Recent Development—Internal Revenue Code § 162(f) and Its Implication on Settlement Agreements Occurring After the Tax Cuts and Jobs Act

“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.”

I. INTRODUCTION

Investigations into potential violations of domestic and foreign laws are often resolved by settlement agreements, which require businesses to make payments to governmental entities such as the U.S. Department of Justice (DOJ), the U.S. Securities and Exchange Commission (SEC), and the U.S. Environmental Protection Agency. One important issue that arises during settlement negotiations is whether the business’s settlement payment will be tax deductible. A taxpayer is allowed to deduct “ordinary and necessary” trade or business expenses when calculating taxable income under Internal Revenue Code (IRC) § 162(a). Since 1969, however, the Internal Revenue Service (IRS) has prohibited deductions for


3. See Wollman et al., supra note 2 (discussing settlement payments’ tax treatment).

“any fine or similar penalty paid to a government for the violation of any law” under § 162(f). 5

Yet despite the language prohibiting deduction of fines or penalties, businesses frequently negotiate settlement agreements with government entities that explicitly state the amount paid is tax deductible.6 For example, out of the $42 billion that British Petroleum Company PLC (BP) paid due to the 2010 Deepwater Horizon rig explosion, at least 80% qualified for a tax deduction, saving BP an estimated $10 billion to $14 billion.7 Similarly, many of the banks that contributed to the 2008 financial crisis were able to deduct portions of their multibillion-dollar settlements.8

The reason behind this lies in what was formerly a tax code “gray area.”9 While § 162(f) prior to the Tax Cuts and Jobs Act (TCJA) prohibited the deduction of fines or penalties, Treasury Regulation § 1.162-21 has always stated compensatory damages are not considered a fine or penalty, and are thus deductible business expenditures under § 162(a).10 Treasury Regulation § 1.162-21(b)(2) also states legal fees are deductible.11 Because Treasury Regulation § 1.162-21 is clear that the nondeductible fines or penalties category does not include

5. See id. § 162(f) (outlining deduction rules for fines, penalties, and other amounts); Nicholas C. Lynch & Michael F. Lynch, The Deductibility of Settlement Payments, J. TAX’N INV., Winter 2018, at 9, 10 (stating taxpayer cannot deduct fines or penalties under ordinary or necessary business expense).
8. See id. (articulating how banks contributing to 2008 recession may deduct part of settlements). When JPMorgan Chase announced a $13 billion settlement with the DOJ, the bank estimated that $7 billion of that sum would be deductible. See id. Experts have also estimated that $11.63 billion out of Bank of America’s $16.65 billion settlement was eligible for tax breaks. See id.
9. See Breslow, supra note 6 (addressing how businesses can deduct settlement payments even though IRC prohibits deducting penalties and fines).
10. See Treas. Reg. § 1.162-21 (as amended in 1975) (stating fines and penalties not deductible). This regulation encompasses payments made to the U.S. government, including any U.S. state, territory or possession of the United States, the District of Columbia, the Commonwealth of Puerto Rico, or the government of a foreign country. See id. § 1.162-21(a)(1)-(2). It also includes fines or penalties paid to “[a] political subdivision of, or corporation or other entity serving as an agency or instrumentality of” any of those governmental entities. Id. § 1.162-21(a)(3).
11. See id. § 1.162-21(b)(2) (outlining expenses excluded from “fine or penalty” definition). This section states that legal fees and related expenses incurred during the defense of a civil or criminal action, such as court costs or stenographic and printing charges, are also deductible business expenditures. See id.
compensatory damages paid to a government or governmental entity, settling parties often categorize settlement payments as “compensatory” rather than as fines or penalties.\(^{12}\) As a result, businesses are often able to deduct large portions of a settlement agreement as ordinary and necessary business expenses under § 162(a).\(^{13}\)

Section 162(f) underwent substantial revisions as part of the U.S. tax reform law, the TCJA, which was enacted in December 2017.\(^{14}\) The revised law applies to settlement agreements and court orders finalized on or after December 22, 2017.\(^{15}\) Under the revised law, no deduction is allowed 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.”\(^{16}\) The revised law shifts the relevant test away from whether a settlement payment constitutes a fine or penalty.\(^{17}\) Instead, any payment to the government relating to a violation or an investigation into a potential violation is strictly not deductible unless one of three exceptions applies.\(^{18}\) The first exception is for amounts paid pursuant to a court order in a private lawsuit.\(^{19}\) The

\(^{12}\) See Lynch & Lynch, supra note 5, at 11 (noting compensatory payments not considered fines or penalties, and thus deductible).


\(^{14}\) See Wollman et al., supra note 2 (noting tax reform changed § 162(f)).

\(^{15}\) See id. (noting TCJA’s effective date). Generally, the new law is effective for amounts paid or incurred on or after December 22, 2017. See id. Payments made pursuant to settlement agreements and court judgments entered into before December 22, 2017 are exempt from these new provisions. See id.

\(^{16}\) See 26 U.S.C. § 162(f) (2012) (stating old law), amended by Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13306, 131 Stat. 2054, 2126-27 (2017). Prior to the enactment of the TCJA, § 162(f) stated: “Fines and penalties. No deduction shall be allowed under subsection (a) for any fine or similar penalty paid to a government for the violation of any law.” Id. The revised law, however, states:

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 . . . 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.

26 U.S.C. § 162(f)(1) (2018) (highlighting new exception for amounts constituting restitution or paid to come into compliance with law). Revised § 162(f)(2) then outlines an “[e]xception for amounts constituting restitution or paid to come into compliance with law.” Id. § 162(f)(2).

\(^{17}\) See Wollman et al., supra note 2 (outlining nuances in revised § 162(f)).

\(^{18}\) See id. (highlighting under new law, settlement payments not deductible unless explicit exception applies). Revised § 162(f) gives three exceptions where a settlement payment would be deductible. See id.; see also infra Section IIIA (detailing three exceptions).

\(^{19}\) See 26 U.S.C. § 162(f)(3) (outlining exception for certain court orders). This exception applies to amounts paid pursuant to court order in a private lawsuit, where the government or governmental entity is not a party and the payment is not being made at the government’s direction. See id.
second exception covers amounts paid as taxes due.\textsuperscript{20} The third exception relates to amounts the taxpayer establishes as restitution or an amount paid to come into compliance with the law.\textsuperscript{21}

This Recent Development focuses on the third exception, which allows the taxpayer to deduct payments that constitute either restitution or an amount paid to come into compliance with the law.\textsuperscript{22} This Recent Development examines § 162(f) and its implication on settlement agreements occurring after the TCJA.\textsuperscript{23} Part II discusses the history of § 162(f) and the impact of enacting the TCJA on the law.\textsuperscript{24} Then, Part III examines the impact of the revised law on the deductibility of government settlement payments.\textsuperscript{25} Specifically, this Recent Development discusses how the law expands the scope of the prohibition on deductions by explicitly outlining what businesses can and cannot deduct, while still leaving room for companies to write off restitution payments.\textsuperscript{26} Finally, Part IV reiterates the argument that the revised law serves a valid purpose because it will mitigate postsettlement conflict between taxpayers and the IRS, eliminate vagueness, facilitate more efficient tax administration, and potentially promote greater transparency.\textsuperscript{27} Additionally, the revised law will likely incentivize corporations to agree to a larger overall settlement as long as a substantial portion of the settlement is classified as restitution or a payment made to come into compliance with the law.\textsuperscript{28} This Recent Development ultimately concludes the revised law is a win-win situation for all parties because the injured party will receive a higher settlement payment, while the business will be permitted to deduct the portion allocated to restitution.\textsuperscript{29}

\textsuperscript{20} See id. § 162(f)(4) (outlining exception for amounts paid “as taxes due”). The law specifically states that the nondeductible fines and penalties category does not apply to amounts paid as taxes due. Id.

