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Report No. 1440
July 13, 2020

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Michael J. Desmond
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1440 – Report on Proposed Regulations under Sections 162(f) and 6050X*

Dear Messrs. Kautter, Rettig, and Desmond:

I am pleased to submit our Report No. 1440 commenting on the proposed regulations under Sections 162(f) and 6050X of the Code issued in May of this year

We commend the Internal Revenue Service and the Department of the Treasury for the thoughtful guidance in the proposed regulations. Our comments are directly primarily at ensuring that Section 162(f) operates in a manner consistent with its intended scope and are largely technical in nature. We have also commented on the applicability of Section 162(f) to qui tam litigation.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to

assist in any way.

Respectfully submitted,

Andrew H. Braiterman
Chair

Enclosure

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**Report No. 1440**

**New York State Bar Association Tax Section**

# Report on Proposed Regulations under Sections 162(f) and 6050X

**July 13, 2020**

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**Report on Proposed Regulations under Sections 162(f) and 6050X**

## I. Introduction

This Report[1] comments on the proposed regulations (the "***Proposed Regulations***")[2] issued by the Department of the Treasury and the Internal Revenue Service (the "***IRS***" and together with the Department of the Treasury, "***Treasury***") on May 13, 2020 providing guidance under Section 162(f),[3] as amended by the legislation commonly referred to as the Tax Cuts and Jobs Act (the "***TCJA***"), and Section 6050X, added by the TCJA.[4] The Proposed Regulations address the disallowance of deductions under Section 162(f) for amounts paid or incurred to, or at the direction of, a government or governmental entity in relation to violations of law or investigations or inquiries into potential violations of law. The Proposed Regulations also provide guidance implementing the reporting requirements under new Section 6050X.

This Report focuses on certain aspects of the Proposed Regulations and is divided into three parts. Part II contains a summary of our recommendations, Part III describes Section 162(f), as in effect before and after the TCJA, and new Section 6050X, as added by the TCJA, and Part IV contains a detailed discussion of our recommendations.

## II. Summary of Principal Recommendations

### A. Investigations and Inquiries into Potential Violation of Law

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[1] The principal drafters of this Report are Erin Cleary and Elliot Pisem. The authors would like to acknowledge the assistance of Bonnie Daniels, Jay Evans, Molly Klinghoffer and Cameron Rotblat in preparing this Report. This Report reflects comments and contributions from Lee Allison, Kim Blanchard, Andy Braiterman, Andrew Carlon, Peter Connors, Jonathan Gifford, Stephen Land, Richard Nugent, Richard Reinhold, Michael Schler, Mark Schwed, Andrew Solomon and Joe Toce. This Report reflects solely the views of the Tax Section of the New York State Bar Association ("***NYSBA***") and not those of the NYSBA Executive Committee or the House of Delegates.

[2] REG-104591-18, 85 Fed. Reg. 28524 (May 13, 2020).

[3] Unless otherwise stated, all "Code" and "Section" references are to the Internal Revenue Code of 1986, as amended (the "***Code***").

[4] The formal name of the TCJA is "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," Pub. L. No. 115-97.

1. We recommend that, in the absence of a court order, settlement agreement, consent decree, or other similar agreement between a taxpayer and a government or governmental entity, amounts paid or incurred in the ordinary course of business to come into or otherwise maintain compliance with law should not be treated as paid or incurred at the direction of a government or governmental entity.

2. As an alternative to, or in conjunction with, the foregoing, where an examination, inspection, audit, or similar review is required to be conducted in the ordinary course of business in connection with the oversight or supervisory authority of a government or governmental entity, such examination, inspection, audit, or similar review, as an initial matter, should not be treated as an investigation or inquiry into a potential violation with law for purposes of Section 162(f), but may result in an investigation or inquiry into a potential violation of law following written communication by a government or governmental authority alleging specific violations or potential violations of law requiring additional investigation or inquiry. Otherwise deductible amounts paid to a government or governmental entity pursuant to a scheme of general applicability *(e.g.*, periodic assessment fees paid to bank supervisory authorities) and that are not dependent on the existence of a violation or potential violation of law should not be subject to Section 162(f)(1).

3. If Treasury declines to adopt either of the two preceding recommendations, we recommend that Treasury permit satisfaction of the identification requirement under Section 162(f)(2)(A)(ii) where a taxpayer receives an examination, inspection or other similar report or other document that identifies a violation or potential violations of law requiring remediation or other action to achieve or maintain compliance, such taxpayer signs an acknowledgement of receipt with respect to such document and such taxpayer undertakes to remediate such violations or potential violations.

B. Restitution and Remediation; Compliance with Law

1. We recommend that Treasury remove the blanket exclusion from treatment as restitution for amounts paid as forfeiture or disgorgement contained in Proposed Regulations Section 1.162-21(f)(3)(iii)(C).

2. We recommend that Treasury include a bright-line rule in the final regulations addressing amounts paid to private parties at the direction of the government. Where harm or damage is sustained by a private party and amounts appropriately identified as restitution in the applicable court order or settlement agreement are paid to such private party at the direction of the government, such amounts should be treated as restitution.

3. We recommend that Treasury clarify or remove Proposed Regulations Section 1.162-21(f)(3)(iii)(D).

4. We recommend that Treasury clarify that amounts paid pursuant to an applicable court order or settlement agreement into a restitution fund or other similar fund established for the benefit of the person or persons harmed by a violation or potential violation of law may constitute restitution.

C. Identification Requirement

1. We recommend that Treasury clarify the relationship between the general identification rule and the presumption contained in Proposed Regulations Section 1.162-21(b)(2). In particular, we recommend that the final regulations include an example of a court order or agreement that would satisfy the general identification rule without satisfying the presumption.

2. We recommend that the final regulations identify additional words that, if used to describe a payment amount in a court order or agreement, would satisfy the presumption contained in Proposed Regulations Section 1.162-21(b)(2)(ii).

3. We agree that the IRS may challenge the characterization of payments as restitution or as amounts paid to come into compliance with law. In challenging the characterization of such payments, we believe it would be more appropriate for the IRS to bring such challenge with respect to the establishment requirement under Section 162(f)(2)(A)(i) rather than the identification requirement under Section 162(f)(2)(A)(ii).

4. Where a court order or settlement agreement that imposes multiple damage awards or involves multiple taxpayers identifies a specific amount as an amount constituting restitution, remediation, or paid to come into compliance with law, the identification requirement under Section 162(f)(2)(A)(ii) should be satisfied with respect to such amount.

5. Generally, we do not believe the identification requirement under Section 162(f)(2)(A)(ii) should be satisfied where a court order or settlement agreement does not identify any particular amount as constituting restitution, remediation, or paid to come into compliance with law, and the total amount to be paid by a taxpayer pursuant to such agreement is known at the time of such settlement agreement, or court order. Where the parties are unable to agree as to the appropriate amount of the damage award that

constitutes amounts paid as restitution or remediation or to come into compliance with law, and the court order or settlement agreement identifies a maximum possible amount that may be as paid as restitution, remediation or to come into compliance with law, the Executive Committee of the Tax Section is evenly divided on whether identification of such a maximum amount should be sufficient to satisfy the identification requirement under Section 162(f)(2)(A)(ii), provided that the taxpayer can satisfy the establishment requirement under Section 162(f)(2)(A)(i).

D. Establishment Requirement

1. We recommend that Treasury clarify that the establishment requirement under Section 162(f)(2)(A)(i) encompasses analysis of the actual purpose of a payment.

2. We recommend that Treasury clarify that Proposed Regulations Section 1.162-21(b)(2)(iii) applies only with respect to amounts that are not reasonably certain at the time of the court order or settlement agreement.

3. We recommend that the final regulations include additional guidance regarding how a taxpayer may substantiate the establishment requirement under Section 162(f)(2)(A)(i) for lump-sum payments and multiple damages awards assuming that, as discussed at C.5 above, the final regulations provide that stating a maximum amount as attributable to restitution, remediation, or coming into compliance with law is sufficient for purposes of the identification requirement under Section 162(f)(2)(A)(ii).

E. Suits between Private Parties

1. We recommend that the final regulations address whether amounts paid to a government by reason of an order of a court in, or a settlement of, a qui tam suit alleging violation of law are within the scope of the exception for suits between private parties.

2. We recommend that the final regulations address whether attorney's fees paid to a private plaintiff, and remitted by that plaintiff to its attorney, or paid directly to the plaintiff's counsel by reason of an order of a court in, or a settlement of, a qui tam suit in which the government has declined to participate should be treated as “paid … to, or at the direction of, a government.”

F. Exception for Taxes

1. We agree with the clarification in the Proposed Regulations of the rule in Section 162(f)(2)(A)(iii) relating to restitution for failure to pay tax.

G. Material Changes to Orders or Agreements Entered into Prior to TCJA

1. We agree that it is appropriate to treat a payment or other obligation arising following a material change in a pre-TCJA order or agreement as falling within the scope of amended Section 162(f) where the change affects the nature or the purpose of the obligation that existed prior to the TCJA or materially increases payment or other obligations. However, we recommend that the final regulations provide additional guidance regarding the scope of Proposed Regulations Section 1.162-21(e).

2. In the context of a subsequent settlement agreement entered into following an action to enforce an existing agreement that was entered into prior to December 22, 2017, we recommend that the final regulations provide that any payment or other obligation under the subsequent settlement agreement that relates back to the existing agreement and that is not otherwise modified is not subject to amended Section 162(f).

H. Section 6050X Reporting

1. We recommend that Treasury clarify that the establishment requirement under Section 162(f)(2)(A)(i) does not apply to Section 6050X reporting obligations, but that the identification requirement under Section 162(f)(2)(A)(ii) applies to such obligations.

2. Where the aggregate payment amount and/or identified restitutionary amount cannot be determined with certainty we recommend that Section 1.6050X-1(e) should apply to the aggregate amount in issue, regardless of whether restitutionary amounts are separately identified.

I. Technical Comments

1. We recommend that the term “essential government function” have the same meaning for purposes of Section 162(f) as such term has for purposes of Section 115.

2. We recommend that Treasury clarify that Section 162(f) has no impact on whether a taxpayer’s own legal fees and related expenses incurred in defending a prosecution or other action or proceeding (including an investigation or inquiry into a potential violation of law) are otherwise deductible under Section 162(a).

3. We have also included in this Report a number of other drafting and technical comments for Treasury's consideration.

## III. Background: Sections 162(f) and 6050X Pre- and Post-TCJA

### A. Law prior to TCJA

Taxpayers generally are permitted a deduction under Section 162(a) for ordinary and necessary business expenses paid or incurred in connection with a trade or business. Prior to its amendment by the TCJA, former Section 162(f) generally operated to disallow a deduction under Section 162(a) "for any fine or similar penalty paid to a government for the violation of any law."[5] For purposes of former Section 162(f), the term "government" includes U.S. federal and state governments, foreign governments and any political subdivision or agency or instrumentality thereof.[6] The Treasury Regulations promulgated under former Section 162(f) also provide guidance on and examples of amounts constituting fines or similar penalties, including amounts paid as civil penalties imposed under federal, state, local or foreign law and settlement payments in respect of civil or criminal fines or penalties.[7] An amount paid as compensatory damages, however, does not constitute a fine or penalty and is not subject to disallowance under former Section 162(f).[8]

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[5] Former Section 162(f), as enacted by The Tax Reform Act of 1969, Pub. L. 91-172. In enacting former Section 162(f), Congress codified then-existing case law disallowing a deduction for fines and penalties paid to a government. *See* S. Rep. No. 552-91 at 273-274 (1969). In *Tank Truck Rentals, Inc. v. Commissioner*, the Supreme Court denied a deduction to a trucking business for amounts paid to New Jersey for violations of road weight restrictions, reasoning that allowing such a deduction "would frustrate sharply defined national or state policies proscribing particular types of conduct evidenced by some governmental declaration thereof." 356 U.S. 30, 33-34. (1958). *See also*, *Grossman & Sons, Inc. v. Comm'r*, 48 T.C. 15 (1967); *Coed Records, Inc. v. Comm'r*, 47 T.C. 422 (1967); *In re Backer*, 1 B.T.A. 214 (1924).

