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How New Tax Law Affects Tax Deductions for White-Collar Clients

White-collar defense attorneys and their clients should pay attention to the tax consequences of monetary awards in criminal and civil enforcement cases. This may potentially prevent a company discovering from its accounting firm that none of the payments is deductible due to the failure to allocate.

By Marvin A. Kirsner and Carolyn F. McNiven | May 15, 2018 | The National Law Journal

White-collar defense attorneys should be aware of a provision in the recent Tax Cuts and Jobs Act that requires government agencies to report to the Internal Revenue Service civil settlements and criminal judgments and alters what types of costs commonly associated with a white-collar matter or other government enforcement matter are deductible.

In a nutshell, TCJA will make it more expensive on an after-tax basis for corporate clients to investigate and then settle enforcement actions brought by government agencies, including white-collar criminal matters. It also creates a duty on government agencies to both report to the IRS and to the taxpayer the amount of the settlement or order and separately identify the portions of that total amount that are

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attributable to restitution or remediation of property, or correction of noncompliance; however, the IRS has delayed these information-reporting requirements to no sooner than Jan. 1, 2019.

While IRS Code §162 provides that ordinary and necessary business expenses paid or incurred in the taxable year are properly deductible, the TCJA amended the code to specify that amounts paid to the government in connection with investigations or enforcement matters are not deductible unless they are compliance related or constitute actual restitution. For example, amounts reimbursing the government for its costs of investigation are not deductible. Likewise, costs of a monitor should be vetted with tax counsel before being claimed as a deduction, and, if a deduction is taken, evidence that such payments qualify under the compliance exception should be gathered to the extent it exists.

The only amounts that are deductible post-TCJA are: restitution; the remediation of property; and payments made to the government or a third party at the government's direction to bring the taxpayer in compliance with the law, which are specified as such in the court order or settlement agreement. In the case of a bank fraud matter where the defendant operated a construction and real estate development business, any amount ordered to be paid in restitution to the victim bank may be deductible as long as the order specifies the payment as restitution and the defendant can demonstrate that restitution was the true purpose of that amount.

To the extent that a client wishes to claim a deduction for any amount contained in a criminal or civil order in a government enforcement proceeding, it should be prepared to establish that the amount sought to be deducted constitutes restitution, including remediation of property, for damage or harm caused by its illegal acts, or was paid to come into compliance with any law that was violated or "otherwise involved in the investigation or inquiry."

Significantly, the code provides that provisions in the operative orders or settlement documents "alone shall not be sufficient" to demonstrate how the specific payment amounts are characterized for deductibility purposes. How the payments are now structured is of paramount importance. For example, if a company is the subject of a parallel criminal and civil investigation into an alleged environmental crime, such as a hazardous waste discharge, and the relevant government attorneys propose a global settlement with a criminal nonprosecution agreement and a $1 million civil settlement, the company's defense counsel may wish to ensure that the lump-sum settlement is broken out into specific amounts in the settlement document and that deductible amounts are maximized and nondeductible amounts are minimized. If the company is required to take steps to ensure future compliance, such as install a legally required safety override mechanism, thought could be given to whether payment for that correction can be characterized in such a way as to qualify it for a tax deduction. Under the new law, if the operative documents only specify the lump-sum payment, it is likely that any deduction that the taxpayer would like to take for all or a portion of the $1 million will be subject to disallowance since there is no proof that a given sum was allocated to remediation and/or restitution.

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The facts must support whatever characterization is given to the payments in the operative documents. In the parallel environmental matter example above, the defendant may pursue the agency to agree to an allocation of $950,000 to deductible remediation costs, and $50,000 to nondeductible (government) investigation costs, with nothing allocated for payment of business damages to adjacent property owners. However, if the evidence shows that the government agency actually paid over $150,000 of the remediation money to the adjacent businesses to compensate them for the time the agency ordered them to close down, then it is likely that the IRS may disallow the deduction for the $150,000 that made its way to the adjacent businesses rather than into remediation costs. The impact of the government's reporting requirements on settlement dynamics, which will begin in 2019, is still uncertain. Government attorneys involved in criminal or civil enforcement have historically been reluctant to involve themselves in tax issues, preferring to settle matters or impose fines without weighing into the attendant tax consequences for the defendant-taxpayer. This is particularly true of state enforcement authorities. This is likely the reason for the IRS decision to delay government reporting requirements until 2019 at the earliest.

In sum, white-collar defense attorneys and their clients should pay attention to the tax consequences of monetary awards in criminal and civil enforcement cases. This may potentially prevent a company discovering from its accounting firm that none of the payments is deductible due to the failure to allocate.

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About the Authors:

Marvin A. Kirsner and Carolyn F. McNiven are shareholders in the Boca Raton and San Francisco offices, respectively, of Greenberg Traurig. Contact Kirsner at kirsnerm@gtlaw.com and McNiven at mcnivenc@gtlaw.com.

Marvin A. Kirsner

kirsnerm@gtlaw.com

Carolyn F. McNiven

mcnivenc@gtlaw.com