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Deduction Disallowance for Fines and Penalties and the Corresponding Reporting Requirements

BY LACEY STEVENSON AND HERSH VERMA

Last week, the Internal Revenue Service released the long-awaited final regulations governing the deductibility of fines and similar penalties paid to governmental entities (and certain nongovernmental regulatory entities) under tax code Section 162(f). The regulations also address the corresponding information reporting requirements imposed on governmental entities pursuant to Section 6050X.

DEDUCTION DISALLOWANCE FOR CERTAIN FINES AND PENALTIES

Prior to the Tax Cuts and Jobs Act of 2017 (TCJA), Section 162(f) provided that fines and penalties paid in connection with a violation of law were generally nondeductible for U.S. federal income tax purposes. As amended by the TCJA, with a few exception discussed below, Section 162(f) disallows an ordinary and necessary business expense deduction for amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a governmental entity in relation to the potential violation of any law.

Which types of expenses or payments are disallowed by Section 162(f)?

The deduction disallowance generally applies to any ''fines, penalties, and other amounts'' paid or incurred to a 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.'' Despite this broad language, the regulations now clarify that any amounts paid or incurred for routine investigations or inquiries that are not related to any evidence of wrongdoing will not fall under the limitations of Section 162(f) (i.e. amounts paid in connection with a routine audit or inspection that is required to ensure compliance with business or industry rules and regulations). Section 162(f) will only be triggered if an audit or investigation is based upon suspected wrongdoing by the taxpayer.

However, once Section 162(f) is triggered by an allegation of wrongdoing or law violation, it is irrelevant whether or not the taxpayer is ultimately found to have engaged in the wrongdoing. The regulations explain that the deduction disallowance will apply even where, at the conclusion of the investigation or inquiry, there is no finding of wrongdoing. While this seems unfair, the regulations provide a taxpayer-friendly nuance to this rule. Assuming a deduction is otherwise allowable under the tax code, taxpayers will still be allowed a deduction for legal fees and other expenses (i.e., stenographic and printing charges) paid or incurred in the defense of a prosecution or civil action arising from a violation of any law. This deduction for legal fees is allowed even where the taxpayer is ultimately found to have violated the law.

What qualifies as a ''suit, agreement, or otherwise''?

The disallowance deduction applies to fines and penalties regardless of whether those payments are incurred by ''suit, agreement, or otherwise.'' The regulations clarify that this phrase includes formal and infor-

Lacey Stevenson and Hersh Verma are attorneys with Norton Rose Fulbright.

mal proceedings alike, including, but not limited to, settlement agreements, non-prosecution agreements, deferred prosecution agreements, judicial proceedings, administrative adjudications decisions issued by officials, committees, commissions, or boards of a government or governmental entity, and any legal actions or hearings in which a liability for the taxpayer is determined or pursuant to which the taxpayer assumes liability. The regulations further note that an order or agreement is treated as binding for purposes of the disallowance deduction even if all applicable appeals have not yet been exhausted.

Does Section 162(f) apply even in the absence of an admission of guilt or liability?

Yes, the preamble to the regulations makes clear that the deduction disallowance applies regardless of whether the taxpayer admits guilt or liability and regardless of the taxpayer's motivation for paying the fine or penalty. For example, if a taxpayer pays a fine or penalty to a governmental entity in order to avoid additional expenses (i.e., attorneys' fees) or to avoid an uncertain outcome of the pending investigation, the taxpayer will not be allowed to claim a deduction for the fine or penalty even though the taxpayer was never found guilty of violating a law.

To whom must the fines or penalties be paid to trigger Section 162(f)?

Section 162(f) applies to fines or penalties paid to a government or governmental entity. The government is defined to include (i) the government of the U.S., a state, or the District of Columbia, (ii) the government of a U.S. territory, (iii) a foreign government, (iv) an Indian tribal government, and (v) political subdivisions of a government, including local government units. Governmental entities are defined as corporations or other entities serving as an agency or instrumentality of a government.

Additionally, for purposes of Section 162(f), the following nongovernmental entities are treated as governmental entities:

- A nongovernmental entity that exercises self-regulatory powers (including imposing sanctions) in connection with a qualified board or exchange
- A nongovernmental entity that exercises self-regulatory powers (including imposing sanctions) as part of performing an essential governmental function

Self-regulatory powers include the adoption, administration, and enforcement of rules.

Are there any exceptions to the disallowance rules under Section 162(f)?

Yes, Section 162(f) and the regulations set forth two exceptions—the Restitution/Remediation Exception and the Coming-into-Compliance Exception—to which the limitations of Section 162(f) do not apply. For either exception to apply, the relevant court order or settlement agreement must satisfy (1) the Establishment Requirement, and (2) the Identification Requirement.

