AICPA

December 17, 2020

Mr. John Moriarty
Associate Chief Counsel
Income Tax & Accounting
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Proposed Regulations Under Sections 162(f) and 6050(X) with Respect to Certain Fines, Penalties and Other Amounts [REG – 104591-18]

Dear Mr. Moriarty:

The American Institute of CPAs (AICPA) is pleased to submit recommendations as requested by [REG – 104591-18] (the "proposed regulations") regarding changes to the disallowance of fines and penalties under Internal Revenue Code (IRC or "Code") sections 162(f)[1] and the new reporting requirement in section 6050X as enacted under Public L. No. 115-97, commonly referred to as the Tax Cuts and Jobs Act (TCJA). The AICPA previously submitted comments[2] on June 13, 2018.

Specifically, the AICPA recommends that Treasury and the IRS provide guidance on the following issues related to sections 162(f) and 6050(X):

I. The principles for determining situations in which disgorgement and forfeiture payments are restitution are based on all facts and circumstances

II. The identification requirement is not subject to a rebuttable presumption

III. A rebuttable presumption is provided for the establishment requirement

IV. Eliminate Prop. Reg. § 1.162-21(f)(3)(iii)(D) addressing payments to a fund

V. Clarify how section 6050X reporting obligations apply to "all orders . . . and agreements . . . with respect to a violation, investigation, or inquiry" as provided in Prop. Reg. § 1.6050X-1(a)(1)

[1]All references herein to "section" or "§" are to the Internal Revenue Code of 1986, as amended, and all references to "Treas. Reg. §" and "regulations" are to U.S. Treasury regulations promulgated thereunder.
[2] https://www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/20180613-aicpa-comment-letter-on-notice-2018-23.pdf (June 13, 2018).

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VI. Clarify the definition of the term "material change" provided by the transition rule in Prop. Reg. § 1.162-21(e)(1) to include only a transformation of the purpose of a taxpayer's payment obligation(s) or the addition of a new obligation different from the taxpayer's existing obligation(s)

VII. Clarify Example 3 provided by Prop. Reg. § 1.162-21(g)

VIII. Clarify that payments not subject to regulatory review and made during the ordinary course of a taxpayer's trade or business in accordance with its internal compliance and risk procedures are not made to or at the direction of the government

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We appreciate your consideration of our recommendations and welcome the opportunity to further discuss our comments. If you have any questions, please contact Connie Cunningham, Chair, AICPA Tax Methods and Periods Technical Resource Panel, at (310) 557-8544, or CCCunningham@bdo.com; Elizabeth Young, Senior Manager – AICPA Tax Policy & Advocacy, at (202) 434-9247, or elizabeth.young@aicpa-cima.com; or me at (612) 397-3071 or chris.hesse@CLAconnect.com.

Sincerely,

Christopher W. Hesse, CPA
Chair, AICPA Tax Executive Committee

cc: The Honorable David J. Kautter, Assistant Secretary for Tax Policy, Department of the Treasury
The Honorable Charles P. Rettig, Commissioner, Internal Revenue Service
The Honorable Michael J. Desmond, Chief Counsel, Internal Revenue Service
Ms. Wendy Friese, Tax Policy Advisor, Office of Tax Legislative Counsel, Department of the Treasury
Mr. Timothy Powell, Tax Policy Advisor, Office of Tax Legislative Counsel, Department of the Treasury
Sharon Horn, Attorney, Associate Chief Counsel, Income Tax & Accounting
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BACKGROUND

Section 162(f) was significantly modified by the TCJA, which also added a new reporting requirement related to fines and penalties in section 6050X. As revised by the TCJA, section 162(f)(1) disallows a deduction for amounts 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.

Section 162(f)(2) provides an exception to the general rule for amounts constituting restitution or remediation, or for amounts paid to come into compliance with the law. To meet the exception, section 162(f)(2)(A)(i) requires that the taxpayer establish that the amount paid or incurred:

> 1) constitutes restitution (including remediation of property) for damage or harm that was or may be caused by the violation of any law or the potential violation of any law; or
>
> 2) is paid to come into compliance with any law that was violated or otherwise involved in the investigation or inquiry described in paragraph (f)(1) (together "the establishment requirement").[3]

In addition, to meet the exception, section 162(f)(2)(A)(ii) requires that the amount paid or incurred is identified as restitution or remediation, or as an amount paid to come into compliance with the law in the court order or settlement agreement (the "identification requirement"). Section 162(f)(2)(A) further provides that meeting the identification requirement alone is not sufficient to meet the establishment requirement. Section 162(f)(2)(A)(iii) provides that in the case of any amount of restitution for failure to pay any tax imposed under the Code, the amount paid is deductible only to the extent that the tax would have been deductible had it been timely paid.