[6] Treas. Reg. § 1.162-21(a). The IRS interpreted agencies and instrumentalities to include certain self-regulating bodies. *See e.g.*, Rev. Rul. 78-96, 1978-1 C.B. 45 (liquidity deficiency penalty imposed by the Board of the Federal Home Loan Bank was a nondeductible penalty), CCA 201623006 (June 3, 2016) (treating FINRA as an agency or instrumentality of the government). Courts also have taken an expansive view of the term "government". In *Guardian Industries Corp. v. Commissioner*, the Tax Court determined the term to include a group representing multiple governments. 143 T.C. 1, 19-21 (2014). *Guardian Industries* established a functional, three-part test to determine whether an entity is an agency or instrumentality of a government, which the IRS applied in CCA 201623006. Under the test, an entity is regarded as an "agency or instrumentality" if it (*i*) has been delegated the right to exercise part of the sovereign power of a government or governments, (*ii*) performs an important governmental function and (*iii*) has the authority to act with the sanction of government behind it. *Guardian Indus. Corp.* at 18-19.

[7] Treas. Reg. § 1.162-21(b)(1).

[8] Treas. Reg. § 1.162-21(b)(2).

Under former Section 162(f), disagreements between taxpayers and the IRS regarding the appropriate treatment of certain payments as fines or penalties resulted in litigation.[9] In analyzing the treatment of an amount as a fine or penalty for purposes of former Section 162(f), courts and the IRS have looked to the origin of the liability giving rise the payment.[10] Payments that were determined to be primarily punitive in nature generally were found to be appropriately treated as fines or penalties for which a deduction was disallowed.[11]

One area where uncertainty existed was the treatment under former Section 162(f) of payments of amounts labeled as "disgorgement." Prior to the Supreme Court's decision in *Kokesh v. Securities and Exchange Commission*,[12] the IRS applied a facts and circumstances-based analysis to determine whether disgorgement represented a fine or penalty or whether disgorgement represented an equitable remedy.[13] Specifically, in a Chief Counsel Advice Memorandum issued prior to *Kokesh* in which the IRS Office of Associate Chief Counsel ultimately concluded disgorgement paid to the SEC was not deductible, the IRS acknowledged that, depending on the particular facts, disgorgement could be primarily punitive or primarily compensatory in nature depending upon the

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9 *See Nacchio v. United States*, 824 F.3d 1370, 1377-1381 (Fed. Cir. 2016) (amounts forfeited following an insider trading conviction constituted a "fine or similar penalty"); *Bailey v. Comm'r*, 756 F.2d 44, 47 (6th Cir. 1985) (settlement amounts for violating Federal Trade Commission consent order nondeductible as penalties even though applied as restitution); *Southern Pacific Transportation Co. v. Comm'r*, 75 T.C. 497, 653-654 (1980) (civil penalties paid the Interstate Commerce Commission for violating certain railroad safety laws had the purpose of enforcing the law and imposing punishment and therefore were nondeductible); *Middle Atlantic Distributors, Inc. v. Comm'r*, 72 T.C. 1136, 1143-44 (1979) (holding that settlement payments to the Custom Service for illegally importing property were liquidated damages and not a "fine or similar penalty" because during settlement negotiations the government sought to recover reimbursement for lost revenue and other damages rather than impose a penalty).

10 In CCA 201825027, the IRS concluded that the terms of a settlement agreement were not conclusive to the question of whether payments made pursuant to the agreement are compensatory in nature. The CCA looked to the underlying origin of the liability, not to the ultimate use of the funds paid to the government. CCA 201825027 (Nov. 18, 2016) (citing *Bailey*, 756 F.2d at 47). Despite the intention of the parties that the payments not be treated as a fine or similar penalty, the underlying statute on which the claims were based contained both punitive and compensatory elements. *Id. See also* IRS, Chief Counsel Advice Memorandum 201748008 (Nov. 17, 2017) (citing *Middle Atlantic Distributors*, 72 T.C. at 1143), which held that the definition of "punitive" payments includes payments that have the purpose of enforcing the law through deterrence.

11 *See Nacchio*, 824 F.3d at 1377-1381; *Bailey*, 756 F.2d at 47; *Southern Pacific*, 75 T.C. 497 at 653-654.

12 137 S. Ct. 1635, 1643 (2017).

13 IRS Chief Counsel Advice Memorandum 201619008 (Jan. 29, 2016).

origin of the underlying liability.[14] In 2017, the Supreme Court held that disgorgement in an SEC enforcement action is treated as a penalty for purpose of applying a five-year statute of limitation contained in 28 U.S.C. § 2462.[15] Following the Court's decision in *Kokesh*, and as a follow-up to the earlier Chief Counsel Advice Memorandum, the IRS released yet another Chief Counsel Advice Memorandum concluding that an amount paid as disgorgement for violating federal securities law constitutes a penalty under former Section 162(f).[16]

B. TCJA Amendments and Scope of Section 162(f)

The TCJA amendments significantly expand the scope of nondeductible payments under Section 162(f). As amended, Section 162(f) generally disallows 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 any law or the investigation or inquiry by such government or entity into the potential violation of any law."[17] Unlike former Section 162(f), amended Section 162(f) is not limited to amounts properly characterized as a fine or similar penalty and is not limited to amounts paid to a government. Unless an exception applies, any amounts paid to or at the direction of a government or governmental entity in relation to a violation or potential violation of law are nondeductible unless an exception applies.

There are three narrow exceptions to the general rule contained in Section 162(f)(1). First, an otherwise permissible deduction will not be disallowed under Section 162(f) if (*i*) the taxpayer establishes (the "***Establishment Requirement***") that such amount either is (*x*) restitution (including remediation of property) for damage or harm which was or may be caused by the violation or potential violation of law (the "***Restitution Exception***") or (*y*) paid to come into compliance with law (the "***Compliance with Law Exception***") and (*ii*) the amount is identified in the court order or settlement agreement (the "***Identification Requirement***") as restitution or as an amount paid to come into compliance with law, but this exception does not apply to amounts payable to the government or other entity in reimbursement for the costs of an investigation or

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14 *Id.* ("For purposes of section 162(f), however—keeping in mind that the scope of the provision includes deterrent as well as retributive measures, and that disgorgement is a discretionary remedy that depends on the facts of a case—we think disgorgement in federal securities law cases can be primarily compensatory or primarily punitive for federal tax law purposes depending on the facts and circumstances of a particular case.")

15 *Kokesh v. Securities and Exchange Commission*, 137 S. Ct. 1635, 1643 (2017).

16 IRS Chief Counsel Advice Memorandum 201748008 (Nov. 17, 2017).

17 Section 162(f)(1) (emphasis added).

litigation.[18] Second, a deduction otherwise permitted under the Code for any amount paid or incurred as taxes due (including amounts constituting restitution for such taxes) is not subject to disallowance.[19] Third, an amount paid or incurred by reason of a court order in a suit in which no government or governmental entity is a party is not subject to disallowance.[20]

Section 162(f)(5) defines "governmental entities" for purposes of Sections 162(f) and 6050X to include certain self-regulating nongovernmental entities, effectively codifying the IRS's prior treatment of self-regulatory bodies as a "governmental entity" for purposes of former Section 162(f).[21]

C. New Section 6050X

The TCJA also enacted Section 6050X, requiring disclosure by officials of any government or governmental entity of amounts required to be paid as a result of a lawsuit or agreement. Sections 6050X(a)(1) and (a)(2)(A) require the relevant official of any government involved in a suit or agreement pursuant to which Section 162(f) applies to file an information return if "the aggregate amount involved in all court orders and agreements with respect to the violation, investigation, or inquiry is $600 or more." Section 6050X(a)(2)(B) provides Treasury the authority to adjust the $600 threshold.

Section 6050X(a)(1) requires that the information return must contain (*i*) the amount required to be paid as a result of the suit or agreement to which Section 162(f)(1) applies disallowing a deduction, (*ii*) any amount required to be paid as a result of the suit or agreement which constitutes restitution or remediation of property and (*iii*) any amount required to be paid as a result of the suit or agreement for the purpose of coming into compliance with any law which was violated or involved in the investigation or inquiry.

Section 6050X(a)(3) requires the relevant government official to file the information return at the time the agreement is entered into, with such timing being determined by Treasury. Section 6050X(b) requires the relevant government official to furnish to each person who is a party to the suit or agreement a written statement, at the time the information return is filed with the IRS, that provides the (*i*) name of the government or entity and (*ii*) information submitted to the IRS.

D. Effective Date

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[18] Section 162(f)(2)(A)(i)-(ii), (f)(2)(B).

[19] Section 162(f)(4), (f)(2)(A)(iii).

[20] Section 162(f)(3).

[21] *See* CCA 201623006 (May 2, 2016).

Amended Section 162(f) and new Section 6050X generally apply to amounts paid or incurred on or after December 22, 2017 other than amounts paid or incurred pursuant to a binding order or agreement entered into prior to December 22, 2017, and, if such order or agreement requires court approval, such approval is obtained before December 22, 2017.[22]

## IV. Detailed Discussion of Proposed Regulations and Recommendations

### A. Investigations and Inquiries into Potential Violation of Law

Amended Section 162(f) is drafted broadly and applies to payments made to, or at the direction of, a government or governmental entity relating to investigations and inquiries into potential violations of law. The Code does not define what constitutes an investigation or inquiry into a potential violation of law. As another commentator noted, the language in the Code could be construed to disallow amounts required to be paid in the ordinary course of business relating to routine inspections and similar inquiries.[23] Treasury has requested comments regarding specific audits, inspections or reviews conducted in the ordinary course of business that are not investigations or inquiries into potential violations of law intended to fall within the scope of Section 162(f).

A taxpayer may incur costs in connection with examinations or inspections by governmental agencies or officials arising in the ordinary course of business for public health or safety reasons. For example, in New York City food service establishments generally are required to undergo inspections on a periodic basis to ensure that such establishments are operating in a sanitary manner.[24] Generally, such establishments are scored on a point system during the inspection, with points corresponding to certain conditions or violations observed during the inspection. A report is prepared in

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[22] Pub. L. 115-97, Sections 13306(a)(2) and (b)(3).

[23] AICPA, Comment Letter on Notice 2018-23, https://www.aicpa.org/content/dam/aicpa/advocacy\tax/downloadabledocuments/20180613-aicpa-comment-letter-on-notice-2018-23.pdf, pg 3.