- *Identification Requirement*: The final regulations require an order or agreement to identify an amount paid or incurred as restitution, remediation, or to come into compliance with a law. In order to satisfy the Identification Requirement, the final regulations ''require the order or agreement to specifically state the amount of the payment and that the payment constitutes restitution, remediation, or an amount paid to come into compliance with a law.'' The Identification Requirement may be met if the order or agreement uses a different form of the requisite words, such as ''remediate'' or ''comply with a law,'' if the nature and purpose of the payment, as described in the order or agreement, are clearly and unambiguously to restore the injured party or property or to correct the non-compliance. The final regulations provide some flexibility to allow orders and agreements to satisfy the Identification Requirement.
- *Establishment Requirement*: The Establishment Requirement is met if the documentary evidence submitted by the taxpayer proves that the amount in question either (1) constitutes restitution (or remediation of property) for damage or harm which was or may be caused by the violation of any law or the potential violation of any law or (2) is paid to come into compliance with any law that has been violated or potentially violated. The taxpayer can provide documentary evidence:
  - that the taxpayer was legally obligated to pay the amount the order or agreement identified as restitution, remediation, or to come into compliance with a law;
  - of the amount paid or incurred; and
  - of the date on which the amount was paid or incurred.

  If the order or agreement identifies a lump sum payment or a multiple damage award, the taxpayer must establish the exact amount paid or incurred for each purpose. Likewise, if an order or agreement involves multiple taxpayers, each taxpayer must establish the amount that taxpayer paid or incurred as restitution, remediation, or to come into compliance.
- *Restitution/Remediation Exception:* An amount is paid or incurred for restitution or remediation if it restores, in whole or in part, the person, the government, the governmental entity, or the property harmed by the violation or potential violation of any law. The final regulations explain that amounts paid or incurred (1) for the purpose of conserving soil, air, or water resources, protecting or restoring the environment or an ecosystem, improving forests, or providing a habitat for fish, wildlife, or plants, and (2) have the requisite nexus with the harm that the taxpayer has caused or is alleged to have caused will constitute restitution or remediation payments.
- *Coming-into-Compliance Exception*: An amount is paid or incurred to come into compliance with a law by performing specific services, taking a specific corrective action, providing specific property, or a combination thereof. The final regulations clarify that the services performed, actions taken, and the provision of property must be done to come into compliance with the law that has been violated, or potentially violated, and also list amounts that will not be treated as paid or incurred to come into compliance with a law.

The final regulations also carve out two other types of payments. First, Section 162(f) does not apply to any

amounts paid or incurred as otherwise deductible taxes or related interest. Second, Section 162(f) does not apply to any amount paid or incurred pursuant to an order in a suit in which no government or governmental entity is a party. If no such party is named in the lawsuit, the limitation of Section 162(f) will not apply to any amounts paid or incurred pursuant to orders or agreements resulting from that private party case. This exception also applies to any lawsuits in which the government or governmental entity is merely enforcing rights as a private party and not in its enforcement, regulatory, or administrative capacity. For instance, Section 162(f) will generally not apply in a lawsuit where a taxpayer makes payments to a governmental entity pursuant to a contract dispute wherein the governmental entity is seeking to enforce its rights as a party contracting for goods or services.

Will Section 162(f) apply to qui tam and whistleblower actions?

Likely yes. The regulations do not address qui tam or whistleblower actions, but the preamble does. The preamble specifically refers to qui tam actions and declares that many such suits will fall under Section 162(f) as the governmental entity is the real party in interest in the suit and receives any funds paid pursuant to the order or agreement. This is so regardless of whether the governmental entity decides to intervene in the suit. As such, any amounts paid or incurred to a government or governmental entity as a result of the suit will likely be disallowed unless another exception to Section 162(f) applies.

When will the deduction disallowance be effective?

The rules set forth in the final regulations will apply to any amounts paid or incurred under an order or agreement that becomes binding on or after the date the final regulations are published in the Federal Register.

INFORMATION REPORTING FOR GOVERNMENTAL ENTITLES

The final regulations also elaborate upon the statutory information reporting requirements imposed on governmental entities under Section 6050X. Generally, if a taxpayer (i.e., the payor) pays a penalty or fine that is subject to Section 162(f) and that meets a certain threshold amount, the governmental entity that is a party to the order or agreement must file an information return with the IRS detailing the payments to be made. Although Section 6050X proposes a threshold amount of $600, the final regulations provide that this reporting obligation is only triggered if the governmental entity reasonably expects the aggregate amount the payor must pay, and the costs the payor will pay or incur to provide services or to provide property, pursuant to the order or agreement, will equal or exceed $50,000. If this threshold amount is met in the aggregate but the payments are to occur over several years, the governmental entity is only required to file one information return for the payor.

These information returns must be filed with the IRS on or before Febr. 28 (March 31 for electronic filings) of the year following the calendar year in which the order or agreement becomes binding. The governmental entity must also furnish a written statement with the same information to the payor by Jan. 31 of such year. If more than one payor is liable for some or all of the threshold amount, the regulations require the governmental entity to file an information return for the separate amount that each payor is required to pay, even if such amount, on its own, is less than the threshold amount.

The final regulations relating to Section 6050X will only apply to orders and agreements, pursuant to suits and agreements, that become binding on or after Jan. 1, 2022, irrespective of whether all appeals have been exhausted.

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Author Information

Lacey Stevenson and Hersh Verma are attorneys with Norton Rose Fulbright.