\textsuperscript{21} See id. § 162(f)(2) (outlining exception for amounts constituting restitution or paid to come into compliance with law).

\textsuperscript{22} See 26 U.S.C. § 162(f)(2) (2018) (outlining exception for amounts constituting restitution or paid to come into compliance with law). The law explicitly states that the category of nondeductible fines and penalties does not apply to any amount that “constitutes restitution (including 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.” See id. § 162(f)(2)(A)(i)(I). The category of nondeductible fines or penalties also does not apply to any amounts “paid to come into compliance with any law which was violated or otherwise involved in the investigation or inquiry.” See id. § 162(f)(2)(A)(i)(II).

\textsuperscript{23} See Wollman et al., supra note 2 (arguing revised rule provides opportunities for companies to negotiate deductible settlement agreements).

\textsuperscript{24} See infra Part II.

\textsuperscript{25} See infra Part III.

\textsuperscript{26} See infra Part III.

\textsuperscript{27} See infra Part IV.

\textsuperscript{28} See infra Part IV.

\textsuperscript{29} See infra Part IV.
II. HISTORY OF PRE-TAX REFORM § 162(F)

The federal income tax laws are intended to tax only the taxpayer’s earnings and profits, minus any expenses and losses, carrying out Congress’s broad policy of taxing only net income.\(^{30}\) Due to this intent, § 162(a) allows a taxpayer to deduct “ordinary and necessary” expenses paid or incurred during the taxable year in carrying on a trade or business.\(^ {31}\) This allows a taxpayer to take deductions for ordinary day-to-day costs of running a business, such as rent and salaries, ensuring only a business’s net income is taxed.\(^ {32}\)

There are limits, however, to what a business may deduct.\(^ {33}\) Deductions are a matter of legislative grace and not every business expense may be deducted.\(^ {34}\) Early on, the judiciary created exceptions to § 162(a), such as disallowing deductions for fines, bribes, penalties, kickbacks, and other immoral payments.\(^ {35}\) The courts disallowed these deductions to avoid frustrating public policy.\(^ {36}\) This exception became known as the public policy doctrine, and the lower courts frequently used this doctrine to deny deductions for claimed business expenses.\(^ {37}\)

In a series of cases, the Supreme Court developed the public policy doctrine by disallowing deductions that frustrate state or federal public policy.\(^ {38}\)

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\(^{31}\) See 26 U.S.C. § 162(a) (2018) (stating deductibility rule for trade or business expenses). Taxpayers are allowed to deduct all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. See id. This includes a reasonable allowance for salaries or other compensation, traveling expenses, and rental payments. See id.; see also Comm’r v. Lincoln Sav. & Loan Ass’n, 403 U.S. 345, 352 (1971) (outlining deductibility requirements). To qualify as a permitted deduction under § 162(a), the item must be “paid or incurred during the taxable year”; for “carrying on any trade or business”; and be an “expense,” a “necessary” expense, and an “ordinary” expense. Lincoln Sav. & Loan Ass’n, 403 U.S. at 352 (quoting 26 U.S.C. § 162(a)).

\(^{32}\) Pace, supra note 30, at 829 (highlighting common business deductions).

\(^{33}\) See Treas. Reg. § 1.162-21(a)-(b) (as amended in 1975) (stating fines or penalties not deductible). The regulation states a fine or penalty includes amounts paid pursuant to guilty pleas or convictions; civil penalties imposed by federal or state laws; settlements of tax liability; or amounts “[f]orfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty.” Id. § 1.162-21(b).

\(^{34}\) See INDOPOCO, Inc. v. Comm’r, 503 U.S. 79, 84 (1992) (holding income tax deduction matter of legislative grace). The taxpayer carries the burden of showing the right to the claimed deduction. See id.; see also Interstate Transit Lines v. Comm’r, 319 U.S. 590, 593 (1943) (holding burden of showing right to deduction on taxpayer).

\(^{35}\) Pace, supra note 30, at 829 (outlining judicially-created exceptions to § 162(a)).

\(^{36}\) See id. (discussing public policy doctrine).

\(^{37}\) Id. at 830 (highlighting how lower courts used public policy doctrine). Prior to Congress enacting § 162(f), the judiciary used the public policy doctrine as a rationale to deny deductions. See id.

\(^{38}\) See Abraham N.M. Shashy, Jr. et al., Beyond Frustration: Section 162(f) and the Deductibility of Fines, Penalties, and Settlement Payments, 17 FLA. TAX REV. 349, 363 (2015) (discussing public policy doctrine’s purpose). Although the term “necessary” includes expenses that are “appropriate and helpful[,]” an expense cannot
A landmark decision outlining the public policy doctrine is *Tank Truck Rentals, Inc. v. Commissioner*. In *Tank Truck Rentals*, a trucking company deducted numerous fines imposed on the corporation for violations of state maximum weight laws. The Supreme Court affirmed the appeals court’s decision, holding deducting fines and penalties frustrates state policy in a “severe and direct fashion by reducing the ‘sting’ of the penalty prescribed by the state legislature.”

In *Hoover Motor Express Co. v. United States*, the Court again used the public policy doctrine to disallow a deduction for fines and penalties. The Court affirmed the appeals court’s decision, which held allowing a violator to gain a tax advantage by deducting the penalty as a business expense weakens the punishment and undermines the public policy’s purpose and effectiveness. Additionally, the Court noted paying fines is not “necessary” to operating a business, and thus cannot be deducted as an “ordinary and necessary” business expense.

While the Supreme Court has held that certain business expenses, such as fines and penalties, cannot be deducted for public policy reasons, the Court has also held that the public policy doctrine is not limitless. In *Commissioner v. Tellier*, the taxpayer was a securities dealer charged with violating the law, and the Court held that the fines were not “necessary” when they would frustrate a governmental declaration of a sharply defined public policy. The Court has held that certain business expenses, such as fines and penalties, cannot be deducted for public policy reasons, but the Court has also held that the public policy doctrine is not limitless. The judiciary later allowed taxpayers to deduct legal fees and related expenses as ordinary and necessary business expenses, even if the costs were paid in defense of a crime or other bad act. See *id.* As long as the deduction does not frustrate sharply defined public policy, it is generally allowable if the expense is an ordinary and necessary cost of doing business. See *id.* at 831-32.

