X, the IRS will likely take the position that if a report to the IRS fails to identify an amount as restitution or a compliance payment, the taxpayer cannot independently establish that amount as deductible. Conversely, a government report to the IRS that is consistent with the taxpayer’s characterization of a payment, while not in itself dispositive,

should help establish the extent to which that payment constitutes restitution or compliance payments.

Practical Implications

Negotiations with government agencies to settle enforcement matters will now need to consider the tax characterization of settlement payments, as the TCJA's changes will force the regulatory agency to determine, and report to the IRS, the character of any payment made to resolve an investigation. Companies will thus need to negotiate agreements that confirm the extent to which a payment constitutes either restitution or a compliance payment, since other amounts will likely not be deductible. Initial IRS guidance addressing the revisions to section 162(f) confirms that if a settlement agreement or court order states on its face that an amount is paid for restitution, remediation, or coming into compliance with the law, the section 6050X's new identification requirement will be treated as satisfied for that amount. Notice 2018-23, sec. 3.02. However, the Notice goes on to state that even if the identification requirement is met, a company must also separately "establish" the character of the payment pursuant to section 162(f)(2)(A)(i).

Government agencies may view this new dynamic as giving them additional negotiating leverage, though they may also recognize that facilitating a company's deduction of its settlement payment may make a matter easier to resolve, by reducing the economic cost of the settlement. Moreover, government agencies may be more willing to characterize a settlement amount that is difficult to identify as restitution as a "payment to come into compliance with the law," as that clause appears fairly open-ended and subject to interpretation.

Even if companies are successful in their negotiations with the government, they should document each step of the negotiation in which the tax characterization is discussed. For example, correspondence to government agencies proposing a settlement might include references to the tax characterization. In addition, schedules identifying or computing payments might reflect the tax characterization of the payments. If any portion of a payment is intended to be treated as restitution, this should be made explicit. Taxpayers might also memorialize in any settlement agreement that the government agency will report, pursuant to section 6050X, the amount of the payment that both parties agree is restitution or is a compliance payment.

Finally, and as under the old version of section 162(f), taxpayers should retain pre-settlement negotiation documents, such as the complaint and answer, the government's allegations, and any damage computations, to bolster any position that the taxpayer may take in the future regarding the nature of the payment or the underlying claims.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Tax practice:

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