
Final Section 162(f) Regulations Liberalize Opportunities to Deduct Disgorgement and Other Payments Made in Government Investigations

FEBRUARY 16, 2021

Background

On January 12, 2021, the Internal Revenue Service (IRS) and the Treasury Department released final regulations governing the deductibility of certain fines, penalties and other amounts paid to, or at the direction of, a governmental entity in relation to the violation of a law. The regulations address the deductibility of payments made to regulators, such as the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission and state regulators, that include some combination of client restitution, disgorgement and penalties. The regulations were promulgated under Section 162(f) of the Internal Revenue Code, as amended by the 2017 Tax Cuts and Jobs Act, and generally disallow a deduction for any payment to, or at the direction of, a government or governmental entity in relation to the violation of a law or an investigation by such governmental entity into the potential violation of a law unless an exception applies.

The principal exception to the bar on deductibility under Section 162(f) is for payments in the nature of restitution or remediation or payments made to come into compliance with a law. The IRS had issued proposed regulations on May 12, 2020, that gave a narrow reading to that exception. The final regulations take a step back from some of the more controversial limitations in the proposed regulations. In particular, as described below, the final regulations allow a deduction for disgorgement or forfeiture amounts under certain circumstances.

Final Regulations

General

Section 162(f) and the final regulations generally disallow a deduction for amounts that are:

1. paid or incurred by suit or agreement, or otherwise;

2. paid to, or at the direction of, a government or governmental entity (or certain nongovernmental entities treated as governmental entities pursuant to the regulations) (a Governmental Entity); and
3. paid in relation to the violation, or investigation or inquiry by such government or governmental entity into the potential violation, of any civil or criminal law.

Section 162(f), however, does not disallow deductions for such amounts if a taxpayer satisfies an applicable exception. There is an exception, among others, for amounts paid or incurred (i) for restitution or remediation for damage or harm connected with an actual or potential violation of a law or (ii) to come into compliance with a law that was the subject of the government investigation, provided that certain identification and establishment requirements are met.

The Identification Requirement

In order for the exception to apply, an amount must be “identified” by the relevant order or settlement agreement as restitution, remediation or an amount paid to come into compliance with the law. Pursuant to the final regulations, the identification requirement may be satisfied by specifically stating in an order or agreement the amount of the payment and that the payment constitutes restitution, remediation or an amount paid to come into compliance with the law. In a departure from the proposed regulations, however, no specific form of words is required so long as the order or agreement specifically describes (i) the damage done, harm suffered or manner of noncompliance with a law, and (ii) the action required of the taxpayer to provide restitution or remediation or to come into compliance with the law. Similarly, if the amount to be paid as restitution or remediation or to come into compliance with the law is not identified (for example, because it is unknown) or does not allocate a lump-sum amount among taxpayers or types of payments, the identification requirement may still be met by describing the items specified in clauses (i) and (ii) of the preceding sentence.

The Establishment Requirement

The exception applies only if the taxpayer “establishes” that the relevant amount constitutes restitution or remediation or is paid to come into compliance with the law. Pursuant to the final regulations, this requirement is met if the taxpayer, using documentary evidence, proves:

1. the taxpayer’s legal obligation, pursuant to the order or agreement, to pay the amount identified as restitution or remediation or to come into compliance with a law;
2. the amount paid or incurred;
3. the date the amount was paid or incurred; and
4. that based on the origin of the liability and the nature and purpose of the amount paid or incurred, the amount the taxpayer paid or incurred was for restitution or remediation or to come into compliance with a law.

For amounts paid to a segregated fund or account, the taxpayer may meet the establishment requirement even if each ultimate recipient, or each ultimate use, of the payment is not designated or is unknown.

Documentary evidence that may be used to show the establishment requirement is met includes, but is not limited to, receipts as well as documents issued by the Governmental Entity relating to the investigation or inquiry, including court pleadings, documents describing how the amount to be paid was determined, and correspondence between the taxpayer and the Governmental Entity.

Disgorgement and Forfeiture

Under the proposed regulations, amounts paid as disgorgement or forfeiture were *per se* nondeductible, based in part on the US Supreme Court's decision in *Kokesh v. Securities and Exchange Commission*, 137 S. Ct. 1635 (2017). In *Kokesh*, the US Supreme Court determined that the statute of limitations applicable to penalties (five years) applied to disgorgement payments imposed as a sanction for violating a federal securities law, as the purpose of disgorgement violations, at least in part, is to deter further violations of such laws by depriving the violators of their gains.