Additionally, section 162(f)(3) provides an exception for amounts paid or incurred by reason of any order of a court in a suit in which no government or governmental entity is a party. Section 162(f)(4) provides an exception for amounts paid or incurred as taxes are due. Section 162(f)(5) provides the definitions of when a nongovernmental entity is considered a governmental entity for purposes of the deduction disallowance.

Section 6050X(a)(1) requires the appropriate official of any government or applicable nongovernmental entity that is involved in a suit or agreement described in section 6050X(a)(2) to

[3] Section 162(f)(2)(A)(i).

make a return in such form as determined by the Secretary of the Treasury ("Secretary") setting forth:

> 1) the amount required to be paid as a result of the suit or agreement to which paragraph (1) of section 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 which was violated or involved in the investigation or inquiry.[4]

Under section 6050X(a)(2), the appropriate official of any government or governmental entity described in section 162(f)(5) must report the amounts required to be paid as a result of a suit or agreement, if the aggregate amount involved in all court orders and agreements with respect to a violation, investigation, or inquiry is $600 or more and such suit or agreement 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 such government or entity has authority.[5]

SPECIFIC COMMENTS

I. The principles for determining situations in which disgorgement and forfeiture payments are restitution are based on all facts and circumstances

Overview

Proposed Reg. § 1.162-21(f)(3)(iii) provides that certain amounts are not considered restitution, remediation, or paid to come into compliance with the law (collectively, "restitution"), even if the amounts are identified as such in the order or agreement. These include, among other things, any amount paid or incurred . . . [a]s forfeiture or disgorgement.

Recommendation

The AICPA recommends that Treasury and the IRS exclude Treas. Reg. § 1.162-21(f)(3)(iii)(C) from the final regulations, and instead provide that whether forfeiture and disgorgement are restitution are based on all facts and circumstances.

[4] Sections 6050X(a)(1)(A), (B) and (C).
[5] Sections 6050X(a)(2)(A)(i)(I) and (II).

Analysis

The basis for the rule that precludes forfeiture or disgorgement from being considered restitution is explained in the preamble to the proposed regulations. *Kokesh v. Securities and Exchange Commission*,[6] *Nacchio v. United States*,[7] and *United States v. Joseph*,[8] cited within the preamble, state that forfeiture and disgorgement, "focus on the unjust enrichment of the wrongdoer, not the harm to the victim." The preamble explains as follows:

> "Section 162(f)(2)(A)(i)(l) provides that restitution and remediation payments relate to the damage or harm caused, or that may be caused, by the violation or the potential violation of a law. The statute does not characterize restitution or remediation in connection with an unjust enrichment to a wrongdoer. Consistent with the statutory language, Prop. Reg. §1.162-21(f)(3)(i) provides that the purpose of restitution or remediation is to restore the person or property, in whole or in part, to the same or substantially similar position or condition as before the harm caused by the taxpayer's violation, or potential violation, of a law. Hence, under Prop. Reg. § 1.162-21(f)(3)(iii)(B)-(C), restitution, remediation, and amounts paid to come into compliance with a law do not include any amount paid or incurred which the taxpayer elects to pay in lieu of a fine or penalty or as forfeiture or disgorgement."[9]

In *Kokesh*, the U.S. Supreme Court held that disgorgement in the context of an SEC civil enforcement action was a penalty within the meaning of the applicable statute of limitations (28 U.S.C. § 2462). The Court in *Kokesh* found that the primary purpose of the disgorgement ordered by the SEC in that case was to deter future violations of the securities laws "by depriving violators of their ill-gotten gains."[10] As the disgorgement order in that case was meant by the SEC to be punitive, the statute of limitations applied and the order was held to be untimely.

