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Alert | Tax

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Tax Cuts and Jobs Act Disallows Deductions for Many Payments Due to Violation of Civil and Criminal Law

A provision in the new tax law greatly expands the scope of the disallowance of deductions for fines and penalties paid to government agencies. The new law disallows a tax deduction for any payment made to a government entity where the payment was made in relation to a violation of law or the investigation of a violation. Furthermore, it will disallow a deduction for payments made to third parties at the direction of a government agency. This deduction disallowance will make it costlier for a company to investigate and settle claims of violation of laws and regulations brought by federal, state, or local agencies or a foreign government. It will potentially touch a wide array of controversies that involve claims or actions alleging the violation of laws, including securities, employment, environmental, Foreign Corrupt Practice Act, white collar, whistleblower, healthcare, insurance, gaming, government contracts, or any other regulated industry. Under a literal reading of the statute, it could also apply to *qui tam* actions brought by private parties under a false claims (whistleblower) or private attorney general act. Any proposed settlement or consent order should be analyzed to determine whether it can be structured to limit the application of this new tax law.

Prior to the Dec. 22, 2017, effective date of the Tax Cuts and Jobs Act (TCJA), § 162(f) of the tax code simply said that fines or penalties paid to a governmental entity are not deductible. The TCJA amends the introduction to § 162(f) so that it now reads:

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> Except as provided in the following paragraphs of this subsection, no deduction otherwise allowable shall be allowed under this chapter 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.

Accordingly, this deduction disallowance rule goes beyond the mere payment of penalties and fines. It now includes *any payment* made in relation to the violation of any law (except for certain restitution payments), or inquiry into the potential violation of any law, whether the payments are made to the agency or to a third party at the direction of the agency. This would include investigation costs, or payments of penalties or damages to third parties made at the direction of the agency. For example, if a state employment agency requires the payment of nonrestitution damages to workers to settle a probe, the payment would not be deductible.

Restitution

There is an exception that would allow a deduction for restitution payments. In order to be deductible as restitution, the company must establish that:

1. The payment is restitution (including remediation of property) for damage or harm which may be caused by the actual or potential violation of law, or is paid to come into compliance with any law which was violated or involved in the investigation; and,

2. Is identified as restitution or as an amount paid to come into compliance with law in the order or settlement agreement.

Consequently, it is imperative that a settlement agreement or court or agency order expressly identify required payments as restitution, for the remediation to property or payments required to bring the company into compliance with law. Note that, the provision says that the mere classification of payments as restitution alone is not adequate to allow the payment to be deductible as restitution. It will be necessary to demonstrate that the payments are, in fact, restitution based on the underlying claim and pleadings or investigation. Thus it is important that the payment not only be identified in a court or settlement document as restitution, but also that there is evidence to demonstrate, in the event of an audit, to the IRS that the payments were properly classified as restitution.

Significantly, payments to reimburse the government agency for the cost of its investigation or litigation are not classified as restitution, so any amounts allocated to such costs would not be deductible. This may provide an incentive to allocate a greater amount of restitution to the government agency (which would be deductible if the above conditions are satisfied) instead of investigation costs, which are no longer deductible.

Qui Tam and Whistleblower Actions

An important issue to many companies is whether a non-intervened *qui tam* action brought under a federal or state false claims or private attorney general statute brought by a whistleblower would trigger this new deduction disallowance provision. Under many such statutes, the private party is acting as the agent of the government. As a result, the IRS might take the position that payments made to investigate and defend such suits as well as the settlement payment to the whistleblower are not deductible.

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Interest Due on Taxes

There is an exception to this disallowance provision for any tax paid, so that any controversy with a government tax agency over the amount of taxes due would allow a company to deduct the amount allocated to taxes. As under prior law, the amount allocated to penalties would not be deductible. However, the statute is silent as to whether interest paid by a corporation in a tax controversy with a state or local tax agency would be deductible. As the statute currently reads, interest in a state or local tax controversy would not be deductible. This issue will need further guidance, and possibly a legislative fix. In the interim, when settling a state or local tax controversy, it might be better to agree to pay a greater amount of tax in exchange for a waiver of interest, assuming the tax agency has the authority to compromise interest.

This issue does not appear to be a problem with federal tax controversies, because the restitution provision expressly says that any payments of federal tax imposed under title 26 (the Internal Revenue Code) that would otherwise be deductible would continue to be deductible, apparently maintaining the deductibility of interest paid by a corporation to the IRS. Unfortunately, this treatment is not extended to state or local tax payments.

Tax Information Reporting Obligations

In addition to this disallowance provision, the new law places an information reporting requirement for governmental agencies to report payments required under the order or agreement, by creating new § 6050X to the tax code. The agency must report to the IRS the amount that is not deductible by the company, and the amount allocated to restitution. Consequently, it is critical that any settlement agreement or order clearly state the amount allocated to restitution, so that there will be no mistake how much the government agency will report as deductible on the information return.

Effective Date

This new provision applies to any payments made or incurred on or after Dec. 22, 2017, unless an enforceable settlement agreement was executed prior to that date. However, if the agreement requires the approval by a court order, the agreement will not be treated as being enforceable until such order is entered by the court. Consequently, even if a settlement agreement was executed prior to the Dec. 27, 2017 effective date of the TCJA, this new deduction disallowance would be applicable if a required court order was entered on or after the effective date the provisions of the new law will be applicable.

This new law will likely make it more expensive to settle conflicts with governmental agencies. It will be important to consult with counsel and review any proposed settlement agreement or order in order to best posture a company settling a conflict.

For more information on the TCJA, click here.

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