40. See *id.* at 35 (discussing why Commissioner issued deficiency against taxpayer). The taxpayer paid $41,060.84 in fines and costs for 718 willful and 28 innocent violations. *Id.* The taxpayer then deducted that amount on its 1951 tax return, which was disallowed by the Commissioner. *Id.*
41. See *id.* at 35-36 (disallowing deduction). The Court further noted, although each case must be judged on its own facts, the “test of nondeductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction.” *Id.* at 35.
43. See *id.* at 40 (denying deduction for fines).
44. See *id.* (affirming lower court’s decision); *see also Hoover Motor Express Co. v. United States, 135 F. Supp. 818, 820-21 (M.D. Tenn. 1955) (outlining rationale for denying deduction of penalties).
45. See *Hoover Motor Express Co.*, 356 U.S. at 39 (noting fine not necessary business expense); *see also Jacob L. Todres, Internal Revenue Code Section 162(f): An Analysis and Its Application to Restitution Payments and Environmental Fines, 99 DICK. L. REV. 645, 656 (1995) (noting Hoover Court created new definition of “necessary”). This new definition of “necessary” was tailored to the facts of *Hoover*. See *Todres, supra*, at 656. In *Hoover*, the Court held that the fines were not “necessary” because they were avoidable. See 356 U.S. at 39. Nevertheless, the Court has “ignored avoidability as a parameter of ‘necessary’” since its *Hoover* decision.
46. See *Pace, supra* note 30, at 831 (noting public policy doctrine not limitless). For example, the judiciary later allowed taxpayers to deduct legal fees and related expenses as ordinary and necessary business expenses, even if the costs were paid in defense of a crime or other bad act. See *id.* As long as the deduction does not frustrate sharply defined public policy, it is generally allowable if the expense is an ordinary and necessary cost of doing business. See *id.* at 831-32.
Securities Act of 1933 and the mail fraud statute. On his federal income tax return, the taxpayer deducted the $22,964.20 in legal expenses incurred during his criminal prosecution. Although the Commissioner conceded that the taxpayer’s legal expenses were “ordinary and necessary” expenses, the IRS disallowed the deduction on public policy grounds, and the Tax Court affirmed this decision. The Second Circuit unanimously reversed the decision, and the Supreme Court affirmed. In its opinion, the Court held that to establish a public policy disallowance, there must be a government declaration of a policy, and an immediate frustration of that policy would result if the tax deduction is allowed. The Court articulated this case fell outside those sharply defined categories and stated that “[n]o public policy is offended when a man faced with serious criminal charges employs a lawyer to help in his defense. That is not ‘proscribed conduct.’ It is his constitutional right.” Thus, the Court held that legal fees paid in defense against criminal charges stemming from business dealings may be deducted under § 162(a) as ordinary and necessary business expenses.

In a series of cases, the Supreme Court continued to articulate the limits of the public policy doctrine. In , an optical business paid kickbacks to doctors in exchange for referrals. The Court held that these payments

48. See id. at 688 (outlining underlying litigation). The taxpayer was found guilty of violating the Securities Act of 1933, ordered to pay an $18,000 fine, and serve over four years in prison. Id. During the course of the litigation, the taxpayer incurred $22,964.20 in legal expenses. Id.
49. See id. (stating taxpayer deducted legal fees on tax return).
50. See id. at 688-90 (explaining grounds for Commissioner’s disallowance).
51. See Tellier, 383 U.S at 688, 691 (explaining procedural posture). The Court began its opinion by noting “the federal income tax is a tax on net income, not a sanction against wrongdoing.” Id. at 691.
52. See id. at 694 (outlining requirements for disallowance under public policy doctrine). The Court added the “test of nondeductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction.” Id. (quoting Tank Truck Rentals, Inc. v. Comm’r, 356 U.S. 30, 35 (1958)).
53. Comm’r v. Tellier, 383 U.S. 687, 694 (1966) (articulating why public policy doctrine not applicable to Tellier). The Court further noted that “[i]n an adversary system of criminal justice, it is a basic of our public policy that a defendant in a criminal case have counsel to represent him.” Id.; see Powell v. Alabama, 287 U.S. 45, 68 (1932) (holding right to counsel constitutional right).
54. See Tellier, 383 U.S. at 689-90 (holding legal expenses deductible). The Court noted the fees the taxpayer deducted were not capital expenditures, but expenses, and that counsel fees have been established in prior decisions as ordinary business expenses, “even though a ‘lawsuit affecting the safety of a business may happen once in a lifetime.’” See id. at 690 (quoting Welch v. Helvering, 290 U.S. 111, 114 (1933)). Even if a lawsuit of this magnitude only happens once to a business, the taxpayer may still deduct the costs of the lawsuit as an ordinary business expense. See Welch, 290 U.S. at 114. “Ordinary” does not necessarily mean habitual, normal, or made often. See id. Legal fees are considered “ordinary” because payments for such a purpose are the “common and accepted means of defense against attack.” See id.
55. See generally Comm’r v. Sullivan, 356 U.S. 27 (1958) (holding rent ordinary and necessary business expense even under illegal circumstances, and thus deductible); Lilly v. Comm’r, 343 U.S. 90 (1952) (holding kickbacks deductible business expense); Comm’r v. Heininger, 320 U.S. 467 (1943) (stating mere relation to illegal acts alone insufficient to disallow deduction).
56. See 343 U.S. at 91, 97 (declining to disallow deduction for public policy reasons). The taxpayers were in the optical business and followed the widespread industry practice of making payments to doctors who recommended purchases and prescribed eyeglasses from them. See id. at 91. The payments were not illegal.
were deductible because there were no governmental declarations that the payments violated public policy at the time the payments were made.\textsuperscript{57} In \textit{Commissioner v. Sullivan}, the Court held that the ordinary expenses of operating a business are deductible, even if the business is illegal or immoral.\textsuperscript{58} Further, in \textit{Commissioner v. Heininger}, the Court held that “the mere fact that an expenditure bears a remote relation to an illegal act” is insufficient to make it nondeductible.\textsuperscript{59}

Together, these cases stand for the proposition that the public policy doctrine is only intended to apply to payments incurred in violating an explicit governmental policy.\textsuperscript{60} Essentially, the doctrine only applies to expenses that relate to a punishment, not normal costs incurred in running a business—even if the business is illegal, the payments are conventionally unethical, or the costs are incurred in defense of the business in a civil or criminal proceeding.\textsuperscript{61} The public policy doctrine’s purpose is \textit{not} to utilize the tax code to regulate morality, but to disallow deductions that would frustrate state or federal policies.\textsuperscript{62}

While the public policy doctrine did not permit businesses to deduct expenses that would frustrate public policy, the judiciary historically allowed deductions for payments that were compensatory, remedial, or otherwise nonpunitive in id. at 94-95. Nevertheless, the Commissioner disallowed their deductions. See id. at 92. The Tax Court sustained the Commissioner on policy grounds and the Fourth Circuit affirmed. See id. The Supreme Court reversed and held the payments were deductible. See id. at 98.

\textsuperscript{57} See id. at 96-97 (holding kickback payments deductible business expenses). The Court reasoned even though some business expenses may be ordinary and necessary, the expense deductions may be denied on public policy grounds when they “frustrate sharply defined national or state policies proscribing particular types of conduct.” See id. (quoting \textit{Heininger}, 320 U.S. at 473). The Court held that the kickback payments at issue in the case did not fall within that category because there were no declared public policies prohibiting these types of payments at the time the payments were made. See id. at 97-98; see also Pace, supra note 30, at 832 (explaining Court’s decision in \textit{Lilly}).