The Supreme Court recently revisited the disgorgement issue in *Liu v. Securities and Exchange Commission*,[11] and had a very different view of the nature of disgorgement. The Court held that traditional principles of equity view disgorgement as equitable relief if the amounts are paid over to the alleged harmed parties and the disgorgement does not exceed the defendant's revenue less its bona fide, permitted expenses.[12] This, the Court stated, avoids "transforming an equitable remedy into a punitive sanction."[13] The Court explained its earlier holding in *Kokesh* as evaluating a version of the SEC's disgorgement remedy that, according to the Court, "seemed to exceed the bounds of traditional equitable principles."[14] In other words, *Kokesh* dealt with a form of disgorgement that was outside the norm of true equitable disgorgement.

[6] 137 S. Ct. 1635, 1643 (2017).
[7] 824 F.3d 1370 (Fed. Cir. 2016), *cert denied*, 137 S. Ct. 2239 (2017).
[8] 743 F.3d 1350, 1354 (11th Cir. 2014).
[9] Preamble to Prop. Reg. § 1.162-21, 85 Fed. Reg. 28,524, 28,527 (May 13, 2020).
[10] 137 S. Ct. 1635 at 1643.
[11] Slip op. No. 18-1501 (June 22, 2020).
[12] *Id*.
[13] *Id.*
[14] *Id.*

The idea, clearly expressed in two different U.S. Supreme Court cases, that disgorgement can mean different things under different circumstances (punitive sometimes, and equitable relief other times), argues strongly against universally prohibiting disgorgement and forfeiture from being considered restitution for purposes of section 162(f). Prior to the Supreme Court's decision in *Kokesh*, the IRS recognized in its informal rulings that disgorgement can be compensatory under certain circumstances. The final regulations should reflect this viewpoint.[15]

The other cases cited by the preamble, *Nacchio* and *Joseph* also do not support a blanket prohibition on disgorgement or forfeiture being treated as restitution. In *Nacchio,* the forfeited amounts did not go to harmed parties, and thus could not have been restitution; the proposed regulations make clear that, for an amount to constitute restitution, it must restore victims. Similarly, in *Joseph*, the taxpayer was required to pay restitution apart from the amounts he was required to forfeit. Thus, in neither case did the disgorgement/forfeiture function as restitution. Accordingly, the cases do not support a per se characterization of all disgorgement and forfeiture as something other than restitution.

Further, the preamble's stated rationale for the per se rule, that "the purpose of restitution or remediation is to restore the person or property . . ." whereas forfeiture and disgorgement "focus on the unjust enrichment of the wrongdoer."[16] The stated rationale relates to the standards for determining the character of a payment under pre-TCJA section 162(f) law, whereas section 162(f)'s establishment requirement appears to have a different focus. Under former section 162(f), the exception from the concept of a fine or penalty for compensatory damages was not found in the statute, but rather was a product of the regulations.[17] Under that regulatory framework, and the applicable case law and rulings, the determination of whether a payment was considered a nondeductible fine, penalty, or punitive damages, or deductible compensatory damages, often hinged on the primary purpose of the payment. If the primary purpose was to punish or deter, former section 162(f) would apply; if the primary purpose was to compensate harmed parties, it would not. Thus, the mere fact that a payment went to harmed parties (i.e., that the effect of the payment was to restore such parties) was not sufficient for the payment to be considered compensatory damages if, in fact, the primary purpose of the payment was to punish.[18]

In contrast to the law under pre-TCJA, amended section 162(f) provides the exception for restitution, remediation, or amounts paid to come into compliance with the law. The statute states that the deduction disallowance of section 162(f)(1) shall not apply to any amount that the taxpayer establishes constitutes restitution or remediation, or payments made to come into compliance with law. The word "constitutes" suggests that Congress was more concerned (at least in respect of the establishment requirement) with the effect of a payment, than with its stated purpose. As a consequence, the final regulations should not treat forfeiture or disgorgement that is actually given over to alleged harmed parties as per se excluded from the scope of deductible restitution.

[15] CCA 201825027 (June 22, 2018); CCA 201619008 (May 6, 2016).
[16] *See supra,* note 5.
[17] Treasury Reg. § 1.162-21(b)(2).
[18] *See, e.g., Bailey v. Commissioner,* 756 T.C. 497 (1980).

