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GUIDE TO THE NEW RULES FOR THE DEDUCTIBILITY OF 'MISCONDUCT' PAYMENTS:

GOVERNMENT- AND QUASI-GOVERNMENT-IMPOSED PENALTIES, FINES, AND OTHER AMOUNTS AND PAYMENTS RELATED TO SEXUAL HARASSMENT

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Recent US tax reform legislation P.L. 115-97, commonly known as the Tax Cuts and Jobs Act, made sweeping changes to when and how a taxpayer will be able to deduct payments made to settle claims of particular acts of misconduct, specifically government- and quasi-government-imposed fines and payments related to sexual harassment.

WHAT YOU NEED TO KNOW

Government- and Quasi-Government-Imposed Fines

- Like under prior law, taxpayers may not deduct any portion of a payment to the government that is punitive in nature. Taxpayers may still be able to deduct payments for restitution or to come into compliance with the law, but only if a new requirement of disclosing such amounts in the court order or settlement agreement has been satisfied. [jump to section]
- Amounts attributable to restitution and compliance must be expressly "identified as restitution or . . . an amount paid to come into compliance . . . in the court order or settlement agreement."[1] Now, explicit identification in the settlement agreement is a threshold requirement for deductibility. Failure to expressly identify how much of the settlement the parties agree is attributable to restitution or compliance in the settlement agreement will *per se* prohibit a later deduction for any of the payment. [jump to section]
- Now, the official representing the government in the dispute must also prepare and provide an information return to the taxpayer and to the US Internal Revenue Service (IRS).[2] The information return must include (1) the name of the government entity involved in resolving the dispute, (2) the overall amount of the settlement, (3) the amount of the settlement attributable to restitution, and (4) the amount of the settlement attributable to coming into compliance.[3] [jump to section]
- Under the new law, amounts paid to reimburse the government's investigation and prosecution costs are *per se* nondeductible.[4] [jump to section]
- These changes do not apply to private claims. Instead, the new law applies to settlements with the government involving a wide range of actions, such as claims under the False Claims Act (FCA), Foreign Corrupt Practices Act (FCPA), Racketeer Influenced and Corrupt Organizations Act (RICO), Clean Water Act, Clean Air Act, Federal Trade Commission Act (FTCA), Sherman Antitrust Act, and Clayton Act. [jump to section]
- The new law also changes the reach of the deduction disallowance rules to fines and penalties paid to "certain nongovernmental regulatory entities."[5] [jump to section]

Payments Related to Sexual Harassment

- The new law prohibits a deduction for any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement, as well as attorney's fees related to such settlement or payment. [jump to section]

A more detailed explanation of these provisions follows.

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1 I.R.C. § 162(f)(2)(A)(ii).

2 I.R.C. § 6050X(a)-(b).

3 I.R.C. § 6050X(a)(1)-(b)(1).

4 I.R.C. § 162(f)(2)(B).

5 I.R.C. § 162(f)(5).

GOVERNMENT- AND QUASI-GOVERNMENT-IMPOSED FINES

Background

Standards for Deduction Under Prior Internal Revenue Code Section 162(f).

From 1969 until the enactment of the Tax Cuts and Jobs Act, Section 162(f) of the Internal Revenue Code of 1986, as amended (the Code), prohibited a deduction for "any fine or similar penalty paid to a government for the violation of any law." The corresponding Treasury Regulations defined a nondeductible "fine or similar penalty" as an amount (1) paid pursuant to conviction or a plea of guilty or *nolo contendere* for a crime (felony or misdemeanor) in a criminal proceeding; (2) paid as a civil penalty imposed by federal, state, or local law, including additions to tax and additional amounts and assessable penalties imposed by Chapter 68 of the Internal Revenue Code of 1954; (3) paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal); or (4) forfeited as collateral posted in connection with a proceeding that could result in imposition of such a fine or penalty.[6] The Treasury Regulations go on to provide that "compensatory damages . . . paid to a government do not constitute a fine or penalty" and therefore may be deductible.[7]

Therefore, whether settlements of civil claims with the government were deductible depended on whether the payment constituted a punitive fine or penalty, or some other type of damages. Payments that were punitive in nature were nondeductible, while payments that were compensatory in nature (rather than imposed to punish or deter) were generally deductible business expenses.