[24] *See* §23-04 of Title 24 of the Rules of the City of New York ("The Department, whenever practicable and subject to §23-04, shall conduct an inspection cycle at least annually at each food service establishment required by §81.51 of the Health Code to post a letter grade for the purpose of issuing such establishment a grade that identifies and represents that establishment's compliance with those laws and regulations that require it to operate in a sanitary manner so as to protect public health."); §23-05 ("The Department shall issue a notice of violation whenever a food service establishment is cited on any sanitary inspection for one or more critical violations or accumulates 14 or more points, regardless of whether any critical violations are cited on such inspection."); §23-06 ("Findings of serious and persistent violations or uncorrected public health hazards on any sanitary inspection may provide the basis for commencement of a proceeding to revoke or suspend a permit pursuant to Article 5 of the Health Code.").

connection with the inspection to document any violations observed, and a notice of violation may be issued where the inspector observes certain critical health and safety violations, or where the establishment scores more than a minimum amount number of points. Penalties may be imposed for sustained violations. If the initial inspection is treated as an investigation or inquiry into a potential violation of law, Section 162(f) may disallow a deduction for certain costs and expenses that may otherwise be incurred in the ordinary course of business.[25] The following examples highlight the concern:

> **Example 1A**. R, a restaurant in City N, is subject to periodic inspections conducted by City N's health department for purposes of ensuring R is operating under safe and sanitary conditions. On Date 1, Inspector performs an inspection of R's premises. Inspector identifies a number of minor violations of City N's health code, documents such violations in an inspection report, and discusses with R certain remediation measures that R may take to resolve such violations. Because the violations are limited in scope and do not raise critical health and safety issues, R passes the inspection and no notice of violation is issued to, or penalties assessed against, R arising from the inspection. R takes steps to remediate the violations identified by Inspector and come fully into compliance with City N's health code prior to R's next periodic inspection.
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> **Example 1B**. Same as Example 1A, except, even though the violations are limited in scope and do not raise critical health and safety issues, Inspector identifies enough minor violations to require a second, follow-up inspection within a month. R takes steps to remediate the violations identified by Inspector and come fully into compliance with City N's health code prior to the follow-up inspection. R passes the second review and is not issued a written notice of violation and is not required to pay any penalties.

In the examples above, it would be reasonable to conclude R would be allowed a deduction to the extent permitted under Section 162(a) for any ordinary and necessary business expenses incurred by R. However, if R is treated as incurring such costs at the direction of City N's health department in connection with an investigation or inquiry into a potential violation of law, it would appear that the general disallowance rule of Section 162(f) would apply, and that R may not be able to avail itself of the Compliance with Law Exception, because, even though R incurs costs to come into compliance with

[25] Another instance where a government agency may conduct ordinary course inspections is routine inspections of buildings and other structures. A building inspector may identify repairs or other matters to be addressed by an owner in the course of an inspection. To the extent that a deduction is otherwise permitted for any such repairs made by the owner, we generally would not expect Section 162(f) to disallow such deduction.

law, the Compliance with Law Exception applies only where the Identification Requirement is satisfied in a court order or settlement agreement. We do not see a justification for such a result based on the facts above, nor do we believe such result is necessarily required by the Code. On the other hand, if the health inspector assessed a penalty, fine or other similar amount against R in connection with the violations identified during the inspections, we believe such amounts would clearly fall within the scope of amended Section 162(f) as such payments would be made to a government or governmental entity due to a violation of a law.

> **Example 2A**. B, a banking institution, is subject to the supervision of, and periodic examinations by, O, a federal banking agency. In the ordinary course of its business, B is required to pay semi-annual assessment fees to O, which fees are used to support O in supervising and examining banking institutions to ensure a safe and sound banking system.[26] Following a routine examination, B receives a letter from O indicating that O has identified certain concerns with B's cybersecurity controls and directs B to take corrective action. In response, B invests in additional technology and takes corrective action to enhance its cybersecurity controls.[27]
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> **Example 2B**. Same as Example 2A, except B's letter identifies certain concerns with B's internal compliance as it relates to B's customer identification program. In response, B invests in its internal compliance function and takes corrective action to enhance its customer identification program.
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> **Example 2C**. Same as Example 2B, except B does not take sufficient corrective action and O then pursues an enforcement action against B. In connection with such enforcement action, O and B enter into a settlement agreement (consent order) pursuant to which B is required to develop a formal action plan and take remedial action (including by way of

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[26] See 12 U.S.C. § 481 & 12 C.F.R. § 8.6.

[27] Example 2A describes the process by which the Office of the Comptroller of the Currency (the "***OCC***") may communicate, in the form of a letter, concerns regarding, or violations arising from, deficiencies in a bank's practice through a *Matter Requiring Attention* ("***MRA***") or a *Matter Requiring Immediate Attention* ("***MRIA***"). While the example focuses on an ordinary course examination of a banking institution by the OCC, such ordinary course examinations arise in other contexts as well. For example, in connection with its general audit oversight of public companies, brokers and dealers, the Public Company Accounting Oversight Board ("***PCAOB***") conducts routine inspections of accounting firms for purposes of assessing compliance with the Sarbanes Oxley Act, the rules of the PCAOB and the Securities and Exchange Commission. Where appropriate, an inspection may result in an investigation into potential violations identified in the course of the inspection as well as an enforcement action.

additional investment) to remedy deficiencies in its compliance. The settlement agreement (consent order) appropriately identifies the additional investment by B as amounts paid to come into compliance with law for purposes of the Identification Requirement.

In each of Examples 2A-C above, B could be viewed as making or incurring payments to or at the direction of a governmental agency. The semi-annual assessment fees collected by O in Example 2A provide the agency with funding to enable it to exercise its supervisory functions. These fees may ultimately be used to fund the costs of examinations or other investigations by O relating to violations or potential violations of law by B or other banking institutions. The payment of semi-annual assessment fees by B represents a cost of doing business for B that is not directly related to an investigation into a violation or potential violation of law. To address such amounts, we recommend Treasury clarify in the final regulations that otherwise deductible amounts paid to a government or governmental entity pursuant to a scheme of general applicability and that are not dependent on the existence of a violation or potential violation of law are not subject to Section 162(f)(1).

Examples 2A and 2B raise similar considerations to those raised by Examples 1A and 1B with regard to remedial expenses incurred by a taxpayer. In each of the examples, the relevant governmental authority identifies a violation or potential violation of law in the course of an inspection or examination conducted in the ordinary course and the violating or deficient party takes remedial measures to correct such violations and deficiencies. If B is treated as incurring costs at the direction of O in connection with an investigation or inquiry into a potential violation of law, then any deductions in respect of the expenses incurred by B would be disallowed under Section 162(f) as no exception would appear to apply under Section 162(f). We contrast Examples 2A and 2B with Example 2C, where, assuming B is able to satisfy the Establishment Requirement, the Compliance with Law Exception would be available given the presence of a settlement agreement. We believe that disallowing deductions in Examples 2A and 2B would be an anomalous result.[28]

There are a number of possible approaches the final regulations could adopt to address the concerns raised by the foregoing examples. The final regulations could provide guidance as to when an amount paid or incurred is appropriately treated as paid or incurred at the direction of the government, bringing such amount within the scope of Section 162(f). More specifically, the final regulations could provide guidance as to

[28] We note that under Section 162(f)(2) a deduction is not disallowed with respect to compliance costs that are identified "in *the* court order or settlement agreement." (emphasis added). A reasonable interpretation of the statute is that Congress did not intend for the limitation on deductions under Section 162(f)(1) to cover compliance costs incurred during the period before there is either a court order or settlement agreement.

whether and/or under what circumstances amounts paid or incurred by a taxpayer in response to an ordinary course examination, inspection or similar undertaking are treated as paid in connection with an investigation or inquiry into the potential violation of any law for purposes of Section 162(f)(1). If the expenses incurred by the taxpayers in the examples above are appropriately viewed as incurred in the ordinary course of business and not paid at the direction of a government in relation to an investigation or inquiry by such government into the potential violation of any law, then amended Section 162(f) would not apply and each of R and B would be able to deduct its ordinary and necessary business expenses to the extent otherwise permitted under Section 162(a). We do not believe that Section 162(f), as amended, was designed to disallow ordinary course business expenses of the type described in the examples above and we believe the final regulations should clarify that the scope of Section 162(f) does not extend to remedial expenses incurred by a taxpayer incident to an ordinary course examination, investigation or similar review where the nature of the examination, investigation or similar review does not result in a dispute involving a court order or settlement agreement.

Arguably, examinations, inspections and other similar reviews of general applicability should not be treated at the outset as an investigation or inquiry into a potential violation of law for purposes of Section 162(f) absent additional facts demonstrating that such examination, inspection or similar review was undertaken in response to a specific violation or potential violation of law. Alternatively, even if such examination, inspection or similar review could be considered at the outset as an investigation or inquiry into a potential violation of law, expenses incurred by a taxpayer in the ordinary course of business for purposes of coming into or maintaining compliance with law generally should not be viewed as paid at the direction of the government where the taxpayer undertakes to remediate any compliance concerns and exercises control over the manner of its compliance. We do not believe that Section 162(f) should be construed in a manner that would frustrate compliance with law, nor do we believe that the deductibility of any amounts described in the examples above should depend on whether the expenses at issue were incurred before or following the applicable inspection or examination.

We recognize that an inspection or examination that commences in the ordinary course of business without regard to a particular violation may evolve into a more targeted investigation or inquiry into a potential violation of law. Consider the following example:

> **Example 2D**. Same as Example 2A, except that in the course of O's routine examination, O alleges violations of criminal and civil anti-money laundering statutes in B's transactions with foreign affiliates and customers. B disputes O's allegations. Eventually, O and B agree to a settlement pursuant to which B agrees to (*i*) improve its compliance systems and internal controls in respect of cross-border transactions and

(*ii*) pay to O the sum of $100 million. B does not admit, however, to any violations of law in the settlement agreement.

Example 2D is distinguishable from the prior examples. In connection with the examination described in Example 2D, O identified specific concerns that B violated law and pursued action against B. Notwithstanding that B may disclaim any potential wrongdoing in the settlement agreement or otherwise, the amounts payable pursuant to the settlement agreement in Example 2D appropriately should be treated as amounts paid or incurred to or at the direction of a government or governmental entity in relation to a violation or potential violation of law subject to Section 162(f)(1) unless an exception applies. We recognize that the precise point of the evolution of an examination of general applicability into a targeted investigation or inquiry into a violation or potential violation of law may not always be clear, although we believe that any amounts paid to or at the direction of a government or governmental entity in connection with a court order, settlement agreement, consent decree or other similar agreement between the taxpayer and such government or governmental entity whether or not arising in connection with an ordinary course examination, inspection or similar review may be disallowed as a deduction under Section 162(f)(1) unless an exception applies.

To address the concerns raised the examples above, we offer the following recommendations for guidance:[29]

- *Recommendation 1: Guidance on "at the direction of"* – Provide in the final regulations that, in the absence of a court order, settlement agreement, consent decree or other similar agreement between the taxpayer and the government or a governmental entity, amounts paid or incurred in the ordinary course of business to come into or otherwise maintain compliance with law, even if prompted by a routine governmental inspection, will not be treated as paid or incurred at the direction of a government or governmental entity and thus are not subject to potential disallowance under Section 162(f) (the "***Primary Recommendation***").

- *Recommendation 2: Guidance on "investigation or inquiry"* – As an alternative to, or in conjunction with, our Primary Recommendation above, provide in the final regulations that, where an examination, inspection, audit or similar review is required to be conducted in the ordinary course of business in connection with the oversight or supervisory authority of a government or governmental entity, such

[29] We note that the Primary Recommendation and the Secondary Recommendation described herein are not necessarily mutually exclusive and Treasury may consider adopting a combination of these recommendations.

examination, inspection, audit or similar review as an initial matter, is not an investigation or inquiry into a potential violation with law but may result in an investigation or inquiry into a potential violation of law following written communication by a government or governmental authority alleging specific violations or potential violations of law requiring additional investigation or inquiry (the "***Secondary Recommendation***").

- *Recommendation 3: Deemed Settlement Agreement* – In the event Treasury does not adopt either of the recommendations above, we would propose as an alternative that the final regulations provide a path to enable satisfaction of the Identification Requirement where the taxpayer receives an examination, inspection or other similar report or other document that identifies a violation or potential violations of law requiring remediation or other action to achieve or maintain compliance, the taxpayer signs an acknowledgement of receipt of such document and the taxpayer voluntarily undertakes to remediate such violations or potential violations. The countersigned document could effectively take the place of a more traditional settlement agreement for purposes of enabling the taxpayer to satisfy the Identification Requirement with respect to such amounts (the *"**Alternative Recommendation**"*).

