

ANOTHER KIND OF TAX CUT

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IRS REQUESTS COMMENTS BY MAY 18

Businesses making payments to governments and governmental entities on or after December 22, 2017 as settlements for violations and investigations or inquiries into potential violations of law may be surprised to learn the payments suddenly are not tax deductible. The Tax Cuts and Jobs Act ("TCJA") significantly limits the deductibility of these kinds of payments. Businesses should take the new rules into account when negotiating settlement agreements since loss of the deduction will effectively increase the net cost of any arrangement.

Tax Reform Wasn't Just About Rate Cuts

These changes can be found in the TCJA amendments to Internal Revenue Code section 162(f). Prior to the TCJA, no deduction was allowed for any fine or similar penalty paid to a government for the violation of any law. In response to concerns triggered in part by Government Accountability Office studies that concluded American taxpayers were subsidizing a broad range of settlements between companies and governments for violations and other compliance concerns, Congress expanded the scope of nondeductible payments. Under the TCJA, deductions are denied *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*. Simply put, the threshold for nondeductibility of a payment has been significantly lowered to include payments to end investigations into potential wrongdoing, even if no wrongdoing has been established.

There are exceptions, of course. Amounts paid for restitution (including remediation) or to come into compliance with the law remain deductible (the "establishment requirement"). However, the new rules do not just take the taxpayer's word for it. The TCJA requires that the amounts for restitution and compliance are identified in the applicable court order or settlement (the "identification requirement"). Even then, the Internal Revenue Service ("IRS") will not rely solely on the paperwork; taxpayers also will be required to substantiate the payments apply to restitution, remediation, and compliance. Amounts paid as reimbursement for the costs of an investigation or litigation are not deductible, while payments pursuant to a court order where no government or government entity is a party will be deductible. In the case of restitution payments for failure to pay a tax, additional requirements apply.

As another check and balance, the TCJA added a new section to the tax code - 6050X - which stipulates information reporting requirements for the aforementioned payments. The government or governmental entity

receiving the payment is required to file an information return telling the IRS and other individuals party to the suit or agreement the full settlement amount to be paid and the share of the settlement constituting restitution and remediation, or to come into compliance. Reporting is required if payments are \$600 or more (consistent with other information reporting rules), but the Secretary of the Treasury has the authority to adjust the threshold amount. The information returns are due at the time of the settlement, not the end of January like most information reporting returns.

Caught By Surprise: Notice 2018-23 Provides a Reprieve for Government, Not Business

The new rules for taxpayers and governments took effect immediately upon enactment of the TCJA. Governments and governmental entities, including the IRS, grumbled, saying they could not comply timely with information reporting requirements because they needed more time to update their systems and develop forms. Unless they had a binding order or agreement in effect prior to December 22, businesses in the midst of negotiating settlements were caught in limbo.

The IRS responded on March 27, 2018, by issuing Notice 2018-23. While delaying the information reporting requirement of governments and governmental entities until proposed regulations were issued, and under no circumstances prior to January 1, 2019, businesses were given no such reprieve. The notice makes clear that the effective date of the more stringent nondeductibility rules remains as December 22, 2017. Notice 2018-23 does provide a modicum of interim relief for businesses by clarifying that statements in settlement agreements and court orders to identify payments for restitution, remediation, and compliance actions meet the identification requirement until proposed regulations are issued, but taxpayers still must meet the establishment requirement in order to deduct such payments.

Treasury and the IRS Are Asking for Input by May 18

Acknowledging the notice is an interim step, and in anticipation of issuing proposed regulations, Treasury and the IRS are requesting comments from the public and from governments and governmental entities regarding all aspects of these provisions. In particular, input is requested regarding how to define key terms in the new law and to identify which entities are nongovernmental entities, as well as the mechanics of the new information reporting regime.

The outcome of the regulatory process will have a direct effect on the bottom line cost to businesses of court orders and settlements and, therefore, will have a direct effect on the net proceeds that governments and governmental entities are likely to receive. Businesses and taxpayers who may be subject to court orders and settlements, and governments and governmental entities who may be on the other side of such actions, should consider submitting comments in order to shape the final outcome of the new law. Comments are due to the IRS by May 18.

The K&L Gates tax policy team is ready to assist you in evaluating the impact of tax reform and providing comments, suggestions, and other input to Treasury, the IRS, and the Office of Management and Budget throughout the entire guidance and regulatory life cycle. Please do not hesitate to contact any of this Alert's authors regarding this or any other tax policy matter.

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