Whether a civil penalty is deductible depends upon "the purpose which the statutory penalty is to serve."[8] Stated another way:

> If a civil penalty is imposed for purposes of enforcing the law and as punishment for the violation thereof, [the payment is not deductible]. However, if the civil penalty is imposed to encourage prompt compliance with a requirement of the law, or as a remedial measure to compensate another party for expenses incurred as a result of the violation, it [is deductible because it] does not serve the same purpose as a criminal fine and is not "similar" to a fine within the meaning of section 162(f).[9]

If the "payment ultimately serves each of these purposes, i.e., law enforcement (nondeductible) and compensation (deductible)," the courts were charged with "determin[ing] which purpose the payment was designed to serve."[10] When determining the character of the settlement payments, the courts looked to all the facts and circumstances. First among these facts to be reviewed was the statute pursuant to which the action or claim was brought. The statute under which a claim is brought is essential to the origin of the claim doctrine, which assigns the same tax treatment and character to the amount received in a settlement as the treatment and character of the income at issue in the claim.[11] And when the nature of the payment couldn't be determined from the statute, or in cases where the statute served dual purposes, the specific facts surrounding the payment at issue were to be considered, including a comparison of the payment amount to the actual damages caused by the taxpayer's conduct.

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6 Treas. Reg. § 1.162-21(b)(1).

7 Treas. Reg. § 1.162-21(b)(2).

8 *Talley Indus., Inc. v. Comm'r*, 116 F.3d 382 (9th Cir. 1997) (quoting *S. Pac. Trans. Co. v. Comm'r*, 75 T.C. 497, 653 (1980)).

9 *Id.*

10 *Id.*

11 The origin of the claim doctrine looks to the claim to determine the character of the settlement. *Hort v. Comm'r*, 313 U.S. 28 (1941); *United States v. Gilmore*, 372 U.S. 39 (1963).

Furthermore, payments in excess of actual damages implied a nondeductible punitive component. These standards survive after tax reform, i.e., punitive payments are not deductible and compensatory payments are deductible.

Impetus for Change: Policy Considerations Underlying the New Law

Since the early 2000s there has been growing concern that companies that violated the law were able to mitigate the cost of their illegal actions by deducting penalty costs. Examples in the press have been widespread, from oil companies deducting costs associated with oil spills to financial institutions deducting mortgage-crisis litigation settlements. Over the years, there has been concern that news of blockbuster settlements by government regulators has been undercut by corporate wrongdoers publicly announcing that the actual costs of settlements are far less due to tax deductions arising from the settlement payments. Prior to the enactment of the Tax Cuts and Jobs Act, Congress had unsuccessfully attempted to require that settlements with the government for violation of the law account for and disclose after-tax values.[12]

Identification of Amounts Paid for Restitution or for Compliance in the Settlement Agreement

The amendment to Code Section 162(f) by the Tax Cuts and Jobs Act retains the punitive vs. remedial test, but imposes an additional condition for deductibility of the payment. Per Section 13306(a) of the Tax Cuts and Jobs Act, fines or penalties paid to the government are generally nondeductible, except to the extent the taxpayer establishes what portion of the payment (1) "constitutes restitution . . . for damage" or is "paid to come into compliance with any law which was violated"; and (2) is "identified as restitution or an amount paid to come into compliance . . . in the court order or settlement agreement."[13] The exception from nondeductibility (i.e., deductible fines and penalties) for payments made in restitution or to come into compliance with the law is similar to the pre–tax reform rules that allowed deduction for remediation/damages payments.

What is new is the requirement that the portion of any payment attributable to deductible restitution/compliance must now be *identified* in the settlement agreement. Moreover, the new Code Section 162(f) provides that a statement in the settlement agreement alone is not enough.[14] As explained by the Tax Cuts and Jobs Act Conference Report, "the IRS remains free to challenge the characterization of an amount so identified; however, no deduction is allowed unless the identification is made."[15] The statutory change, therefore, preserves the requirement that evidence of the basis for reaching settlement (including the parties' intentions) must be established. Thus, identification of the character of the payment in the settlement agreement is a necessary but not sufficient condition for allowance of a later deduction. As such, the more thoughtful and detailed the reasoning behind how a settlement amount is determined, the better.