\textsuperscript{58} See 356 U.S. at 28-29 (holding rent and salaries paid for illegal gambling business deductible). In \textit{Sullivan}, the taxpayers engaged in an illegal gambling enterprise, and sought to deduct rent and employee salaries from their taxable income. See id. The Tax Court held these payments were not allowable deductions because they were made in connection with illegal acts. See id. The court of appeals reversed, and the Supreme Court granted certiorari. See id. The Court held that “[t]he policy that allows as a deduction the tax paid to conduct the business seems sufficiently hospitable to allow the normal deductions of the rent and wages necessary to operate it.” See id. at 29; see also Pace, supra note 30, at 832 (explaining Court’s holding in \textit{Sullivan}).

\textsuperscript{59} See 320 U.S. at 471, 474 (holding legal defense expenses “normal”). The Court also reasoned that the language of § 23(a) does not contain any reference to the lawful or unlawful nature of the business expenses, which are deductible. See id. at 474.

\textsuperscript{60} See Pace, supra note 30, at 832-33 (explaining public policy doctrine).

\textsuperscript{61} See id. at 829 (addressing limits of public policy doctrine); see also Todres, supra note 45, at 662 (noting illegal business expenses permitted deduction). The Court held “that the federal income tax is a tax on net income, not a sanction against wrongdoing[,]” and therefore “illegal income is taxed the same as lawful income.” Comm’r v. Tellier, 383 U.S. 687, 691 (1966); Todres, supra note 45, at 662.

\textsuperscript{62} See Pace, supra note 30, at 833 (stating purpose of public policy doctrine does not include regulating morality). The purpose of the public policy doctrine is to deny deductions whose allowance would frustrate state or local public policies. See id.
Compensatory payments include actual (single) damages or payments made to resolve claims without admitting liability. Any additional amounts beyond single damages could either be punitive or compensatory, depending on the parties’ intent. Unlike fines and penalties, the judiciary viewed compensatory payments as nonpenal and a nonviolation of public policy; thus, payments categorized as compensation were allowable deductions under § 162(a). For example, in Grossman & Sons, Inc. v. Commissioner, the taxpayer paid $100,000 to the United States in settling a claim under the FCA. The taxpayer claimed the payment was compensatory or restitutionary—and not penal—in nature. Because of that, the taxpayer argued, there was no sharply defined public policy that would render the payment nondeductible. The Tax Court agreed with the taxpayer and allowed the deduction. Additionally, in Helvering v. Hampton, the Ninth Circuit held that restitution payments were deductible as ordinary and necessary business expenses.

Congress codified the judicially-created public policy doctrine in the Tax Reform Act of 1969. Although § 162(a) remained unchanged, § 162(f) was added as a limiting provision. Before the TCJA was enacted in 2017, § 162(f)
prohibited deductions for any fine or similar penalty paid to a government or governmental entity for the violation of any law.\textsuperscript{74} This pre-TCJA exception excluded fines or penalties from the category of ordinary and necessary business expenses.\textsuperscript{75} The Treasury Regulations defined a “fine or similar penalty” to include amounts “[p]aid as a civil penalty imposed by Federal, State, or local law” and amounts “[p]aid in settlement of the taxpayer’s actual or potential liability for a fine or penalty (civil or criminal)”\textsuperscript{76} But while a payment that constituted a fine or penalty was not deductible under pre-TCJA § 162(f), the Treasury Regulations further stated that compensatory damages or restitution are deductible business expenditures under § 162(a).\textsuperscript{77} Thus, the post-1969 inquiry into a settlement payment’s deductibility came down to whether the payment was a fine, penalty, or compensatory damage.\textsuperscript{78} This inquiry, however, led to controversy between the IRS and taxpayers over whether a particular payment should be categorized as a nondeductible fine or penalty, or as a deductible restitution payment.\textsuperscript{79}

III. RECENT DEVELOPMENT

A. Post-Tax Reform § 162(f)

On December 22, 2017, President Donald Trump signed into law the TCJA—the largest tax overhaul since 1986.\textsuperscript{80} The revised law attempted to reduce the

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\item See id. (outlining fines or penalties exception).
\item See id. (excluding fines or penalties from deductible business expenses).
\item See Treas. Reg. § 1.162-21(b)(1)(ii)-(iii) (as amended in 1975) (providing Treasury Regulation definition).
\item See id. § 1.162-21(b)(2) (stating “fine or penalty” excludes compensatory damages). Further, the definition of fine or penalty also excludes related legal fees. See id.
\item See Shashy et al., supra note 38, at 351-52 (discussing pre-TCJA settlement agreements). To the extent a settlement payment was not a fine or similar penalty as outlined in § 162(f), the payment would generally be deductible. See id. at 360. The result is if a payment is not a fine or penalty, the taxpayer can deduct the settlement amount, resulting in a federal tax savings of more than a third of the payment amount. See id.
\item As a result, taxpayers who settle under the FCA have faced great uncertainty as to whether their settlement payment is deductible or not. See id. This uncertainty is part of the reason why § 162(f) was revised as part of the TCJA. See id. Now, there will be greater certainty due to the requirement that the settling agency explicitly classify the payment’s tax treatment in the settlement agreement. See id.
controversies under the prior law by tightening the restrictions on deducting settlement payments under § 162(f). Under the revised tax law, whether a payment is a fine or penalty no longer controls whether the payment is tax deductible. Instead, any payment to a governmental entity relating to a violation or an investigation into a potential violation is not deductible unless a specific exception applies.

Revised § 162(f) provides for three exceptions where a taxpayer’s settlement payment paid to a governmental entity may be deducted. Two of those exceptions relate to private court orders or amounts paid as taxes due. The third exception is for amounts that either constitute restitution or are paid to come into compliance with the law. To qualify under this third exception, the taxpayer must satisfy specific requirements that were not required under the prior law.

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17-19; see also Tracy Watkins & John Charin, IRS Releases Transitional Guidance on Sections 162(f) and 6050X, RSM (Mar. 29, 2018), https://rsmus.com/what-we-do/services/tax/lead-tax/accounting-methods-and-periods/irs-releases-transitional-guidance-on-sections-162f-and-6050x.html [https://perma.cc/68QT-V7YT] (discussing new reporting requirement under revised § 162(f)). For example, there is a new reporting requirement under the revised law that requires the government and governmental entities to report amounts received from taxpayers under § 162(f). See Watkins & Charin, supra. Although this is written into the IRC, the IRS delayed the reporting date because the IRS has not finalized the form or made the form available to the public yet. See id.

1. See New Restrictions, supra note 79, at 1 (discussing reasons for revised law). In an attempt to reduce the controversy stemming from the prior inquiry into whether the payment was a fine, penalty, or restitution, the TCJA placed greater restrictions on settlement payments’ deductibility under the revised § 162(f). See id. Now, taxpayers must satisfy several criteria before they are allowed to deduct a settlement payment. See id. at 1-2.

2. See 26 U.S.C. § 162(f)(1)(2018) (omitting language relating to fines and penalties). The new law states that deductions will not be allowed for “any amount paid or incurred . . . 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.” Id. (emphasis added). The new rule omits the prior language that specifically excluded fines or penalties as an allowable deduction. See id.; see also Wollman et al., supra note 2 (discussing revisions to new tax law).