We believe the presumption contained in the Primary Recommendation described above offers a manageable standard of application and avoids unnecessary administrative disruption. Therefore we strongly recommend that Treasury adopt the Primary Recommendation. We also believe that the Secondary Recommendation described above offers a promising path forward for addressing the concerns raised in the examples above, and that it is particularly well suited to determining whether amounts paid to cover costs of government examinations are subject to disallowance as "amount[s] paid or incurred as reimbursement to the government or entity for the costs of any investigation or litigation" pursuant to Section 162(f)(2)(B). However, we acknowledge that the Secondary Recommendation ultimately requires an evaluation of the facts and circumstances underlying the particular examination, inspection or similar review on a case by case basis that may be in tension with the aim of Section 162(f) to minimize opportunities for disputes that existed under prior law. As to the Alternative Recommendation, we acknowledge that such a construct may increase administrative and other burdens placed on taxpayers and the government. In addition, we note that any agreement that is treated as a settlement agreement for purposes of Section 162(f) would be subject to reporting under Section 6050X, which could further complicate the government's reporting obligations (particularly where the government may not have insight into the amount of remedial costs and expenses paid or incurred by the

taxpayer).[30] Finally, we note that the Primary Recommendation may also operate to preserve deductibility of certain ordinary and necessary expenses paid or incurred incident to an investigation or inquiry targeted at specific concerns over violations of law where such expenses are not subject to the resolution of the investigation or inquiry or where such expenses may be viewed as unrelated to the targeted investigation or inquiry.

> **Example 2E**. Following a whistleblower complaint alleging violations by B of criminal and civil anti-money laundering statutes, O commences an investigation into B's transactions with foreign affiliates and customers. O determines that the whistleblower's allegations are unfounded and does not pursue further action against B in respect of such allegations. However, in the course of O's review of B's transactions, O identifies certain concerns with B's internal compliance as it relates to B's customer identification program. At the conclusion of its review, O issues a letter to B acknowledging that it has concluded its investigation into anti-money laundering and requesting B take corrective action to enhance its customer identification program by adopting a set of "best practices" published by an industry trade group.

Under the Primary Recommendation, Section 162(f)(1) should not apply to deductions for ordinary and necessary business expenses incurred by B to enhance its customer identification program. Such expenses are not incurred pursuant to a court order, settlement agreement, consent decree or other similar agreement between O and B. Further, it would seem inappropriate to treat expenses incurred in response to a request or a recommendation to adopt "best practices" or otherwise enhance general compliance as nondeductible under Section 162(f).

B. Restitution and Remediation; Compliance with Law

A deduction generally will not be disallowed under Section 162(f)(1) for amounts paid or incurred as restitution, remediation or to come into compliance with law, *provided* that each of the Establishment Requirement and the Identification Requirement is satisfied.[31] Proposed Regulations Section 1.162-21(f)(3)(i) provides that an amount is treated as paid or incurred for restitution or remediation "if it restores, in whole or in part, the person, as defined in section 7701(a)(1); the government, the governmental entity; or property harmed by the violation or potential violation of law." Proposed Regulations Section 1.162-21(f)(3)(ii) provides that an amount can be treated as paid or incurred for purposes of coming into compliance with law "by performing services, taking action, providing property, or doing a combination thereof." The Proposed Regulations

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30 *See* discussion in Part IV.H.

31 Section 162(f)(2)(A).

explicitly exclude from these definitions certain categories of payments, including, amounts paid to reimburse a government for investigation or litigation cost, amounts paid in lieu of a fine or penalty, or amounts paid as forfeiture or disgorgement.[32] Also excluded from treatment as a payment for restitution, remediation or compliance with law are payments to restitution or remediation funds to the extent the payment does not satisfy the definitional requirements described above.

We appreciate Treasury's efforts to provide guidance defining restitution for purposes of Section 162(f) and we generally agree that amounts paid to restore harm are appropriately treated as restitution. We recommend, however, that Treasury include in the final regulations the following underscored drafting comments to Proposed Regulations Section 1.162-21(f)(3)(i), which we view as consistent with Treasury's description of restitution contained in the Preamble to the Proposed Regulations:[33]

> An amount is paid or incurred for restitution or remediation pursuant to paragraph (b)(1) of this section if it <u>is paid or incurred to restore</u>, in whole or in part, the person, as defined in section 7701(a)(1); the government; the governmental entity; or property harmed <u>or damaged</u> by the violation or potential violation of a law described in paragraph (a)(3) of this section <u>to the same or substantially similar position or condition as existed prior to such harm or damage</u>.

Consistent with the above, we view the Restitution Exception to be relevant where the amounts paid or incurred by a taxpayer are restorative in nature or otherwise provide compensation to a party that has suffered harm or damages for the purpose of making such party whole. We do not believe, however, that the blanket exclusion in Proposed Regulations Section 1.162-21(f)(3)(iii)(C) for amounts paid as forfeiture or disgorgement is appropriate in all circumstances because we do not foreclose the possibility that amounts labeled as forfeiture or disgorgement may be appropriately treated as restitution in some cases. The Preamble to the Proposed Regulations cites *Kokesh v. Securities and Exchange Commission*[34] as support for excluding forfeiture and disgorgement from restitution on the basis that "[f]orfeiture and disgorgement focus on the unjust enrichment of the wrongdoer, not the harm to the victim." *Kokesh* involved the question of whether disgorgement in the context of an SEC enforcement action operates as a penalty and is therefore subject to a five year statute of limitations on

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32 Prop. Treas. Reg. § 1.162-21(f)(3)(iii).

33 85 Fed. Reg. 28527.

34 *Id.*

claims.[35] In holding that disgorgement, as applied in the context of the particular SEC enforcement proceeding, operates as a penalty, the Court considered the payment of disgorgement to be imposed for punitive purposes.[36] The Court in *Kokesh* noted that, while disgorged funds may be applied by the government to compensate securities fraud victims, the lower court was under no compulsion to require such funds to be paid out as compensation.[37] In the context of disgorgement for securities law violations, as described in *Kokesh*, where the remedy is intended to be punitive in nature, with no obligation on the part of the government to further disburse such amounts to restore harm or damage to injured parties, our view is that such amounts should not be treated as restitution under amended Section 162(f)(2)(A).

We do not foreclose, however, that on different facts payments of amounts labeled as disgorgement may properly be treated as restitution. The terms disgorgement and restitution may at times be used interchangeably and at other times treated as distinct remedies.[38] As the Supreme Court recently recognized in its decision *Liu v. Securities and Exchange Commission*, disgorgement may constitute an equitable remedy—and thus not a penalty—if the award does not exceed a wrongdoer's net profits and it is awarded to

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[35] 137 S. Ct. 1635, 1639 (2017) ("A 5–year statute of limitations applies to any 'action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise.' 28 U.S.C. § 2462. This case presents the question whether § 2462 applies to claims for disgorgement imposed as a sanction for violating a federal securities law. The Court holds that it does. Disgorgement in the securities-enforcement context is a "penalty" within the meaning of § 2462, and so disgorgement actions must be commenced within five years of the date the claim accrues.")

[36] As it relates to SEC enforcement proceeds, "courts have consistently held that "[t]he primary purpose of disgorgement orders is to deter violations of securities laws by depriving violators off their ill-gotten gains."" *Id*. at 1643 (citing *SEC v. Fischbach Corp.*, 133 F.3d 170, 175 (C.A.2 1997)).

[37] *Id*. at 1644. *See also Fischbach Corp.*, 133 F.3d at 175 ("Once the profits have been disgorged, it remains within the court's discretion to determine how and to whom the money will be distributed, and the district court's distribution plan will not be disturbed on appeal unless that discretion has been abused.").

[38] *See, e.g.*, JAMES M. FISCHER, UNDERSTANDING REMEDIES § 51 (2010). *See also* Saul Levmore & William J. Stuntz, *Remedies and Incentives in Private and Public Law: A Comparative Essay*, 1990 WIS L. REV. 483, 484 (1990) ("In this Essay we often use the terms disgorgement and restitution interchangeably. The traditional connotation of restitution is that A returns to B that which A unjustly received as a result of B's efforts or misfortune. And inasmuch as some of the circumstances discussed in this Essay concern situations where B has not caused A's enrichment, some commentators and readers will prefer the label of disgorgement."). In other contexts, the two may be distinguished with restitution defined as "the giving back of wealth received by a defendant from a claimant, which must be given back or restored because it amounts to an unjust enrichment at the claimant's expense" and disgorgement defined as "the giving up to a claimant of a gain made by a defendant, as consequence of a wrongdoing committed against the claimant, but received from a third party. R. B. Grantham & C. E. F. Rickett, *Disgorgement for Unjust Enrichment*, 62 CAMBRIDGE L. J. 159 (2003).

victims.[39] The IRS has similarly acknowledged that disgorgement can be primarily compensatory in nature depending on the facts and circumstances of a particular case.[40] Where a particular type of remedy may serve more than one purpose, we believe it appropriate to consider the purpose of the remedy in the context of the particular action.[41] Further, while the Preamble to the Proposed Regulations points to *Kokesh* as support for excluding forfeiture and disgorgement from restitution, the analysis in *Kokesh* is confined to a particular SEC enforcement action and is not necessarily dispositive of the appropriate treatment of forfeiture or disgorgement in other types of actions.[42] As the Court noted in *Liu*, the *Kokesh* Court evaluated a particular application of the SEC's disgorgement remedy and the characterization of the remedy in *Kokesh* does not necessarily extend to other applications of the disgorgement remedy.[43]

In some cases disgorgement may be punitive. In other cases, damages that are intended to restore a victim for harm caused by an offending party may be calculated by reference to an offending party's profits.[44] And in still other cases, disgorgement may be identified as an equitable remedy, intended neither for punitive nor compensatory purposes.[45] The amount of the offending party's profit may equal the victim's losses or disgorgement may be used to obtain compensation for victims who can receive

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39 No. 18-1501, slip op. at 1 (S. Ct. June 22, 2020).

40 *See* CCA 201825027 (Nov. 18, 2016).

41 *See Middle Atlantic Distributors*, 72 T.C. at 1145.

42 *See Kokesh*, 137 S. Ct. at 1642 ("The sole question presented in this case is whether disgorgement, as applied in SEC enforcement actions, is subject to § 2462's limitations period."). *See also Liu v. SEC*, No. 18-1501, slip op. at 17 (S. Ct. June 22, 2020) ("Petitioners go further. They claim that this Court effectively decided in *Kokesh* that disgorgement is necessarily a penalty, and thus not the kind of relief available at equity. Not so. *Kokesh* expressly declined to pass on the question.").

43 *Id.* at 12-13.

44 For example, in the context of a trademark infringement case, damages owed to a victim of trademark infringement may be determined by reference to the infringer's profits. Courts have described such disgorgement as being intended to "compensate the plaintiff for sales which he has lost as a result of his customers being diverted to the infringer." *SpinMaster, Ltd. v. Zobmondo Entm't, LLC*, 944 F. Supp. 2d 830, 840 (C.D. Cal. 2012).

45 For example, under former Section 162(f), the IRS Office of Chief Counsel concluded that the disgorgement of profits under a consent decree entered into to resolve an action brought on behalf of the Food and Drug Administration for a taxpayer's alleged violations of the Federal Food, Drug, and Cosmetic Act with respect to its drug manufacturing operations was not non-deductible. A key factor in this determination was that the Food and Drug Administration viewed disgorgement in this context as neither compensatory nor punitive, but as a deterrent for other regulated companies. *See* LAFA 20152103F (May 22, 2015).

distributions through a compensation fund.[46] Where the available remedy is described as disgorgement, but the purpose and application of the remedy is to compensate or restore an injured party for harm or damages suffered, we believe payment of such amounts to or for the benefit of such injured party appropriately should be treated as restitution for purposes of Section 162(f). As currently drafted, however, the Proposed Regulations would appear to deny a deduction for any payment labeled as "disgorgement" in a court order or agreement even if paid to restore or compensate an injured party for harm or damages suffered and identified as restitution in the applicable court order or settlement agreement.