Now that the government and the taxpayer must affirmatively state in writing the agreed-to portion of any settlement that should be treated as deductible, inconsistent characterizations should be avoided and the value of settlements will be more transparent. The new law should also facilitate more efficient tax administration. By requiring taxpayers and their government counterparties to address and resolve the deduction issue as part of the upfront settlement negotiations, tax deduction disputes may be forestalled

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12 *See, e.g.*, the Government Settlement Transparency Act and the Truth in Settlements Act legislation, which were introduced but never enacted into law.

13 The portion of any amount "paid or incurred as taxes due" to the government is also deductible. I.R.C. § 162(f)(4).

14 I.R.C. § 162(f)(2)(A) ("The identification [above] alone shall not be sufficient to make the establishment required [of restitution].").

15 H.R. Rep. No. 115-466, pt. 1, at 430 (2017).

and fewer IRS resources should be devoted to determining the proper character of settlement payments with the government.

New Code Section 6050X: Reporting Requirements Imposed on the Official Representing the Government

The Tax Cuts and Jobs Act also added new Code Section 6050X, which imposes a duty on the "appropriate official" of the government responsible for reaching a settlement to issue an information return to the settling taxpayer.[16] A copy of the information return must also be filed with the IRS.[17] The information return must provide the following information: (1) the name of the government entity involved in resolving the dispute, (2) the overall amount of the settlement, (3) the amount of the settlement attributable to restitution or remediation of property, and (4) the amount of the settlement attributable to coming into compliance.[18]

Because the IRS has yet to create a form for use in reporting Code Section 162(f) settlements, forms used by the IRS in the 1098 and 1099 series are likely instructional. This additional requirement will need to be negotiated as a part of the ultimate resolution with the US Department of Justice or other quasi-governmental entity because the information return must be furnished "at the time the agreement is entered into."[19] Because the new law imposes an affirmative duty on the government to report the financial terms of any settlement in excess of $600 (regardless of allocation among deductible and nondeductible amounts), the government will no longer be able to remain silent, as had been the longtime practice of the Department of Justice.

Reimbursement of Investigation and Prosecution Costs *Per Se* Nondeductible

Code Section 162(f)(2)(B) is also new. No longer can a taxpayer deduct "any amount paid or incurred as reimbursement to the government . . . for the costs of any investigation or litigation." This new provision may be particularly relevant to payments authorized under FCA Section 3729(a)(3) for repayment of the government's investigation and prosecution costs. Under prior law, a taxpayer could deduct amounts paid to reimburse the government's costs, so long as the taxpayer could substantiate what part of the settlement payment was attributable to reimbursement.[20]

New Nondeductibility Rules Apply to Payments Made to Federal Government Departments and Agencies

Like under prior law, Section 162(f) continues to apply to settlements with the government involving a wide range of actions. Examples of penalty/restitution settlements that will continue to fall within the scope of the new Section 162(f) include claims brought under the following acts:

- False Claims Act (FCA)[21]
- Foreign Corrupt Practices Act (FCPA)[22]

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16 *See* I.R.C. § 6050X(b). The new law defines "appropriate official" as the "officer or employee having control of the suit, investigation, or inquiry or the person appropriately designated for purposes of this section." New Code Section 6050X(c).

17 *See* I.R.C. § 6050X(a).

18 *See* I.R.C. § 6050X(a)(1)-(b)(1).

19 *See* I.R.C. § 6050X(a)(3).

20 *See* T.A.M. 200502041 (Jan. 14, 2005) ("We agree with Taxpayer, in theory, that such amounts [paid for relator fees, pre-settlement interest, and the government's investigatory costs] could constitute compensatory damages."); *see also* C.C.M. AM-2007-0015 (July 12, 2007); *Fresenius Medical Care Holdings, Inc. v. United States*, 763 F.3d 64, 68-69 (1st Cir. 2014).

21 *See Fresenius*, 763 F.3d 64 (settlement payments under 31 U.S.C. §§ 3729-3733).

22 *See* C.C.A. 201619008 (May 6, 2016) (disgorgement payments to the US Securities and Exchange Commission).