3. See 26 U.S.C. § 162(f) (outlining new rule for deducting fines, penalties, and other amounts). Under the new law, there are three exceptions where a payment made to a government or governmental entity in relation to a violation or potential violation of the law will be deductible for tax purposes. See id. § 162(f)(2)-(4); see also Wollman et al., supra note 2 (discussing exceptions under revised law).


5. See 26 U.S.C. § 162(f)(3)-(4) (stating two exceptions to general rule); see also GUIDE TO THE NEW RULES, supra note 1, at 2 (noting § 162(f) does not apply to private claims).


7. See id. (repeating exception for amounts constituting restitution or paid to come into compliance with law). The taxpayer must independently establish that the amount constitutes restitution (including remediation of property) for damage or harm that was caused by the violation (or potential violation) of law, or is an amount paid to come into compliance with the law that was violated or the law that was the subject of the investigation or inquiry. Id. § 162(f)(2)(A)(I)-(II). Additionally, for the payment to be deductible, the court order or settlement agreement must specifically identify the payment as restitution, or an amount paid to come into compliance with the law. Id. § 162(f)(2)(A)(ii). Finally, the taxpayer must establish that the payment did not reimburse the governmental entity for the costs of any investigation or litigation. Id. § 162(f)(2)(B) (providing limitation); see New Restrictions, supra note 79, at 2 (outlining requirements to satisfy exception). The new law requires that
In addition to certain taxpayer requirements, there is also a new reporting requirement that compels the government and governmental entities to report amounts received from taxpayers under § 162(f).\(^88\)

Revised § 162(f) expands the scope of the tax code in three critical ways.\(^89\) A deduction may be disallowed not only where the amount is paid to the government or governmental entity, but also where a payment is made at the government’s direction.\(^90\) Additionally, the revised law encompasses investigations into potential violations rather than just the resolution of actual violations.\(^91\) Lastly, the revised statute removes the “fine or similar penalty” language, emphasizing its broader focus on both actual and potential legal violations.\(^92\) The result is that any payment made to resolve an investigation is subject to this rule—regardless of whether the payment is a fine or penalty—unless one of the exceptions applies.\(^93\)

The effect of the revised law is that settling taxpayers will face greater hurdles when trying to obtain settlements that are tax deductible.\(^94\) Additionally, settling agencies will have broader discretion in determining whether a taxpayer’s the taxpayer satisfy three new requirements before a deduction will be allowed under this exception. See New Restrictions, supra note 79, at 2.

88. See 26 U.S.C. § 6050X (2018) (stating reporting requirement); see also Watkins & Charin, supra note 80 (discussing new reporting requirement). The report must specify the amount of the nondeductible payment, any amount that constitutes restitution or remediation of property, and any amount paid to come into compliance with the law that was violated or involved in the investigation or inquiry. See Watkins & Charin, supra note 80.

89. See New Restrictions, supra note 79, at 1-2 (discussing revised law’s nuances).

90. See id. (noting new law encompasses payments to nongovernmental entities at direction of government); see also Wollman et al., supra note 2 (discussing expansion of payees under revised law). Not only are payments made at the direction of the government covered under the new law, but the definition of “governmental entity” is also expanded. See Wollman et al., supra note 2. The definition now includes nongovernmental entities that have self-regulatory powers and other specific entities identified in the statute. See id. Self-regulating agencies that use self-regulatory powers as part of performing an “essential government function” are now included within the definition of governmental entity. See id. For an entity to fall under this definition, it must be explicitly identified in the revised law or the Treasury Regulations. See id. Although the IRS had previously taken the position that the old law encompassed self-regulatory agencies, the new law makes it clear that only those agencies identified in the new statute or Treasury Regulations are covered. See id.

91. See New Restrictions, supra note 79, at 1-2 (discussing critical changes to law). Because potential violations, in addition to actual resolved violations, are swept up under revised § 162(f), a taxpayer may disclaim legal liability in the settlement agreement yet still be subject to a nondeductible settlement payment. See id. Therefore, even if the taxpayer asserts that no violation of law actually occurred, the payment made to settle the investigation into the potential violation may not be deductible. See id.

92. See id. (highlighting new law’s scope); see also Short Takes: Recent Developments of Interest to Investors—With a Focus on the New Tax Law, J. TAX’N INV., Spring 2018, at 85, 94 (highlighting revisions and exceptions to § 162(f)).

93. See New Restrictions, supra note 79, at 1-2 (highlighting revised law’s scope).

settlement is deductible.95 Ultimately, however, the IRS will have the final say in whether a deduction is allowed under the revised law.96

B. The Revised Law’s Implications on Post-TCJA Settlement Agreements

It is difficult to quantify exactly how § 162(f) has affected settlement agreements since the enactment of the TCJA.97 The overwhelming majority of cases are settled out of court, which allows companies to hide exactly how much of the settlement payment is eligible for a tax write-off.98 Many critics argue that, despite the revision, the updated law essentially serves the same purpose: It is a tax loophole that allows corporate wrongdoers to violate laws and then write off those violations as a cost of doing business.99 But despite the fact that the revised law leaves this possibility open, the law still serves a valid purpose.100

The revised law eliminates the gray area that existed under the prior law because it explicitly prohibits the deduction of settlement payments unless an exception applies.101 As a result, the revised law makes it significantly more difficult to obtain a settlement that is tax deductible.102 Additionally, the revised law will result in fewer disputes between the IRS and taxpayers because the revised law requires settling parties to agree on the tax characterization of the

95. See id. (highlighting additional requirements taxpayer must satisfy). Because the settling agency must specifically identify in the settlement agreement which portions are deductible and then report that classification to the IRS, the settling agency now has broader discretion under the revised law to decide internally on the settlement’s tax classification. See id.

96. See 26 U.S.C. § 162(f)(2)(A) (2018) (stating identification alone insufficient to make establishment required by law). While the settling agency now has broad discretion to characterize a settlement payment as deductible or nondeductible, the agency’s payment characterization does not guarantee tax deductibility. See Briggerman et al., supra note 94. The IRS can disregard the payment classification and conclude instead the payment does not constitute a deductible restitution payment. See id.

97. See Cohen, supra note 7 (discussing secrecy of government settlement payments). “Which payments are deductible and which are not is often a mystery to the public. The overwhelming majority of cases, whether with a government agency or private individuals, are settled, enabling companies to hide just how much of the agreement’s sticker price is eligible for a write-off.” Id.

98. See id. (explaining how settlements’ details remain hidden).

99. See id. (highlighting critiques of law). “This tax loophole allows corporations to wreak havoc and then write it off as a cost of doing business.” Id. (quoting Senator Patrick Leahy of Vermont).

100. See supra notes 86-87 and accompanying text (outlining deductible restitution exception); see also O’Neal, supra note 1 (stating tax law leaves room for companies to write off settlement payments).

101. See Breslow, supra note 6 (discussing IRC’s gray area). This gray area under the prior law enabled businesses to claim deductions for payments that had unclear classifications, that is, a payment that was not explicitly specified as a nondeductible fine or penalty, nor defined as a restitution or compensation payment. See id. This lack of clarity allowed many businesses to successfully claim deductions for their settlement payments. See id. “With large settlements, though, payments are often not a penalty or fine, but rather meant to address some form of liability connected to alleged misdeeds. When that’s the case, firms can typically write that amount off as a cost of doing business.” Id.; see supra notes 80-83 and accompanying text (stating settlements not deductible under new law unless exception applies).