We recommend Treasury remove the exception for forfeiture or disgorgement contained in Proposed Regulations Section 1.162-21(f)(3)(iii)(C) and instead, where identified as restitution (or its corollaries, as appropriate) in the applicable court order or settlement agreement, leave the further burden with the taxpayer to establish that amounts paid in the form of forfeiture or disgorgement are appropriately treated as restitution. We generally would expect that a payment made at the direction of the government to a private party that is (*i*) established as being paid to restore or compensate the injured party for harm or damages suffered and (*ii*) identified in the applicable court order or settlement agreement as restitution and that otherwise satisfies the other requirements contained in Section 162(f)(2)(A) may be appropriately treated as restitution. For disgorgement or forfeiture payments that are made to the government, we would similarly expect that a payment that is (*i*) established to be compensatory or restorative with respect to harm or damage suffered by the government or another party and (*ii*) identified in the applicable court order or settlement agreement as restitution and that otherwise satisfies the other requirements contained in Section 162(f)(2)(A) may be appropriately treated as restitution. In the case where the government was not itself harmed or damaged by the relevant the violation or potential violation of a law, we would generally expect that the taxpayer would also need to establish that the government is generally required to pay such amounts out as compensation to parties harmed or damaged by the taxpayer's violation or potential violation.

We acknowledge that there is some disagreement as to whether restitution should include forfeiture and disgorgement.[47] We also acknowledge that the absence of a bright-line rule excluding forfeiture and disgorgement from restitution may leave the application of Section 162(f) open to interpretation by taxpayers, including interpretation that may be inconsistent with the statutory intent, resulting in further disputes with the IRS. However, we believe that the potential treatment of disgorgement as restitution should be

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[46] *See* CCA 201825027 (Nov. 18, 2016). *See also* CCA 201619008 (Jan. 29, 2016) (noting the SEC may be using disgorgement as a means to obtain compensation for harmed investors, who can receive distributions through a Fair Fund or Disgorgement Fund).

[47] *See* 85 Fed. Reg. 28527.

evaluated based upon the particular facts and circumstances at issue. The burden should remain with the taxpayer to properly establish that amounts paid as disgorgement may be treated as restitution.

Regardless of whether Treasury adopts the foregoing recommendation, we recommend that Treasury consider including a bright-line rule in the final regulations addressing amounts paid to private parties at the direction of the government. In the case where harm or damage is sustained by a private party and amounts appropriately identified as restitution in the applicable court order or settlement agreement are paid to such private party at the direction of the government, such amounts would appear to be restitution. This would appear to be the case regardless of whether (*i*) such amounts were paid directly to such private party or to a fund or other arrangement established for the benefit of such private party or (*ii*) the remedy for damages takes the form of disgorgement or is otherwise measured by reference to the violating party's profit.[48] We contrast the case of a private party recipient with a case in which the government is the recipient of disgorged amounts. We acknowledge that in the case of a payment to the government, the case for restitution treatment generally will be harder absent a clear and convincing factual demonstration that such disgorged amounts are paid to the government to restore the government for harm or damages sustained or are required to be paid over by the government to the injured party or parties.

Finally, we recommend that Treasury clarify Proposed Regulations Section 1.162-21(f)(3)(iii)(D). This provision excludes from the definition of restitution, remediation, and amounts paid to come into compliance with a law amounts paid or incurred to an entity; to a fund, including a restitution, remediation, or other fund; to a group; or to a government or governmental entity to the extent such amounts would otherwise not meet the satisfy the restitution or compliance with law requirements contained in Proposed Regulations Sections 1.162-21(f)(3)(i) and (ii). The meaning and intent of Proposed Regulations Section 1.162-21(f)(3)(iii)(D) are not entirely clear. Additionally there appears to be an inconsistency between the text of the Proposed Regulation and the explanation of the provision in the Preamble. The Preamble provides that under Proposed Regulations Section 1.162-21(f)(3)(iii)(D) "restitution, remediation, and amounts paid to come into compliance with a law do not include any amount paid or incurred to an entity; to a fund, including a restitution, remediation, or other fund; to a group; or to a government or governmental entity, to the extent ***it was not harmed by the taxpayer's violation or potential violation of a law***".[49] The Preamble presupposes that for

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[48] We contrast the case of a private party recipient with a case in which the government is the recipient of disgorged amounts. Generally we expect the case for restitution treatment where the government is the recipient will be much harder absent clear and convincing facts that such disgorged amounts are paid to the government to restore the government for harm or damages sustained or required to be paid by the government to the injured party.

[49] 85 Fed. Reg. 28527 (emphasis added).

a payment to qualify for the Restitution Exception the recipient of the funds must have been harmed by the taxpayer's violation. In contrast, the Proposed Regulations seem to only require that the funds be paid or incurred in restoring the person or property harmed by the taxpayer's violation or potential violation of law. We ask that Treasury remove or otherwise clarify Proposed Regulations Section 1.162-21(f)(3)(iii)(D). We also recommend that Treasury clarify that amounts paid pursuant to an applicable court order or settlement agreement into a restitution fund or other similar fund established for the benefit of the person or persons harmed by a violation or potential violation of law may constitute restitution.[50]

> **Example 3A**. D is a defendant in a consumer fraud action brought by State A under state law. State A alleges D misrepresented, omitted and concealed material information regarding services offered by D to consumers in State A. In settlement of the case, D and State A enter into an agreement pursuant to which D is obligated to pay $200,000 civil penalties to State A, $25,000 to cover State A's attorney's fees and other costs and $5,000,000 identified as consumer restitution in the settlement agreement. D's consumer restitution payment is required to be deposited into a subaccount of State A's Consumer Restitution Fund and earmarked for further payment to consumers who received services provided by D. D is required to provide contact information and the amount paid by each consumer to enable State A to administer restitution payments to D's consumers. It is reasonably expected at the time of D's payment to the fund that the amount identified as consumer restitution will be paid to D's customers as restitution.

The civil penalties ($200,000) and State A's attorney's fees and other costs ($25,000) described in Example 3A are non-deductible expenses under amended Section 162(f). In contrast, the consumer restitution ($5,000,000) required to be earmarked as separate funds for payment to consumers harmed by D's actions should be treated as restitution not subject to Section 162(f), provided that D satisfies the Establishment Requirement.

> **Example 3B**. Same as Example 3A, except that if the administrator of the funds earmarked for D's consumers is unable to locate a consumer for payment, or if any payments made or attempted to be made to D's consumers remain unclaimed after a period of time, the amounts deposited

[50] We recognize that whether a payment may be appropriately treated as constituting restitution, remediation, or an amount paid to come into compliance with a law will in many cases require a highly fact-specific analysis. The conclusions to our simplified examples in this Report are solely intended to illustrate the particular principles being discussed and different conclusions may be warranted depending on the facts presented.

into the restitution fund earmarked for such consumers unable to receive payment will be distributed to State A's general consumer protection fund, to be applied at the discretion of State A.

We do not believe that the possibility of unclaimed amounts in the restitution fund reverting to State A's general consumer protection fund under the facts above should impact the nature of the consumer restitution payment made by D as restitution for purposes of Section 162(f). That is to say, the possibility that a portion of the funds otherwise earmarked for consumers who received services provided by D may revert to the general consumer protection fund in the event that such consumers cannot be located by the administrator should not impact the nature of the payment as long as at it was reasonably expected at the time the consumer restitution payment was made by D that the amount would be used for restitution payments to D's customers.

> **Example 3C**. Same as Example 3A, except that the $5,000,000 consumer restitution payment paid by D is not deposited into a separate subaccount earmarked for payment to D's consumers, but instead is required to be deposited into State A's general consumer protection fund and available to be paid to victims of consumer fraud in State A at State A's discretion. D's consumer restitution payment is not intended to be restitution or remediation for any harm suffered by State A or an amount paid by D to come into compliance with law.

Example 3C is distinguishable from Examples 3A and 3B above in that amounts identified as consumer restitution in D's settlement agreement with State A are not required to be paid to consumers of D's services harmed by D's actions or omissions. Given that amounts are not required to be paid to restore D's consumers to the same or substantially similar position or condition such consumers maintained prior to D's fraudulent activity, we do not believe that such amounts are appropriately treated as restitution with respect to D's consumers for purposes of Section 162(f)(2). The analysis of whether a payment may be appropriately treated as restitution is highly fact-specific and under different facts a different outcome may be warranted.

C. Identification Requirement

The Proposed Regulations provide a general rule that a court order or agreement must identify with respect to each payment the taxpayer is obligated to pay the (*i*) the nature or purpose of such payment and (*ii*) amount of such payment.[51] The Proposed Regulations also provide that the identification requirement is presumed to be met if an order or agreement specifically states that the payment and the amount of the payment constitute restitution, remediation, or an amount paid to come into compliance with a

[51] Prop. Treas. Reg. § 1.162-21(b)(2)(i).

law.[52] The presumption can also be satisfied if the order or agreement uses a different form of the required words, such as, "remediate" or "comply with a law."

We recommend that Treasury consider clarifying the relationship between the general identification rule and the presumption. It also would be helpful for the Proposed Regulations to include an example of a court order or agreement that would satisfy the general identification rule without satisfying the presumption. For example, we believe that court orders and settlement agreements in languages other than in English (or English translations of such court orders or agreements) may satisfy the Identification Requirement, even if they do not use the specific words noted in Proposed Treasury Regulations Section 1.162-21(b)(2)(ii) or their direct cognates, so long as the nature or purpose of the payment is sufficiently described therein and such nature or purpose is consistent with restitution, remediation or amounts paid to come into compliance with law.[53] Similarly, a court order or settlement agreement that appropriately conveys the nature or purposes of an amount as restitution, remediation, or an amount paid to come into compliance with a law without using those particular words, may satisfy the general rule without satisfying the presumption. For example, in the context of a violation of environmental law, a court order or agreement that identifies an amount as being paid to "reverse the harm to the property" or "bring the property back into conformity with environmental regulations" would appear to convey appropriately the nature or purpose of the payment.

We also recommend that Treasury identify additional words that if used to describe a payment amount in a court order or agreement would satisfy the presumption. For example, we believe that a payment that is described as being paid to a victim as "compensation" or "reparation" for harm or damage caused by the payor's violation of law should satisfy the presumption. Similarly a payment that is described as being made to come into "conformity" or "adherence" with law should satisfy the presumption. We also believe that identifying an amount as "taxes due" where any associated penalties and interest such penalties are separately stated should satisfy the presumption.[54]

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[52] Prop. Treas. Reg. § 1.162-21(b)(2)(ii).

[53] We are not aware of any evidence that Congress sought to exclude payments made pursuant to court orders of foreign governments from the Restitution Exception. We also note that the Proposed Regulations define a "government or governmental entity" for purpose of Section 162(f) to include the government of a foreign country. Prop. Treas. Reg. § 1.162-21(f)(1)(iii). It would be an anomalous result to exclude any payments made under a court order or settlement agreement in a language other than English from the Restitution Exception, by interpreting Section 162(f)(2)(A)(ii) as requiring that such court order or settlement agreement use a particular set of enumerated words when the same substance may be conveyed through the use of different terms.

[54] *See* discussion in Part IV.F.