- Racketeer Influenced and Corrupt Organizations Act (RICO)[23]
- Clean Water Act[24]
- Clean Air Act[25]
- Comprehensive Environmental Response, Compensation, and Liability Act[26]
- Federal Trade Commission Act (FTCA)[27]
- Sherman Antitrust Act[28]
- Food, Drug, and Cosmetic Act (FDCA)[29]

New Nondeductibility Rules Apply to Payments Made to Certain Quasi-Government Entities

While payments to the government under the listed claims above remain the same, under the new law there is a potential expansion of the reach of the deduction disallowance rules to fines and penalties made to "certain nongovernmental regulatory entities."[30] Under prior law, Section 162(f) applied only to fines and penalties paid to the US government and to any "corporation or other entity serving as an agency or instrumentality" of the US government. Whether an entity qualified as an "agency or instrumentality" for purposes of the prior Section 162(f) depended on a three-prong analysis of whether the entity (1) was delegated the right to exercise part of the US government's sovereign power; (2) performed an important function of the US government; and (3) had the authority to act with the sanction of the US government behind it.[31]

The new law, by contrast, now applies to two groups of *non*governmental entities, in addition to the US government.[32] First, new Section 162(f) applies to fines and penalties paid to nongovernmental entities that "exercise self-regulatory powers (including imposing sanctions) in connection with a qualified board or exchange (as defined in section 1256(g)(7))."[33] Two examples of self-regulated organizations (SROs) affiliated with qualified boards or exchanges include the Financial Industry Regulatory Authority (FINRA) and Municipal Securities Rulemaking Board (MSRB).

The new Section 162(f) applies to settlement payments made to the group of nongovernmental entities that are SROs connected with a qualified board or exchange as of the new law's enactment date, December 22, 2017.

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23 *See Ginsburg v. Comm'r*, T.C. Memo 1994-272 (criminal forfeiture penalties of 18 U.S.C. § 1963).

24 *See Colt Indus., Inc. v. United States*, 880 F.2d 1311 (Fed. Cir. 1989) (civil penalties under 33 U.S.C. § 1319(d)).

25 *See id.* (civil penalties under 42 U.S.C. § 7413(b)).

26 *See* Field Service Advice #955 (Nov. 30, 1992).

27 *See Bailey v. Comm'r*, 756 F.2d 44 (6th Cir. 1985) (civil penalties under 15 U.S.C. § 45).

28 *See Flintkote Co. v. United States*, 7 F.3d 870 (9th Cir. 1993) (penalties under Sections 1 and 2 of the Sherman Act).

29 *See* L.A.F.A. 20152103F (May 22, 2015) (disgorgement of profits paid under 21 U.S.C. §§ 301-399a).

30 I.R.C. § 162(f)(5).

31 *See Guardian Indus. v. Comm'r*, 143 T.C. 1 (2014).

32 I.R.C. § 162(f)(1).

33 Section 1256(g)(7) defines a "qualified board or exchange" as (1) a national securities exchange that is registered with the Securities and Exchange Commission; (2) a domestic board of trade designated as a contract market by the Commodities Futures Trading Commission; or (3) any other market that the Secretary determines has rules adequate to carry out the purposes of the section.

Second, the new law extends the deduction disallowance rules to a potentially broader group of nongovernmental entities, but not immediately. Under Section 162(f)(5)(B), settlement payments made to nongovernmental entities that "exercise self-regulatory powers (including imposing sanctions) as part of performing an essential governmental function" will be subject to the deduction disallowance rules of Section 162(f) "to the extent provided in regulations." In a departure from the three-factor test of *Guardian Industries*, both the US government's delegation of authority and its backing in imposing penalties are no longer relevant.

While this addition would appear to expand the reach of the new Section 162(f) to fines and penalties paid to a much broader group of nongovernmental entities, two subtle provisions in the new law actually narrow the rules. First, the arguably higher "essential governmental function"[34] standard replaces the prior "important governmental function" standard under the case law. And second, until regulations are developed, fines and penalties paid to nongovernmental entities that perform an essential governmental function remain deductible. To date the IRS has not issued regulations identifying which nongovernmental entities "perform an essential governmental function" for purposes of the new Section 162(f) standards.

PAYMENTS RELATED TO SEXUAL HARASSMENT OR SEXUAL ABUSE

A separate provision in the Tax Cuts and Jobs Act added new Code Section 162(q), which disallows a deduction for (1) any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement, or (2) attorney's fees related to such a settlement or payment. The impetus for this change was based on news stories outlining widespread sexual harassment and the resulting #MeToo movement. There was a public outcry regarding these stories, and legislators took aim at nondisclosure provisions in agreements settling sexual harassment claims, claiming that such provisions may have allowed harassment to continue.