102. See supra notes 93-94 and accompanying text (discussing hurdles for taxpayers under new law). The result of the revised law is settling taxpayers will face greater hurdles when trying to obtain settlements that are tax deductible. See New Restrictions, supra note 79, at 1; see also 26 U.S.C. § 162(f)(2) (2018) (outlining requirements taxpayers must meet to obtain deductible settlement).
payment upfront at settlement. Further, the revised law provides greater incentives for corporations to offer higher overall settlement amounts in exchange for characterizing the payment as restitution. This is beneficial for all parties involved because the injured party will receive a higher overall payment from the wrongdoer, while the settling taxpayer may deduct the portion attributed to restitution. Lastly, the revised law establishes a statutory reporting scheme that has the potential to result in greater transparency regarding the true after-tax cost of settlement agreements.

1. Revised § 162(f) Mitigates Disputes and Resolves Ambiguities that Existed Under the Prior Law

In order for a deduction to qualify as the restitution or compliance exception under the revised law, the taxpayer and the settling governmental entity must agree on the portion of the payment that constitutes restitution or an amount paid to come into compliance with the law. This amount must be identified in the settlement agreement or court order. Additionally, the revised law adds a reporting requirement for any deductible settlement payments. The settling governmental entity must now file a report with the IRS specifying the entire amount of the settlement, as well as the portion of the payment qualifying for a deduction.

The prior § 162(f) did not include these requirements, and therefore settlement agreements typically did not specify the tax characterization of any payments made thereunder. Accordingly, prior to the tax reform, a business could unilaterally decide and report the character and deductibility of settlement payments. The new law provides greater incentives for the government and businesses to negotiate settlements that will benefit both parties.

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104. See O’Neal, supra note 1 (discussing benefits of revised law for businesses). Although it is never ideal for a business to be involved in an investigation or litigation relating to a violation or potential violation of the law, revised § 162(f) retains the statutory authority for businesses to take deductions on settlement payments if the payment is categorized as either restitution or a payment made to come into compliance with the law. See id. Additionally, the business must follow the new procedural requirements of revised § 162(f). See id. Although there are more hurdles in place, the new law provides greater incentives for the government and businesses to negotiate settlements that will benefit both parties. See id.
105. See id. (discussing benefits of revised law for governmental entities).
106. See supra note 88 and accompanying text (discussing new reporting requirement under revised § 162(f)); see also McElroy et al., supra note 13 (critiquing old law). One common critique of the pre-TCJA § 162(f) was that businesses hid the true, after-tax amount of a settlement agreement from the public. See McElroy et al., supra note 13.
107. See Engell et al., supra note 103 (noting settling parties must agree on tax treatment during settlement negotiation).
108. See id. (discussing identification requirement).
109. See id. (introducing reporting requirement).
110. See id. (detailing reporting requirement).
111. See Engell et al., supra note 103 (highlighting pre-TCJA lack of identification and reporting requirements).
payments, subject only to a future IRS audit. Businesses argued that their settlement payments were compensatory or restitutionary in nature, and thus deductible under § 162(a) as an ordinary and necessary business expense. Significant controversy arose between the IRS and taxpayers concerning the tax treatment of settlement payments due to ambiguous payment classifications in settlement agreements. These tax characterization issues often arose after the settlement concluded, when the IRS was reviewing and auditing the business’s tax return. In response to the continuing controversy and litigation, Congress sought to clarify the scope of nondeductible fines and penalties when it enacted the revised § 162(f).

Michelle Surka, Director of the U.S. Public Interest Research Group Campaign for Budget Transparency, praised the new law stating, “In the past it was really mired by uncertainty. Old 162(f) was super vague.”

Removing this ambiguity and clarifying the law provides certainty. The revised law will avoid disputes between the IRS and settling taxpayers because the statute now provides clearer guidance as to what types of payments can and cannot be deducted. In addition to explicitly stating what is deductible, the new requirements will help to avoid postsettlement disputes between the IRS and taxpayers regarding the deductibility of specific payments. The revised law requires, for tax purposes, that the court order or settlement agreement must explicitly state the amount that constitutes compensation or restitution. Although the IRS will have the final say, to conform with this new requirement, settling taxpayers will need to negotiate their payment’s tax characterization at settlement, rather than when the taxpayer’s tax return is reviewed.

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112. See id. (highlighting issues with pre-TCJA § 162(f)).
113. See McElroy et al., supra note 13 (noting room for businesses to justify deductibility under old law); see also Lynch & Lynch, supra note 5, at 11 (noting compensatory payments not considered fines or penalties, and thus deductible).
114. See McElroy et al., supra note 13 (discussing controversy regarding tax treatment of fines and penalties). For the last twenty years, there have been significant disputes between the IRS and taxpayers regarding the tax treatment of settlement payments that generated from an ambiguity as to whether a payment was a deductible compensatory payment or a nondeductible fine or penalty. See id. This was exacerbated in settlement agreements with the DOJ, which took the position that settlement agreements should be tax neutral. See id.
115. See Engell et al., supra note 103 (noting controversy regarding deductions arises during IRS audit).
116. See McElroy et al., supra note 13 (discussing policy reasons behind revised § 162(f)). The revised law was enacted along with the reporting requirement in § 6050X to resolve the ongoing disputes. See id.
117. See O’Neal, supra note 1 (noting old law vague and taxpayers faced with uncertainty).
118. See id. (stating old § 162(f) created uncertainty for settling taxpayers).
120. See id. § 6050(X) (outlining new requirements under § 162(f)); see also GUIDE TO THE NEW RULES, supra note 1, at 4-5 (discussing how new requirements will prevent controversy).
121. See 26 U.S.C. § 6050(X) (outlining restitution reporting requirement).
122. See GUIDE TO THE NEW RULES, supra note 1, at 8 (noting parties need to address deductibility issue during settlement). While the IRS is free to challenge the tax characterization of a claimed deduction, no deduction is allowed unless the identification is first made. See H.R. REP. NO. 115-466, pt. 1, at 439 (2017) (Conf.
the revised law requires taxpayers and governmental agencies to resolve the deduction issue as part of the settlement negotiation, future tax deduction disputes will be avoided between the IRS and taxpayers.123

Addressing deduction issues upfront significantly benefits both businesses and the IRS.124 Businesses will have a better grasp at the outset as to what portions of their settlement are deductible, providing greater certainty and avoiding costly postsettlement litigation with the IRS.125 Additionally, the revised law will facilitate more efficient tax administration for the IRS.126 In the past, the IRS was not equipped with the resources to determine whether certain portions of settlement payments were deductible or not.127 Now, because the tax characterization of a settlement payment is determined by the court or settling agency prior to the business filing a tax return, fewer IRS resources will be devoted to determining the proper characterization of settlement payments and to resolving deduction disputes.128

By removing the ambiguity, the revised law also makes it more difficult for taxpayers to obtain tax deductible settlement agreements.129 The revised law makes it more difficult for taxpayers to deduct settlement payments because the new rule prohibits settlement deductions unless a specific exception applies.130 Under the old, more flexible law, businesses could argue that if a payment was not a fine or penalty, it was a deductible business expense.131 If the payment’s tax characterization was ambiguous, many companies argued to the IRS that the payment was compensatory or remedial in nature, and thus deductible.132 Coupled with the fact that the IRS lacked the resources to determine the proper characterization of certain settlement payments, this meant taxpayers could get away

Rep.); see also supra note 96 and accompanying text (noting IRS has final say in whether deduction allowed under revised law).