The Proposed Regulations provide that the IRS may challenge the characterization of an amount that otherwise satisfies the identification requirement.[55] In particular, the IRS can rebut the presumption discussed above by developing sufficient evidence that the amount paid or incurred was not for the purposes identified in the order or agreement. We agree that the IRS should be able to challenge the characterization of payments that a taxpayer claims to qualify for the Restitution Exception or the Compliance with Law Exception. However, we believe that in challenging the characterization of such a payment, the IRS would more appropriately be challenging the Establishment Requirement rather than the Identification Requirement, which looks to whether certain language identifying the nature or purpose of a payment is present in a governing document, rather than to whether that language accurately expresses the actual intent of the parties or the overall purpose or nature of the amounts paid or incurred. It would appear that Section 162(f)(2)(A)(i) requires the taxpayer to establish the payment was made for a qualifying purpose while Section 162(f)(2)(A)(ii) only requires that the payment be identified in a court order or agreement as having been made for a qualifying purpose. A substantive challenge to the nature of payment would more appropriately fit under the Establishment Requirement rather than the Identification Requirement.

Treasury has requested comments as to how taxpayers may satisfy the identification requirement with respect to court orders or settlement agreements that impose lump-sum judgments or settlements, that impose multiple damage awards or that involve multiple taxpayers. Where such a court order or settlement agreement identifies a specific amount as an amount constituting restitution, remediation or paid to come into compliance with law, the Identification Requirement should be satisfied with respect to such amount. On the other hand, where the court order or settlement agreement does not identify any particular amount as constituting restitution, remediation or paid to come into compliance with law, and the total amount to be paid by a taxpayer pursuant to such agreement is known at the time of such settlement agreement or court order, we do not see a compelling reason as to why the Identification Requirement should be satisfied.

In the case where the parties are unable to agree as to the appropriate amount of the damage award for which the Restitution Exception or Compliance with Law Exception should be available, the court order or settlement agreement may identify a total amount to be paid by a taxpayer pursuant to such agreement and a maximum possible amount that represents restitution, remediation or an amount paid to come into compliance with law. The Executive Committee of the Tax Section is evenly divided on whether the identification of a maximum amount that represents restitution, remediation or an amount paid to come into compliance with law should be treated as satisfying the Identification Requirement. For example:

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[55] Prop. Treas. Reg. § 1.162-21(b)(2)(iv).

**Example 4**. C, a chemical manufacturer, operates a manufacturing plant upriver of a state park operated by State S. A discharge of chemicals into the river causes damage to the park. State S incurs remediation costs to restore the park. S brings an action against C, alleging that C has violated State S environmental laws and regulations and seeking a $20 million penalty. S also brings an action against C seeking $10 million in compensatory damages to make S whole for the remediation costs of restoring the park and an additional $20 million in punitive damages. C denies that it violated any State S environmental laws and regulations and further denies that any damage to the park was caused by C's facility. C also disputes that the amount of compensatory damages claimed by S appropriately represents the remediation costs attributable to the damage to the park from the chemical discharge. C argues that a substantial portion of the remediation costs incurred by S were to restore damage attributable to a recent flood rather than damage attributable to the chemical discharge. The parties ultimately agree to a settlement pursuant to which C agrees to make a payment to S of $15 million. The settlement agreement provides that up to $10 million of the payment represents amounts paid as restitution.

The Executive Committee of the Tax Section is divided as to whether it would be appropriate to treat the Identification Requirement as satisfied where, as in Example 4, the settlement agreement does not designate a specific amount as constituting restitution but instead states that a portion "up to" a stated amount ($10 million in the Example) of an overall lump sum settlement payment constitutes restitution. If the Identification Requirement is treated as satisfied, we would expect that the taxpayer would retain the burden of establishing the actual amount paid for such purpose under the Establishment Requirement.

With respect to payments that may otherwise satisfy the Restitution Exception or the Compliance with Law Exception, the Preamble to the Proposed Regulations highlights concerns expressed by prior commentators regarding the ability to quantify and appropriately identify actual amounts required to be paid as restitution or to come into compliance with law at the time the court order or settlement agreement is entered into. Treasury has specifically requested comments regarding the ability to satisfy the Identification Requirement where the applicable court order or settlement agreement identifies a payment amount that is less than the amount the taxpayer is able to establish is paid for restitution, remediation or to come into compliance with law. We believe Proposed Regulations Section 1.162-21(b)(2)(iii) offers a construct for addressing this concern. The Preamble indicates that Proposed Regulations Section 1.162-21(b)(2)(iii) is intended to put taxpayers that are required to make in-kind payments (including by providing services or property) on equal footing with taxpayers required to make cash

payments pursuant to a court order or settlement agreement.[56] However, as drafted, Proposed Regulations Section 1.162-21(b)(2)(iii) could also apply to amounts required to be paid by a taxpayer that cannot be identified with reasonable certainty at the time of the court order or settlement agreement (for example, ongoing costs of compliance or remediation required to be undertaken by the taxpayer in the future). So long as the court order or settlement agreement sufficiently describes the damage or harm done or the manner of noncompliance with law and identifies the corrective action to be taken or costs to be incurred in connection with such harm, damage or noncompliance, then we believe that the Identification Requirement may be satisfied with respect to amounts ultimately paid in respect of such damage or harm. However, we recommend Treasury clarify that Proposed Regulations Section 1.162-21(b)(2)(iii) generally applies only with respect to amounts that are not reasonably certain at the time of the court order or settlement agreement.

D. Establishment Requirement

The Proposed Regulations provide that a taxpayer will satisfy the establishment requirement by providing documentary evidence of the (*i*) taxpayer's legal obligation to pay the amount the order or agreement identified as restitution, remediation, or to come into compliance with a law, (*ii*) amount paid and (*iii*) date on which the amount was paid or incurred.[57]

We note there is ambiguity in the Proposed Regulations as to whether the taxpayer is required to substantiate merely the taxpayer's legal obligation to pay the identified amounts or if the taxpayer must also substantiate that the identified amounts were *appropriately* identified as restitution, remediation, or to come into compliance with a law. That is to say, once the taxpayer has substantiated the amount paid and the date the amount was paid, it is unclear whether evidence that the taxpayer was under a legal obligation to pay the amount is sufficient to meet the establishment requirement or if something more is required.

The Proposed Regulations imply that the taxpayer must establish something more than a legal obligation to pay. For example, the list of documentary evidence described as relevant to the Establishment Requirement includes documents issued by a government relating to an investigation, documents describing how the amount to be paid was determined, and correspondence exchanged between the taxpayer and a government before the order or agreement became binding.[58] These documents would seem to be

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[56] 85 Fed. Reg. 28528.

[57] Prop. Treas. Reg. § 1.162-21(b)(3).

[58] Prop. Treas. Reg. § 1.162-21(b)(3)(ii).

most relevant to the analysis of the underlying purpose of a payment, but have limited relevance in determining whether a payment was legally obligated. Similarly, Example 2 in the Proposed Regulations suggests that Corp. A must establish that an amount identified in an agreement with State T's security agency as required to be paid to third-party B as restitution for B's investment losses "was paid for that purpose."[59] This too suggests that the Establishment Requirement goes to the purpose of a payment rather than whether such payment is legally obligated to be made.

As discussed above, in the case where a payment is identified as restitution or to come into compliance with law in a court order or settlement agreement and the taxpayer establishes through documentary evidence its legal obligation to make such payment, the date of such payment, and the amount of such payment, but where in reality the purpose of such payment is to penalize the payor rather than restore a victim or come into compliance with law, it is unclear whether the payment would fail the Identification Requirement or the Establishment Requirement. We recommend that Treasury clarify that the Establishment Requirement encompasses analysis of the actual purpose of a payment and that in contrast the Identification Requirement is formulaic concerning whether required language is included in the court order or agreement. If Treasury adopts this clarification, we believe that it would no longer be necessary to include Proposed Regulations Section 1.162-21(b)(2)(iv) in the final regulations, as a challenge to the purported purposes of a payment would fall squarely within the scope of the Establishment Requirement. If Treasury instead takes the position that the Identification Requirement encompasses analysis of the actual purpose of a payment, we suggest that Treasury clarify that for purposes of the Establishment Requirement, a taxpayer's legal obligation to pay an amount is satisfied if a court order or agreement directs the taxpayer to pay such amount.

Finally, if the final regulations provide that the Establishment Requirement encompasses an analysis of the actual purpose of a payment and Treasury adopts the position discussed in connection with Example 4 that the Identification Requirement may be satisfied for lump-sum or multiple damages payments where the court order or settlement agreement specifies a maximum amount of restitution, remediation, or coming into compliance with law, it would be helpful for Treasury to provide additional guidance in the final regulations as to how taxpayers may satisfy the Establishment Requirement in the context of such payments. Where the parties are unable to agree as to the specific portion of a payment constituting restitution, remediation or made to come into compliance with law, it would be helpful for the final regulations to provide examples of documentation necessary to satisfy the Establishment Requirement and how much deference should be given to the amount identified in the court order or settlement agreement. For example, what impact, if any, should the dispute between the parties

[59] Prop. Treas. Reg. § 1.162-21(g), Ex.(2).

regarding the appropriate measure of remediation costs in Example 4 above have on C's ability to satisfy the Establishment Requirement? Would State S's claim of $10 million for remediation costs be sufficient to substantiate the Establishment Requirement? We recommend Treasury include additional guidance in the final regulations regarding how a taxpayer may substantiate the Establishment Requirement for lump-sum payments and multiple damages awards.

E. Suits between Private Parties

Section 162(f)(3) provides that Section 162(f)(1) will not disallow a deduction for any amount paid or incurred by reason of any order of a court in a suit in which no government or governmental entity is a party, even if such amount is paid to a government in relation to the violation of any law.

1. Scope of Exception; Qui Tam Suits

The final regulations should address whether amounts paid to the government by reason of an order of a court in, or a settlement of, a qui tam suit alleging violation of law are within the scope of the private party exception.[60] A majority of the Executive Committee of the Tax Section is of the opinion that, because a qui tam suit is brought for the benefit of a government, this exception should not apply. However, a substantial minority took a contrary view when the government for whose benefit a suit is brought has declined to participate and the taxpayer can demonstrate, based on all of the facts and circumstances, that it made a payment only to free itself from the costs of meritless litigation and not because there was a bona fide assertion of violation of law. The final regulations should clarify the matter.

We also believe that the final regulations should clarify whether attorney's fees paid to the private plaintiff and remitted by that plaintiff to its attorney, or paid

[60] A qui tam lawsuit is a type of whistleblower lawsuit that is brought under the False Claims Act (31 U.S.C. §§ 3729-3733) or an analogous state statute. Generally, a person who is found to have violated the False Claims Act is liable for treble the amount of the government's damages, a penalty of $10,000 (adjusted for inflation) per fraudulent claim, and certain other monetary penalties. The whistleblower who brings the case is generally entitled to 15-25% (or up to 30% if the government declines to participate in the action) of the proceeds of such an award or of the settlement amount, and the private plaintiff also "receive[s] an amount for reasonable expenses which the court finds to have been necessarily incurred, plus reasonable attorneys' fees and costs. All such expenses, fees, and costs shall be awarded against the defendant." Many states, including New York, have similar statutes. *See, e.g.*, New York State Finance Law, Art. 13, §§ 187-194.