The actual ramifications of the statute, however, are unclear. What exactly is a payment "related to sexual harassment or sexual abuse"? How far reaching is the "related to" qualification? And what will the effect be if an individual brings a number of claims against a defendant? If an individual brings a number of claims including a claim for sexual harassment, to the extent the facts of the particular case support it, the amount of attorney's fees and payments related to sexual harassment should be separately stated in the settlement agreement, so that those payments attributable to non–sexual harassment claims can still be deductible. Importantly, as with any settlement, even if it is agreed to in writing between the parties, the IRS can still challenge an allocation if it does not comport with the facts.

Finally, it remains to be seen whether defendant employers will be willing to delete nondisclosure agreements from such settlements or payments. If the settlement or payment is not subject to a nondisclosure agreement, then the payment can be fully deductible. Will the result be that more sexual harassment settlements become public knowledge? Or will the result be that it now costs employers more, dollar for dollar, to settle sexual harassment claims, thereby incentivizing employers to settle for less.

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34 It is unclear what types of entities will qualify as performing "an essential governmental function" under Section 162(f)(5)(B), but guidance exists in other contexts. With respect to determining whether bonds have been issued for private or public activity purposes, an "essential governmental function" is described as "improvements to utilities and systems . . . that are available for use by the general public (such as sidewalks, streets and streetlights; electric, telephone, and cable television systems; sewage treatment and disposal systems; and municipal water facilities [and] parks." Treas. Reg. § 1.141-5(d)(4)(i). The "essential governmental function" standard similarly focused on schools, streets, and sewers in the legislative history to Section 7871(c) with respect to tax-exempt bond issuances by Indian tribal governments. *See* H.R. Rep. No. 97-982, 97th Cong. 2d. Sess. 17 (1982); S. Rep. No. 97-646, 9th Cong. 2d. Sess. 13-14 (1982).

KEY TAKEAWAYS

- No deduction will be allowed unless a settlement agreement expressly identifies which portions of the payment are attributable to (a) restitution or remediation, or (b) coming into compliance. Settlement negotiations, therefore, must now address these new requirements in order for a taxpayer to be able to later deduct any part of a settlement payment. There should be support establishing the basis for amounts attributable to deductible restitution/compliance.
- Payments made to reimburse the government for investigation and prosecution costs are now *per se* nondeductible.
- Fine and penalty payments made to nongovernmental SROs in connection with a qualified board or exchange now fall within the coverage of Section 162(f).
- Fine and penalty payments made to nongovernmental SROs performing "essential government functions" now fall within the coverage of Section 162(f). It is unclear how expansive this may be.
- Otherwise, the substantive standards of the prior Code Section 162(f) (i.e., the remedial vs. punitive test found in case law) remain in effect to determine the allowance of a deduction for a settlement payment, once the new procedural requirements are satisfied.
- The government party to a settlement is required to issue an information return to the taxpayer and to the IRS, stating the amount of the overall settlement and what portions of the overall settlement are attributable to deductible restitution and compliance costs.
- While the new law may appear to be a sword, taxpayers may be able to use it as a shield and push the government to engage meaningfully on the character of any payments being made.
- The new law prohibits a deduction for any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement, and for attorney's fees related to such settlement or payment.

EFFECTIVE DATE OF CHANGES

The new Code Section 162(f) rules "shall apply to amounts paid or incurred on or after the date of the enactment of this Act." Tax Cuts and Jobs Act § 13306(a)(2). US President Donald Trump signed the Tax Cuts and Jobs Act into law on December 22, 2017. The prior Code Section 162(f), however, continues to apply "to amounts paid or incurred under any binding order or agreement entered into before such date [December 22, 2017]," so long as court approval (when required) was "obtained before such date." *Id.* Thus, under the transition rules, only binding agreements entered into before December 22, 2017, will be grandfathered under the prior Code Section 162(f) rules. Informal, nonbinding settlement agreements "in principle" and even formal settlement agreements that have not yet received court approval (if required), therefore, must satisfy the new Code Section 162(f) standards.

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