123. See GUIDE TO THE NEW RULES, supra note 1, at 4-5 (noting future tax deduction disputes potentially forestalled).
124. See id. (discussing revised law’s benefits).
126. See GUIDE TO THE NEW RULES, supra note 1, at 4-5 (discussing benefits of new law affecting tax administration).
127. See O’Neal, supra note 1 (noting IRS did not have capacity to determine tax characterization under prior law).
128. See GUIDE TO THE NEW RULES, supra note 1, at 4-5 (noting new law will result in decreased use of IRS resources).
129. See McElroy et al., supra note 13 (discussing how businesses took advantage of law’s ambiguity to claim deductions); see also Cohen, supra note 7 (discussing how businesses justified tax deductibility of settlement payments). “Companies defend the practice, pointing out that they are frequently the target of frivolous lawsuits and sometimes suffer from what they consider excessive jury awards. Settlements and damages are an inevitable cost of doing business, they say, and are, therefore, justifiable deductions.” Cohen, supra note 7.
130. See generally 26 U.S.C. § 162(f) (prohibiting deductions for payments relating to legal violations or investigations into potential violations).
131. See McElroy et al., supra note 13 (discussing controversy arising from prior vague law).
132. See id. (noting ambiguity on whether payments deductible).
with deducting payments with unclear tax characterizations. This is no longer the case. Now, in light of the bright line rule that a payment is not deductible unless an exception applies, a taxpayer must meet one of the three exceptions before a deduction is permitted. Additionally, once it is determined an exception applies, there are new statutory requirements the government and taxpayers must follow in order to obtain a settlement that, on its face, appears deductible. And even after that, the IRS retains the right to challenge a settlement payment’s tax characterization.

2. Section 162(f) Will Incentivize Corporate Wrongdoers to Offer Higher Settlement Amounts

When negotiating settlement agreements, the taxpayer accused of wrongdoing and the governmental entity handling the investigation typically have diverging interests. While the taxpayer wants to pay as little and deduct as much as possible, the government wants the taxpayer to pay a high sum and deduct very little. Revised § 162(f) incentivizes parties to negotiate settlements that can benefit both the government and the settling taxpayer.

133. See O’Neal, supra note 1 (noting IRS did not possess ability to determine tax classification of certain payments); see also GUIDE TO THE NEW RULES, supra note 1, at 4-5 (discussing decreased use of IRS resources under new law). Under revised § 162(f), fewer IRS resources will be devoted to determining the proper character of settlement payments with the government. See GUIDE TO THE NEW RULES, supra note 1, at 4-5.
134. See 26 U.S.C. § 162(f)(1)(2018) (stating post-TCJA rule on settlement deductions). Given that the new rule requires a settlement payment’s tax characterization to be decided upfront as part of the negotiation and explicitly identified in the agreement, the tax character of settlement payments under the new law will not be vague. See O’Neal, supra note 1 (noting old law vague and taxpayers plagued with uncertainty).
135. See O’Neal, supra note 1 (prohibiting deductions for payments relating to legal violations or investigations into potential violations); see also 26 U.S.C. § 162(f)(2)-(4) (discussing exceptions).
136. See 26 U.S.C. § 6050X (stating reporting requirement). The new statutory requirements are mainly procedural, establishing the processes a settling taxpayer must take before a deduction is permitted. See id.; see also supra note 88 and accompanying text (discussing new statutory requirements).
137. See 26 U.S.C. § 162(f)(2)(A) (stating identification alone insufficient to make establishment required by law). The IRS can disregard the payment’s classification and conclude instead that it does not constitute a deductible restitution payment. See id.; McElroy et al., supra note 13 (noting IRS makes final tax determination). Although the revised law provides clearer guidance on settlement deductions, which will hopefully limit audits, settling parties should still anticipate IRS challenges. See McElroy et al., supra note 13.

An unfortunate consequence is that when an agreement is reached and the tax treatment is established and identified, companies will need to be prepared to defend the payments as deductible restitution before the IRS in an exam context. Even though a payment is labeled as deductible in an agreement, this does not necessarily show that the establishment requirement is satisfied. History would suggest that taxpayers should anticipate that the IRS will challenge the deduction. Companies will be required to substantiate payments with other objective information from the settlement discussions to substantiate the ultimate tax return position.

Id.

138. See O’Neal, supra note 1 (discussing diverging interests in negotiation process).
139. See id. (noting interests of government versus interests of settling taxpayer).
140. See id. (noting parties more incentivized to negotiate).
Prior to the TCJA, companies could deduct a settlement payment if they had proof the payment was compensatory to victims.141 Because the law did not require the settling parties to address the deduction issue upfront, and the IRS was not equipped with the resources to determine the true tax characterization of every vague payment with an unclear classification, taxpayers could get away with deducting sums that the revised law no longer permits.142 Now, because deductions are not allowed unless they fall under an exception, a settling taxpayer may agree to a larger overall settlement if a significant portion of the settlement is classified as restitution or a payment made to come into compliance with the law, because that portion is deductible.143 This is especially true in jurisdictions where the settling taxpayer does not pay taxes to its government counterparty, such as cases where a foreign state or local government is pitted against a U.S. company not based in that jurisdiction.144 In those situations, a cash-strapped state or local government may be willing to allocate a large portion of the settlement to tax deductible restitution if it will make the overall settlement larger.145

In situations where the business is a taxpayer of the counterparty’s jurisdiction, there is still an opportunity to negotiate a settlement that will be most beneficial to both the government and the settling taxpayer.146 Revised § 162(f) presents an opportunity for companies to negotiate settlements with the government in a manner that will satisfy the deduction requirements and compensate the injured party.147 For example, if a settling taxpayer agrees to distribute a significantly higher amount of money back to the victims or the injured party, the government may agree to allocate a larger portion of the settlement to a tax deductible classification and a smaller portion of the settlement to nondeductible classifications.148 Examples of nondeductible classifications include payments made to reimburse the government for the costs of its investigation or litigation, or amounts attributed to unjust enrichment rather than restitution.149

But ultimately, regardless of whether the government counterparty is a large federal agency, such as the SEC, or a local municipal government, the revised law provides greater incentives for a business to offer a higher overall payment amount as long as a significant portion of the settlement is allocated to

141. See id. (highlighting opportunity to deduct payments pre-TCJA).
142. See supra notes 130-33 and accompanying text (noting opportunity under prior law to deduct payments with vague classifications).
143. See supra note 1 (discussing settlements under new law).
144. See id. (discussing settlements where business not taxpayer in counterparty’s jurisdiction).
145. See id. (stating state and local governments more incentivized to attribute large portion of settlement to restitution). Scott Levine, a tax partner at Jones Day, stated, “I suspect, all things being equal, they would be more incentivized to play ball, because they might be able to get a larger settlement.” Id.
146. See Wollman et al., supra note 2 (noting how companies may obtain tax deductions under new law).
147. See id. (discussing new opportunities present under revised law).
148. See id. (discussing tax deductible payment classifications).
149. See Kirsner, supra note 84, at 2 (noting payments to government for investigation or litigation reimbursement nondeductible); see also Wollman et al., supra note 2 (stating amounts constituting unjust enrichment nondeductible).
restitution. This is beneficial for both the business and the government counterparties, because the injured party will receive a higher restitution amount, while the settling taxpayer will be permitted to deduct the portion attributed to restitution.