However, in light of the US Supreme Court's decision in *Liu v. Securities and Exchange Commission*, 140 S. Ct. 1936 (2020), which was decided after the proposed regulations were issued, as well as comments received on the proposed regulations, the IRS amended its earlier stance and the final regulations now permit deductibility of disgorgement and forfeiture amounts under certain circumstances. In *Liu*, the US Supreme Court found that amounts paid through disgorgement that are awarded to individual victims and do not exceed the wrongdoer's net profits may constitute an equitable remedy, which generally cannot be used to impose penalties. Similar requirements apply under the final regulations with respect to deducting amounts paid as disgorgement or forfeiture.

Provided the identification and establishment requirements discussed above are met, the final regulations provide that restitution may include amounts paid or incurred as disgorgement or forfeiture if such amounts are:

1. paid directly to the person harmed by the violation or potential violation of a law or to a segregated fund or account for the benefit of such person; and
2. not in excess of the taxpayer's net profits.

The final regulations also provide that disgorgement or forfeiture amounts will not be treated as restitution if, pursuant to the order or agreement, the amounts are disbursed to the general account of the Governmental Entity for general enforcement purposes or other discretionary purposes. It is unclear how this provision will be applied in circumstances where the Governmental Entity is itself the person harmed by the violation or potential violation of a law.

Settlement Funds and Reversion of Excess Amounts

At the time a Governmental Entity enters an order or negotiates a settlement agreement, it is often the case that the affected customers, clients or other parties to whom settlement funds are to be

paid have not yet been identified. As a result, regulatory orders and settlements may require the investigated party to set aside a discrete amount in a fund (such as an SEC Fair Fund) to make restitution or disgorgement payments. If such a fund is classified as a “qualified settlement fund” under Treas. Reg. § 1.468B-1, as is often the case, the payor will claim any tax deduction for its payment in the tax year when money is contributed to the fund, rather than the tax year when amounts are paid out to customers, clients or other parties.

As noted above, the final regulations contemplate that payments to such a fund may qualify for the exception for restitution, remediation or amounts paid to come into compliance with a law, and they provide that a taxpayer may satisfy the establishment requirement by showing that amounts have been transferred to such a fund, even if they have not yet been paid out to relevant third parties. In addition, the preamble to the final regulations addresses a comment that was received about the treatment of amounts set aside in a fund that are unclaimed or not required in order to make harmed parties whole. The preamble states that, in such a situation, the IRS and Treasury “generally agree” that where the identification and establishment requirements are otherwise satisfied, a deduction will not be disallowed if, after the taxpayer makes the payment, the amount paid to the fund is not used for the purpose identified (but instead, for example, reverts to the Governmental Entity) as long as the amount does not revert to the taxpayer or otherwise accrue to the benefit of the taxpayer.

Other Significant Provisions

The final regulations address a number of other issues, including the following:

- Clarifying Section 162(f) does not apply to disallow deductions for:
 - amounts paid pursuant to an order or agreement in a suit pursuant to which the Governmental Entity enforces its rights as a private party (and the preamble to the final regulations states that vendor overcharge recoveries will generally fall into this category);
 - amounts paid pursuant to routine investigations or inquiries, such as audits or inspections, of regulated businesses that are not related to any evidence of wrongdoing or suspected wrongdoing, but are conducted to ensure compliance with the rules and regulations applicable to those businesses; or
 - amounts paid or incurred as restitution for failure to pay tax imposed under the Internal Revenue Code, such as excise and employment taxes, that are equal to or less than the amount of tax that would have otherwise been deductible if the amount were timely paid;
- Clarifying, in the preamble to the final regulations, that restitution may include criminal restitution;
- Providing that if an amount that was deducted by the taxpayer under Section 162(f) reverts to the taxpayer, under the tax benefit rule, the taxpayer must include such amount in income; and
- Providing that amounts paid for general conservation, protection, or restoration of the

environment, wildlife or natural resources may qualify as deductible restitution or remediation payments, even if they do not directly remediate the harm caused or alleged to have been caused by the taxpayer, so long as there is a “strong nexus or connection” between the purpose of the payment and the harm caused or alleged to have been caused.

Authors



**Julie Hogan
Rodgers**

RETIRED PARTNER

☎ +1 617 526 6000



**Richard E.
Andersen**

RETIRED PARTNER

☎ +1 212 230 8800