To the extent that a qui tam suit makes claims grounded in contract or tort, rather than in violation of law, there is no basis for Section 162(f) to apply. (The same, indeed, is true of actions by governments directly against taxpayers.)

directly to the plaintiff's counsel by reason of an order of a court in, or a settlement of, a qui tam suit in which the government has declined to participate should be treated as "paid … to, or at the direction of, a government." Meritorious arguments grounded in general principles of tax law and in the particular nature of qui tam suits can be made on each side of this issue. One argument in favor of treating such fees as paid to or at the direction of the government is the assignment of income doctrine laid out in *Commissioner v. Banks*.[61] In that case, the Supreme Court held that the plaintiff's attorney's contingent fees were properly characterized as gross income to the plaintiff, since the plaintiff exercised dominion and control over the income-producing source (i.e., the claim) and, therefore, the attorney was properly viewed as acting as the plaintiff's agent, without any separate property interests in the claim. The same argument could apply to characterize attorney's fees in a qui tam suit, if the plaintiff is viewed as acting on behalf of the government,[62] and the government in turn is viewed as exercising dominion and control over the claim. On the other hand, reasonable arguments can be made that, when the government declines to participate in a qui tam suit, the government relinquishes any control over the claim, so that attorney's fees should not be viewed as being paid "on behalf of " the government, and that, where fees are statutorily awarded directly to the plaintiff's attorney, those fees could be characterized as property belonging, in the first instance, to the attorney and therefore not subject to disallowance under Section 162(f).[63] The final regulations should clarify the treatment of such amounts.[64]

### 2. Settlement of Suits That Do Come Within the Private Party Exception

Proposed Regulations Section 1.162-21(c)(1) expands the private party exception to amounts paid or incurred by reason of an agreement in settlement of suits that otherwise comes within its scope. We concur with this expansion, because the settlement of lawsuits should be encouraged, and because there is no sound policy to limit allowance

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61 543 U.S. 426 (2005).

62 *Compare* 31 U.S.C § 3730(b)(1) (*qui tam* action brought for private party "and for the United States").

63 *See, e.g., Flannery v. Prentiss*, 26 Cal. 4th 572 (2001) (fees awarded under California Fair Employment and Housing Act belonged "to the attorneys who labored to earn them" and not to the plaintiff). *See also, e.g., Commissioner v. Banks*, 543 U.S. 426, at 438–-39 (declining to address whether awards under statutory fee-shifting provisions might possibly be treated differently from those under private contingent-fee contracts like the one at issue in *Banks*).

64 Whether similar arguments could be made regarding the treatment of amounts paid by the defendant directly to the private plaintiff itself is beyond the scope of this Report.

of a deduction in circumstances otherwise within the statutory exception to cases in which a formal court order is obtained.

F. Exception for Taxes

As described above, Section 162(f)(2)(A) provides that deductions will not be disallowed for certain payments constituting restitution. Section 162(f)(2)(A)(iii) contains an additional requirement that must be met in order for the Section 162(f)(2)(A) exception to apply to "any amount of restitution for failure to pay any tax imposed under this title in the same manner as if such amount were such tax." (We refer to such amounts below as "***tax restitution***.") The additional requirement is that such amount would have been allowed as a deduction under chapter 1 of the Code if it had been timely paid.[65] The Code's definition of "tax restitution" is garbled, and the legislative history of the provision is unelucidating.[66] Proposed Regulations Section 1.162-21(c)(3) interprets this provision to mean simply that disallowance of deductions under Section 162(f) does not apply to amounts paid or incurred as restitution for failure to pay taxes imposed under the Code which would otherwise be deductible. We concur with this reading.

G. Material Changes to Orders or Agreements Entered into Prior to TCJA

The TCJA amendments to Section 162(f) generally do not apply to amounts paid or incurred pursuant to a binding order or agreement entered into prior to December 22, 2017.[67] The Proposed Regulations provide that, if an order or agreement is materially

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[65] Examples of Federal taxes imposed by title 26 that are deductible for income tax purposes include the GST tax imposed on income distributions (Section 164(a)(4)), employer FICA and FUTA taxes (*see Westby v. Comm'r*, TC Memo 2004-179; James Edward Maule, "State, Local, and Federal Taxes," 525-3rd Tax Mgmt. (BNA) U.S. Income, at IV.C), and one-half of most self-employment taxes (Section 164(f)(1)). Section 275 provides that many Federal taxes are not deductible for income tax purposes, and this prong of the exception for payments of restitution will accordingly not apply to those taxes.

[66] The House report simply states that "[a]n exception also applies to any amount paid or incurred as taxes due." H.R. Rep. No. 115-466, at 430 (2017). The "Bluebook" (the General Explanation of Public Law 115-97 (JCS-1-18)) repeats the same explanation and explains in a footnote that "amounts paid or incurred as taxes due are not affected by the provision (*e.g.*, State taxes that are otherwise deductible). The reference to taxes due is also intended to include interest with respect to such taxes (but not interest, if any, with respect to any penalties imposed with respect to such taxes)."

[67] *See* Section III(B). Such amounts would be subject to the narrower scope of former Section 162(f). We note that none of the TCJA, Section 162(f) or the Proposed Regulations clarifies whether an order subject to appeal is considered binding for this purpose. The Preamble to the Proposed Regulations provides that for the purpose of determining the due date for the information return under Proposed Treasury Regulations Section 1.6050X–1(b)(2), the relevant order or agreement is considered binding "even if all appeals have not been exhausted with respect to the suit, agreement, or otherwise." 85 Fed. Reg. 28530. We recommend that Treasury specify in the final regulations or the preamble to the final regulations that this same rule applies with respect to other uses of the term binding order or agreement in the context of Section 162(f).

changed on or following the date the final regulations become applicable, amounts paid or incurred following the date of any such change will be subject to the provisions of amended Section 162(f).[68] The Proposed Regulations do not define when a modification or change would be considered material so as to bring payments pursuant to an amended court order or settlement agreement within the scope of amended Section 162(f). Rather, the Proposed Regulations appear to subscribe to a facts and circumstances-based approach providing that a material change (*i*) *may* include a change in the nature or purpose of a payment obligation or a change, addition or removal of a payment obligation and (*ii*) does not include a change in payment date or a change to the address of a party to the order or agreement.[69]

We generally agree that it is appropriate to treat a payment or other obligations arising following a material change in a pre-TCJA order or agreement as falling within the scope of amended Section 162(f) where the change affects the nature or the purpose of the obligation that existed prior to the TCJA or materially increases payment or other obligations. We believe additional guidance and examples clarifying the scope of Proposed Treasury Regulations Section 1.162-21(e) would be helpful.

We ask that Treasury consider the following examples:

> **Example 5**. (*Modifications requiring court approval*)
>
> Prior to December 22, 2017, Taxpayer enters into an agreement with X, a government agency, for violating environmental laws. Under the agreement, Taxpayer is required to pay civil penalties and take certain remedial actions to come into compliance with law. The agreement, by its terms, requires that any material modifications to the agreement require court approval. Following the date of publication of the final regulations, Taxpayer and X agree to certain modifications to Taxpayer's remediation plan requiring court approval.

Given the obligation to obtain court approval for any material changes, we would expect any payments made or incurred pursuant to Taxpayer's amended or otherwise modified agreement to be subject to amended Section 162(f).

> **Example 6**. (*Enforcement of existing agreement*)
>
> Facts are the same as Example 5, except following entry into the agreement, X brings a claim against Taxpayer for failure to fully comply

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[68] Prop. Treas. Reg. § 1.162-21(e)(1)

[69] Prop. Treas. Reg. § 1.162-21(e)(2)

with the remedial measures required under the agreement. Taxpayer and X settle the matter and Taxpayer agrees to pay additional penalties together with X's legal costs in pursing enforcement.

We would expect any additional payment or other obligations of Taxpayer arising from X's enforcement action to be subject to amended Section 162(f). However, with respect to any payment or other obligation that relates back to the original agreement and that is not otherwise modified in connection with X's enforcement action, we recommend that the final regulations provide that such amounts are not subject to amended Section 162(f).

**Example 7**. *(Interpretive amendments; no increase in payment obligations)*

Prior to December 22, 2017, Taxpayer enters into an agreement with certain governments settling claims in relation to products manufactured by Taxpayer. The agreement provides for ongoing payments to be made by Taxpayer calculated by reference to sales of such products. Following the entry into the original agreement, the parties dispute how certain payments are required to be calculated under the agreement. The parties resolve their dispute and amend the prior agreement following the date of publication of final regulations under Section 162(f). The amendment does not increase the amount of ongoing payments required to be made by taxpayer and does not otherwise change or modify the nature or purpose of the payments required under the original settlement agreement.

In two recent private letter rulings, the IRS addressed facts similar to Example 7.[70] In these private letter rulings, the IRS concluded that subsequent agreements resolving certain limited contractual disputes arising under a pre-TCJA settlement agreement did not result in a modification of the pre-TCJA settlement agreement that changed the nature or character of the underlying settlement payments. In reaching this conclusion, the rulings rely on the fact that the subsequent agreements resolved a dispute over a provision in the pre-TCJA settlement agreement that operated to reduce but not to increase the settlement payments. While these rulings address a very narrow fact pattern, we would expect the same outcome under the Proposed Regulations as currently drafted. More generally, we would not expect a "material change to the terms of [an] order or agreement" to include amendments or modifications to a pre-TCJA agreement or order that resolve questions of general interpretation. However, we recognize this may be a very fact-specific inquiry and the underlying facts may differ from case to case.

H. Section 6050X Reporting

[70] *See* Priv. Ltr. Rul. 202018005 (Feb. 4, 2020) and Priv. Ltr. Rul. 202019023 (Feb. 6, 2020).

Section 6050X imposes reporting obligations on the "appropriate official" of a government, governmental entity, or nongovernmental entity treated as a governmental entity that is party to a successful suit or agreement with respect to (*i*) amounts for which a deduction is disallowed under Section 162(f)(1) ("***non-restitutionary amounts***") and (*ii*) amounts constituting restitution or remediation of property or paid to come into compliance with a law (collectively, "***restitutionary amounts***"). The reporting obligations under Section 6050X apply if the aggregate amount subject to the reporting obligation equals or exceeds the "threshold amount," which the Proposed Regulations, as authorized by Section 6050X(a)(2)(B), set at $50,000. If the reporting obligations apply, the appropriate official must separately list the amounts that qualify as restitution or remediation or as paid to come into compliance with a law.

The statute leaves unanswered several questions. First, is the "aggregate amount" for purposes of determining whether the reporting obligations apply (*i*) the gross amount paid to or at the direction of the government or governmental entity pursuant to the court order or settlement agreement, including both the non-restitutionary and the restitutionary amounts or (*ii*) solely the non-restitutionary amounts? We recommend clarifying that the term "aggregate amount" refers to the gross amount.[71] This is consistent with the policy reflected by the Section 6050X reporting requirements and the Section 162(f) Identification Requirement of improving verification tools and transparency with respect to amounts claimed as deductions to which Section 162(f) applies.[72]

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[71] A separate, though similar question, is whether the restitutionary amounts are included, along with the non-restitutionary amounts, as a gross amount if the report is made. The Treasury Department and IRS appear to have determined that the gross amount should be reported. *See* Instructions for Form 1098-F (Rev. Dec. 2019) (noting that the amount reported in box 1 *Total amount required to be paid* may or may not equal the sum of the restitutionary amounts). We concur with this conclusion since it facilitates reporting in cases where the aggregate payment is expected to equal or exceed the threshold amount and a portion of the payment is identified as a being made for restitution, remediation, or coming into compliance with a law, but the exact payment amount is not identified. In such case, the aggregate amount for purposes of determining whether reporting obligations apply may be greater than the amounts that can be clearly established as restitutionary or non-restitutionary.

[72] *See generally* Steven P. Johnson and Mary "Handy" Hevener, *Government-and Quasi-Government Imposed Penalties, Fines, and Other Amounts*, in New York University 77th Institute on Federal Taxation §2.03 (Matthew Bender 2020) (describing the amendments to Section 162(f) as facilitating efficient tax administration by avoiding inconsistent characterizations and bringing transparency to the value of settlements and stating that because of the new Section 6050X reporting obligations, "the government will no longer be able to remain silent [as to the characterization of the payments], as had been the longtime practice of the Department of Justice"); Douglas W. Baruch and John T. Boese, *How Tax Reform Will Change FCA Settlements*, 2018 Law360 12-19 (2018) (stating that the Section 6050X reporting obligations should solve the issue of companies needing to use Freedom of Information requests to obtain the information that the government is now mandated to report).