3. Section 162(f) Has the Potential to Result in Greater Transparency

In addition to resolving ambiguity and limiting controversy between the IRS and taxpayers, revised § 162(f) has the potential to result in greater transparency regarding the true cost of settlements. One critique of the old law was that the publicly-announced settlement amount was often not reflective of the true after-tax amount. Critics argued allowing large deductions effectively shifted a portion of the penalty to the federal government and to the public—yet this reality was hidden from public scrutiny because many investigations are settled out of court and the settlement details are kept private.

In an effort to address these concerns regarding the true after-tax penalty amount, the TCJA enacted a formal reporting requirement that requires the government official or entity involved in the suit or agreement to report to the IRS any settlement of at least $600. The report must specifically identify any settlement amount that is eligible for a tax deduction under the restitution exception. Currently, it is unclear exactly how the reporting requirement will work because the IRS has not issued any regulations. Although Congress enacted this statute as part of the TCJA, the IRS recently issued a notice indicating

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150. See O’Neal, supra note 1 (examining how businesses more incentivized to offer higher settlement amounts under new law).
151. See id. (highlighting ways settlements can benefit both parties under new tax law).
152. See Watkins & Charin, supra note 80 (discussing new reporting requirement under revised § 162(f)); see also GUIDE TO THE NEW RULES, supra note 1, at 4 (noting greater transparency should result from new law). “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.” GUIDE TO THE NEW RULES, supra note 1, at 4.
153. See McElroy et al., supra note 13 (discussing critiques of old § 162(f)); see also GUIDE TO THE NEW RULES, supra note 1, at 4 (noting lack of transparency in old law). “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.” GUIDE TO THE NEW RULES, supra note 1, at 4.
154. See McElroy et al., supra note 13 (highlighting concerns about old law); see also Cohen, supra note 7 (stating tax deductions pass settlement costs along to taxpayers). With respect to the $42 billion settlement that BP paid out due to the 2010 Deepwater Horizon rig explosion, about 80% of it was eligible for a tax deduction. See Cohen, supra note 7. This saved the company an estimated $10 billion to $14 billion. See id. Brandon Garrett, a law professor at the University of Virginia and author of Too Big to Jail, said BP was “asking taxpayers, in effect, to pay for the victim compensation fund it agreed to set up.” Id. “Any future penalties should not permit massive hidden tax write-offs.” Id. Further, Gregg Polsky, a law professor at the University of North Carolina at Chapel Hill stated, “When it’s deductible, you’re basically subsidizing the punishment.” Id.
155. See McElroy et al., supra note 13 (discussing § 6050X reporting requirement).
156. See supra note 88 and accompanying text (discussing new reporting requirement under revised § 162(f)).
157. See McElroy et al., supra note 13 (discussing lack of regulations and IRS Notice 2018-23).
additional time was needed to put the new reporting requirement into place. The reporting requirement is therefore deferred until the proposed regulations are issued.

It remains to be determined whether the new reporting requirement achieves the desired results. The IRS should use this statutory change as an opportunity to promote greater public transparency regarding the true costs of settlement agreements. For example, the regulations should require the report containing the settlement amount be made available to the public. That way, federal prosecutors and government regulators will no longer be allowed to publicly flaunt large settlement amounts against big corporations when the actual cost to the company is much lower due to the tax benefits of a deduction.

IV. CONCLUSION

Although Congress has allowed businesses to deduct the necessary and ordinary costs of running a business from their taxable income, the judicially-created public policy doctrine has long been used to deny deductions that frustrate public policy. One result of the public policy doctrine is a business is not allowed to take deductions for fines and penalties. Prior to 2017, the Treasury Regulations specifically excluded fines and penalties from the category of deductible business expenses. But unlike fines and penalties, restitution or compensation

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159. See id. (stating reporting not required until date specified in proposed regulations).
160. See McElroy et al., supra note 13 (discussing goals of revised § 162(f)).

In response to the concerns raised in Congress and the continuing litigation, TCJA sought to clarify the scope of non-deductible fines and penalties and, under section 6050X, also imposed a formal reporting requirement in an effort to ameliorate such disputes. It will be interesting to see whether these statutory changes achieve the desired result.

Id.

161. See I.R.S. Notice 2018-23, 2018-15 I.R.B. 474 (stating proposed regulations regarding § 6050X forthcoming). The IRS has yet to issue proposed regulations for the reporting requirement under § 6050X, which is a new law issued in conjunction with revised § 162(f). See id. The new reporting requirement is halted until the IRS issues the proposed regulations. See id. The proposed regulations will provide additional information on exactly how the new reporting requirement will work. See id. To assist in developing the regulations, the IRS has requested comments from the public and “affected governments and nongovernmental entities, on any and all issues related to the application and implementation of §§ 162(f) and 6050X.” Id.

162. See supra notes 152-53 and accompanying text (discussing lack of transparency regarding after-tax settlement amount under old law). Because the prior law was criticized for not requiring transparency from settling taxpayers or the government entities involved in settling or litigating the case, one way to resolve that issue is to require that the report mandated by the new law is made available to the public. See supra notes 152-53 and accompanying text.

163. See 26 U.S.C. § 6050X (2018) (stating reporting requirement); see also Watkins & Charin, supra note 80 (discussing new reporting requirement). Because the new law requires the settling parties to report the amount of a settlement that is eligible for a tax write-off, both businesses and the government will no longer be able to publicize a large, pre-deduction settlement amount if there is a risk the public may have access to the true cost of the settlement. See Watkins & Charin, supra note 80.
payments were allowable business deductions. This led to controversy between the IRS and taxpayers. If a settlement payment had a vague tax classification, then a business could potentially argue the payment fell within the category of deductible restitution payments, rather than a nondeductible fine or penalty.

Congress aimed to mitigate the ongoing controversy when it revised the deduction rules as part of the TCJA in 2017. Now, there is a bright line rule prohibiting settlement payment deductions unless an exception applies. The revised law retained the prior allowance for restitution or compensatory payments, which will allow taxpayers to deduct portions of a settlement that are properly allocated to restitution or compensation. Although critics of the revised law may argue the law is a tax loophole that allows corporations to write off the cost of wrongdoing, others praise the law for its many benefits.

The revised law promotes certainty and eliminates vagueness. It facilitates more efficient tax administration and has the potential to result in greater transparency. Additionally, the law will lessen controversy between the IRS and taxpayers by forcing parties to address tax consequences during settlement negotiations, rather than later if a tax return is audited. Lastly, the revised law will incentivize corporate wrongdoers to agree to higher overall settlement amounts in exchange for labeling a significant portion of the payment as restitution, resulting in higher overall payouts to injured parties.

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