

IRS Issues Transitional Guidance Regarding the New "Restitution" Tax Deduction That Affects False Claims Act and Other Government Settlements and Judgments

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Effective immediately, a settlement agreement or a judgment with the government must set forth the specific amount of restitution, remediation of property, or monies paid to come into compliance with any law violated, for that payment to be deductible pursuant to 26 U.S.C. § 162(f). On March 27, 2018, the Internal Revenue Service, in consultation with the U.S. Department of the Treasury, issued transitional guidance regarding newly amended Internal Revenue Code (the Code) Section 162(f), which was amended pursuant to Section 13306 of Pub. L. 115-97 (the 2017 Tax Act) and signed into law on December 22, 2017. IRS Notice 2018-23. Thus, a party's failure to insert such required language in a settlement agreement will likely mean that the amount of damages (single or more) being paid in a False Claims Act case will no longer be deductible on a defendant's tax return. (See the related discussion in our February 16, 2018, [intelligence report](#).) Interestingly, the elements that a defendant must be able to establish with the Internal Revenue Service to deduct the amount of a settlement includes a broad definition of what is potentially deductible: that is, the amount that "(I) constitutes restitution (including remediation of property) for damage or harm which was or may be caused by the violation of law or the potential violation of any law; or, (II) is paid to come into compliance with any law which was violated or otherwise involved in the investigation or inquiry described in paragraph (1)." 26 U.S.C. § 162(f)(2)(A)(I) & (II). Thus, a settlement of a "potential violation" could fit this definition. This may be significant because newly amended Section 162(f) states that the "identification under clause (ii) alone shall not be sufficient to make the establishment clause under clause (i)." Finally, it will be important to a defendant in a non-intervened False Claims Act case to be sure, considering all issues, whether the government should intervene for purpose of settling the case because the deduction appears to exist only when the government is a party. 26 U.S.C. § 162(f)(3). There may be times, in contrast, where the defendant does not want the government's intervention, recognizing that may endanger the ability to deduct some portion or all of the settlement amount.

In conjunction with the amendment of Code Section 162(f), the 2017 Tax Act added new Code

Section 6050X that bears on government-required information reporting in respect of any amounts paid under the sets of circumstances set forth therein.¹ The government's internal reporting obligation takes a different approach than Section 162(f) and uses a narrower definition. 26 U.S.C. § 6050X. The government official assigned by the involved agency must internally report to the Internal Revenue Service "(A) the amount required to be paid as a result of the suit or agreement to which paragraph 1 applies, (B) any amount required to be paid as a result of the suit or agreement which constitutes restitution or remediation of property, and (C) any amount required to be paid as a result of suit or agreement for the purpose of coming into compliance with any law which was violated or involved in the investigation or inquiry." 26 U.S.C. § 6050X(a)(1) (emphasis added). At this point, the transitional guidance does not instruct government officials how to perform this task, but the transitional guidance does provide government agencies such as the Department of Justice, the U.S. Securities and Exchange Commission, and the Internal Revenue Service with additional time to come into compliance with their separate reporting obligations pursuant to 26 U.S.C. § 6050X. The IRS and the Treasury intend to issue regulations on this reporting obligation after receiving comments, and we will continue to provide updates. IRS Notice 2018-23. The government officials assigned for each agency (and some officials from quasi-government entities) will be required, once the regulations are issued, to report to the Treasury the amount of monies that a defendant is paying in restitution, remediation of property, or monies to be paid to come into compliance with the violation of law, as those terms are understood under Section 162(f) and Section 6050X. The Internal Revenue Service will be receiving comments through May 18, 2018, from the public and government agencies regarding this governmental reporting obligation. IRS Notice 2018-23. The Notice provides, however, that reporting will not be required with respect to amounts required to be paid or incurred under a binding court order or agreement entered into before the specified date. The specified date will not be earlier than January 1, 2019 and will not be earlier than the date of publication of the proposed regulations.

Practice Point: Until the regulations are issued, it is advisable for practitioners to track the precise wording in 26 U.S.C. § 6050X, not the language in 26 U.S.C. § 162(f)(2)(A)(I) & (II), in the settlement agreement so that the government and the defendant are in agreement about how both parties view the settlement amount (e.g. as "restitution").

¹Section 6050X(a)(1) requires the appropriate official of any government or nongovernmental entity described in § 162(f)(5) that is involved in suits or agreements described in § 6050X(a)(2) to make a return in such form as determined by the Secretary, setting forth (1) the amount required to be paid

as a result of the suit or agreement to which § 162(f)(1) applies, (2) any amount required to be paid as a result of the suit or agreement that constitutes

restitution or remediation of property, and (3) any amount required to be paid as a result of the suit or agreement for the purpose of coming into

compliance with any law that was violated or involved in the investigation or inquiry. Under § 6050X(a)(2), amounts required to be paid as a result of a

threshold in § 6050X(a)(2)(A)(ii) is met. A suit or agreement is described in § 6050X(a)(2)(A)(i) if it is (1) a suit with respect to a violation of any law over which the government or entity has authority and with respect to which there has been a court order, or (2) an agreement that is entered into with respect to a violation of any law over which the government or entity has authority or with respect to an investigation or inquiry by the government or entity into the potential violation of any law over which the government or entity has authority.