Second, should amounts that do not satisfy the Identification Requirement and/or Establishment Requirements of Section 162(f) be treated for Section 6050X reporting purposes as non-restitutionary amounts? We recommend clarifying that the Establishment Requirement does not apply, since it is a taxpayer-level requirement that cannot easily be policed by the government or entity responsible for the reporting. However, the Identification Requirement should apply, since no benefit is derived from separately listing non-deductible amounts.

Third, what are the appropriate official's obligations where (*i*) the aggregate amount potentially subject to the reporting requirement is not stated in the order or agreement and/or (*ii*) a payment or cost is separately identified as being for restitution or remediation or to come into compliance with a law, but the exact amount of such payment or cost is not identified? Proposed Regulations Section 1.6050X-1(e) partially addresses these issues, but, as drafted, it only addresses the aggregate amount issue if there is also a restitutionary amount issue. We recommend clarifying that Proposed Regulations Section 1.6050X-1(e) applies to the aggregate amount issue regardless of whether restitutionary amounts are separately identified.[73]

Treasury also requests comments on the reporting of unidentified payment amounts. In order to ensure that large payments subject to Section 162(f) are reported, even if the total amount of the payments cannot be determined with certainty, we recommend adopting an approach similar to the one used for purposes of reporting real estate transactions with contingent amounts in Treasury Regulations Section 1.6045-4, which provides that the reportable "gross proceeds" of real estate transactions include ascertainable amounts that may be received in connection with contingent payment transactions. On the other hand, for purposes of reporting restitutionary amounts, we recommend reporting only the payments that are sure to be made. This combination of reporting the maximum gross amount and the minimum restitutionary amount will facilitate efficient allocation of IRS resources in determining which returns to audit.

We recommend revising Proposed Regulations Section 1.6050X-1(e) as follows to clarify *(i)* that "aggregate amount" includes restitutionary and non-restitutionary amounts, *(ii)* that the Identification Requirement, but not the Establishment Requirement, applies for purposes of Section 6050X reporting, and *(iii)* the appropriate official's reporting obligations where the aggregate amount and, if applicable, restitutionary amounts, cannot be ascertained with certainty:

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[73] Treasury may also wish to clarify that if the government or governmental entity does not expect the aggregate amount to exceed the threshold amount and therefore does not report under Section 6050X but then later has actual knowledge that the amount paid to or at the direction of the government or governmental entity in fact exceeded the threshold amount, then the government or governmental entity is required, at such time, to report pursuant to the provisions of Section 6050X and the Treasury Regulations thereunder.

(e) *Identification of Amounts* – (1) *In general.* For purposes of this section, an amount shall be treated as restitution, remediation, or an amount paid to come into compliance with a law (as defined in § 1.162-21(f)(3)) only if the amount has been identified (within the meaning of § 1.162-21(b)(2)) as such. The establishment requirement in § 1.162(b)(3) is not applicable to this section.

(2) *Payment amount identified as restitution, remediation, or as paid to come into compliance with a law.* If the order or agreement identifies a payment (or the cost to provide property or to provide services) as restitution, remediation, or an amount paid to come into compliance with a law (as defined in §1.162-21(f)(3)), such amount is included in the amount required to be paid in determining whether the amount to be paid equals or exceeds the threshold amount.

(3) *Payment amount not identified* – (i) If, under the facts and circumstances, the government or governmental entity expects the aggregate amount required to be paid to, or at the direction of, a government or governmental entity as a result of the order or agreement to equal or exceed the threshold amount under paragraph (g)(5) of this section, the appropriate official must file an information return, and furnish the written statement to the payor, as provided by the instructions to Form 1098-F (or any successor form), including instructions as to the amounts (if any) to include on Form 1098-F. In such case, the aggregate amount reported on such return and listed on such written statement shall be the greater of the maximum determinable aggregate amount and the threshold amount. The term "maximum determinable aggregate amount" for purposes of this section means that portion of the aggregate amount that can be determined with certainty, assuming that all of the contingencies contemplated by the order or agreement are met or otherwise resolved in a manner that will maximize the amount paid to, or at the direction of, the government or governmental entity. In determining whether the aggregate amount is expected to exceed the threshold amount, the government or governmental entity shall consider all the facts and circumstances, including (as applicable), but not limited to, (a) the extent to which the maximum determinable aggregate amount is close to the threshold amount, (b) the government or governmental entity's experience with respect to amounts paid for similar

projects or arrangements, (c) the scope of the required work to satisfy the order or agreement, and (d) the time estimated to complete such work.

(ii) If the order or agreement identifies a payment (or the cost to provide property or to provide services) as restitution, remediation, or an amount paid to come into compliance with a law (as defined in §1.162-21(f)(3)), but does not identify some or all of the aggregate amount the payor must pay (or some or all of the aggregate cost to provide property or to provide services), any such restitution, remediation or compliance amount reported on Form 1098-F shall be the minimum determinable amount. The term "minimum determinable amount" for purposes of this section means that portion of the restitution or remediation amount or of the amount paid to come into compliance with a law, as applicable, that can be determined with certainty, assuming that all of the contingencies contemplated by the order or agreement are met or otherwise resolved in a manner that will minimize the amount of the applicable payment or cost.

(iii) To the extent required by Form 1098-F (or any successor form) and its instructions, the information return should indicate whether the payment amount was identified.

## I. Technical Comments

### 1. Essential Governmental Function

The denial of a deduction in Section 162(f) only applies if the relevant payment is made to or at the direction of (*i*) a government, (*ii*) a governmental entity or (*iii*) a nongovernmental entity that is treated as a governmental entity. Proposed Regulations Section 1.162-21(f)(2)(ii)(B) provides that a nongovernmental entity that exercises self-regulatory powers as part of performing an "essential governmental function" is treated as a governmental entity for this purpose. The term "essential governmental function" is not defined in the Proposed Regulations, but the same term is used in Section 115 (excluding from gross income amounts derived from the exercise of an "essential governmental function" and accruing to a State, political subdivision thereof, or the District of Columbia).[74] A body of authority that interprets this term has developed under

[74] The phrase "essential government function" appears in several provisions of law other than Section 115, but some of these other provisions themselves incorporate by reference whatever standards have

Section 115.[75] We see no reason why the meaning of such term should be different for purposes of Section 162(f). Therefore, in order to avoid the need to "reinvent the wheel," we recommend that Proposed Regulations Section 1.162-21(f)(2)(ii)(B) state that "essential government function" has the same meaning under Section 162(f) as it has under Section 115.

2. Nongovernmental Entities Treated as Governmental Entities

Proposed Regulations Section 1.162-21(a)(2) separately refers to a "government or governmental entity" and a "nongovernmental entity." Proposed Regulations Section 1.162-21(c)(1) discusses suits in which no "government or governmental entity" is a party and Proposed Regulations Section 1.162-21(f)(3) references amounts paid to a "government or governmental entity," but neither section references nongovernmental entities. Presumably, this is because Proposed Regulations Section 1.162-21(f)(2) provides that a "nongovernmental entity" (as defined in such subsection) is treated as a governmental entity. However, since nongovernmental entities are specifically referenced in some, but not all, provisions of the Proposed Regulations, ambiguity is created regarding whether nongovernmental entities are to be treated as governmental entities when they are not specifically referenced. To clarify that nongovernmental entities treated as governmental entities are treated as such for all purposes of Section 162(f), we recommend:

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been developed under Section 115. *See* Treas. Reg. § 305.7871-1(d) and Treas. Reg. § 301.7701(i)-4(a). The phrase is used, without reference to Section 115, in Section 141(c)(2)(A). Treasury Regulations Section 1.141-5(d)(4) provides no definition for this purpose but does list some specific activities that may qualify and specifically excludes non-listed commercial and industrial facilities. The phrase is also used, without definition or reference to Section 115, in Section 414(d), but that provision's exclusion of "commercial activities" from other "essential governmental functions" makes it an inappropriate model for Section 162(f). On balance, we believe that application of Section 115 standards will provide a useful starting point in determining whether a deduction should be disallowed under Section 162(f) for a payment to a nongovernmental entity.

[75] For example, activities that have been found to be "essential governmental activities" include investment of public funds (Rev. Rul. 77-261, 1977-2 D.B. 45), operating a municipal insurance pool (Rev. Rul. 90-74, 1990-2 C.B. 34), and providing certain health care related services (Priv. Ltr. Rul. 9212010) (Dec. 19, 1991)).

- Removing the reference to nongovernmental entities in Proposed Regulations Section 1.162-21(a)(2);

- Adding a new clause (vi) to Proposed Regulations Section 1.162-21(f)(1): "(vi) A nongovernmental entity treated as a governmental entity as provided in paragraph (f)(2) of this section."

- Revising paragraph (f)(2): "(2) *Nongovernmental entity treated as a governmental entity*. A nongovernmental entity is treated as a governmental entity for purposes of this section if it is an entity that -- …."

To clarify the corollary ambiguity in Proposed Regulations Section 1.6050X-1, we recommend:

- Removing the reference to nongovernmental entities in Proposed Regulations Section 1.6050X-1(a);

- Adding a new clause (iii) to Proposed Regulation Sections 1.6050X-1(g)(2): "(iii) A nongovernmental entity that is treated as a governmental entity as provided in paragraph (g)(3) of this section."

- Revising paragraph (g)(3): "(3) *Nongovernmental entity treated as a governmental entity*. A nongovernmental entity is treated as a governmental entity for purposes of this section if it is described in § 1.162-21(f)(2) and is not (i) described in §1.162-21(f)(1)(ii)-(iv), (ii) a political subdivision of a government described in §1.162-21(f)(1)(ii)-(iii), or (iii) a corporation or other entity serving as an agency or instrumentality of a government described in §1.162-21(f)(1)(ii)-(iv)."[76]

[76] Treasury noted in the Preamble to the Proposed Regulations that no reporting obligations should be imposed on U.S. territories, foreign countries, or Indian tribal governments. *See* 85 Fed. Reg. 28529. As such, those governments are excluded from the definition of "government or governmental entity" for purposes of the reporting obligations under Section 6050X. Our recommended language avoids any ambiguity regarding whether such a government (or a political subdivision, agency or instrumentality thereof) could be brought back under Section 6050X by reason of the "nongovernmental entities" provision.

### 3. Reimbursement of Government Costs

We recommend that Proposed Regulations Section 1.162-21(f)(3)(iii)(A) be revised as follows "To reimburse the government or governmental entity for investigation costs or litigation costs incurred in such government or governmental entity's investigation or inquiry into the potential violation of law."

### 4. Suit, Agreement or Otherwise

Proposed Regulation 1.162-21(f)(4), as corrected by 85 Fed. Reg. 35606 (June 11, 2020), defines the term "suit, agreement or otherwise" as "[a] suit, agreement [*sic*] agreements, non-prosecution agreements…." We recommend revising paragraph (f)(4): "(4) *Suit, agreement, or otherwise*. The phrase "suit, agreement, or otherwise" refers to suits, settlement agreements, non-prosecution agreements…."

### 5. Taxpayer's Own Defense Costs

The Treasury Regulations promulgated under former Section 162(f) clarify that amounts constituting "legal fees and related expenses paid or incurred in the defense of a prosecution or civil action arising from a violation of law" are not subject to disallowance as a fine or penalty under former Section 162(f).[77] We do not believe the expansion of Section 162(f) to cover any amounts paid to or at the direction of the government in connection with a violation or potential violation of law has any impact on whether a taxpayer's own legal fees and related expenses incurred in defending a prosecution or other action or proceeding (including an investigation or inquiry into a potential violation of law) are otherwise deductible under Section 162(a). We recommend Treasury clarify this in the final regulations.

### 6. Examples

Finally, we recommend Treasury include additional examples in the final regulations applying the facts of the examples set forth in this report to such final regulations.

[77] Treas. Reg. § 1.162-21(b)(2).