Proposed Regulations on Deductibility of Governmental Settlements

May 27, 2020

In 2017, Congress limited the ability to take tax deductions for payments made to, or at the direction of, a governmental entity (including a nongovernmental entity, such as FINRA, exercising self-regulatory powers) for any violation of law or potential violation of law. I.R.C. § 162(f).

Such payments are not deductible unless (i) the payor establishes that the payment is for restitution, remediation of property or correction of noncompliance, and (ii) the payment is identified as such in the relevant settlement agreement or court order. The new law also requires the governmental entity to report to the IRS the amount of any payment. I.R.C. § 6050X. These rules do not limit the deductibility of amounts paid in suits between private parties in which no government or governmental entity is a party. Nor do they limit the deductibility of otherwise deductible taxes.

On May 13, 2020, Treasury issued proposed regulations further explaining the requirements for a payor to be eligible for a deduction. Treasury requested comments on the proposed regulations by July 13, 2020. The key provisions include:

How to "establish" entitlement

The proposed regulations describe several types of documents a payor could use to substantiate that its payment qualifies for the deduction, including:

- receipts;
- the legal or regulatory provision related to the violation or potential violation of a law;
- documents issued by the government or governmental entity relating to the investigation or inquiry;
- documents describing how the amount to be paid was determined; and
- correspondence exchanged between the taxpayer and the government or governmental entity before the order or agreement became binding under applicable law.

Treasury has requested comments on other types of evidence and supporting documentation that payors may use to establish entitlement to the deduction.

"Forfeiture or disgorgement" does not qualify

The proposed regulations provide that amounts paid as forfeiture or disgorgement do not qualify as deductible payments for restitution, remediation of property or correction of noncompliance. Treasury explained that this is because forfeiture and disgorgement focus on the unjust enrichment of the wrongdoer, not the harm to the victim. In Treasury's view, the statutory language's focus on remediation indicates that Congress intended the deduction to be available only for payments that remedy the harm to victim rather than payments that merely deprive the payor of its unjust enrichment.

Notably, given the substantiation requirements discussed above, it could be problematic if the background documentation suggests that the payment amount was calculated based on the enrichment to the payor rather than on the harm to the victim.

"Identification"

There is a rebuttable presumption that the identification requirement is met if a court order or agreement identifies that the amount paid is for restitution, remediation, or to come into compliance with the law. However, the identification of the payment as such is not itself sufficient to establish the payor's entitlement to the deduction. The payor must also be able to substantiate with documentary evidence that the payment is for one of the qualified purposes and not an unqualified payment for a penalty or forfeiture or disgorgement. Treasury recognizes that the identification requirement may be difficult to meet in situations involving lump-sum payments, multiple damage awards, and multiple payors. Treasury has requested comments on how the identification requirement may be met in these situations.

Practically, this means that a payor will effectively be admitting or agreeing that a victim was harmed or that it did not comply with the law.

Government reporting

Notice 2018-23 provided that governmental information reporting is not required until a date specified in proposed regulations, and the proposed regulations limit the requirement to orders and agreements that become binding under applicable law on or after January 1, 2022.

The proposed regulations also clarify that the appropriate official to report the payment to the IRS is the governmental officer or employee that has control of the suit or investigation, or an appropriately designated person. If there are multiple governments or governmental entities involved, then only the first one listed as a signatory or party needs to make the report to the IRS. The proposed regulations also except de minimis payments under $50,000 from the reporting requirement. It is advisable for payors to include language in orders and agreements that expressly requires the appropriate official to report the identified amounts to the IRS and send a copy of the report to the payor.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.

Mario J. Verdolini	+1-212-450-4969	mario.verdolini@davispolk.com
Kiara L. Rankin	+1 212 450 3015	kiara.rankin@davispolk.com
Michael Scheinkman	+1 212 450 4754	michael.scheinkman@davispolk.com