II. The identification requirement is not subject to a rebuttable presumption

Overview

Section 162(f)(2)(A) provides that the disallowance under section 162(f) does not apply to an amount if the establishment requirement is met (section 162(f)(2)(A)(i)) and "is identified as restitution [including remediation] or as an amount paid to come into compliance with any law, as the case may be, in the court order or settlement agreement."[19] Section 162(f)(2)(A) further provides that "[t]he identification under clause (ii) alone shall not be sufficient to make the establishment required under clause (i)." In other words, an amount only meets the exception provided by the section if it meets both the establishment and the identification requirements. Further, the section emphasizes that meeting the identification requirement alone does not establish that the amount paid is restitution or remediation, or to come into compliance with the law.

Proposed Reg. § 1.162-21(b)(2)(ii) provides that "the identification requirement is presumed to be met if an order or agreement specifically states that the payment, and the amount of the payment, described in paragraph (b)(2)(i) of this section, constitutes restitution, remediation, or an amount paid to come into compliance with a law or if the order or agreement uses a different form of the required words, such as, "remediate" or "comply with a law." Paragraph (b)(2)(iv) further provides that the IRS may challenge the characterization of an amount identified under paragraph (b)(2). In order to rebut the presumption described in paragraph (b)(2)(ii), the IRS must develop sufficient contrary evidence that the amount paid or incurred was not for the purpose identified in the order or agreement.

Recommendations

The AICPA recommends that Treasury and the IRS issue final regulations that do not subject the identification requirement to a rebuttable presumption. Instead, the final regulations should provide that the identification requirement is satisfied if the agreement or order explicitly provides that a prescribed or unspecified amount is paid for restitution, remediation, or to come into compliance with a law.

In addition, the AICPA recommends that the final regulations allow for the use of terms that are synonymous with the terms "restitution," "remediation," or to "come into compliance with the law."

Analysis

Prior to the amendment made by the TCJA, section 162(f) disallowed a deduction for any fines or penalties paid to the government, but did not disallow a deduction for payments to the government that were compensatory (i.e., amounts that were neither a fine nor a penalty). Amounts paid to compensate for injury and damages or to come into compliance with a law were allowable as a deduction. In amending section 162(f), Congress did not intend to deny a deduction for amounts paid to compensate injured parties. Instead, Congress intended to preserve the deductibility of these amounts by adding both an identification requirement and an establishment requirement.

[19] Section 162(f)(2)(ii).

The identification requirement first specifically requires that the court order or the settlement agreement explicitly provide that an amount was paid for an excepted purpose (either restitution or an amount paid to come into compliance with any law). The establishment requirement then requires the taxpayer to substantively establish, apart from the identification provided by the court order or settlement agreement, that the payment was in fact restitution or remediation, or paid to come into compliance.

The identification requirement was intended to align with the establishment requirement as a means to add certainty to the application of the exception provided by section 162(f)(2). For example, in cases for which a lump sum settlement includes both punitive and compensatory elements, or in which there could be overlapping intent for a payment to serve both punitive and compensatory purposes, the identification requirement initially serves to recognize the amount considered as restitution or remediation, or an amount paid to come into compliance with the law. As noted above, the taxpayer is then obligated to establish that this purported amount reported as either restitution or remediation or paid to come into compliance was in fact paid for the identified purpose.

The rebuttable presumption provided by the proposed regulations does not serve this intended purpose. First, an agreement or order explicitly stating that an amount is paid for restitution or remediation, or to come into compliance with the law, should itself satisfy the identification requirement. The role of the establishment requirement is to require substantiation for the dated effect of the payment, not the identification requirement. Importing a substantiation requirement into the identification requirement, a provision that is satisfied by reference to the words that are used, confuses the respective roles of the identification and the establishment requirements. If certain words are required to identify an amount as eligible for a particular treatment, and those words are used, there remains nothing about that identification to rebut.

Additionally, although the proposed regulations presently provide that the identification requirement is met if the order or settlement agreement uses different forms of the words restitution, remediation, or compliance with the law (e.g., remediate or comply with the law), the regulations should also indicate that the use of synonyms for these same words also satisfies the identification requirement.[20] Given the clear intent of Congress to preserve the deductibility of amounts that are in fact restitution or remediation, and subjecting these amounts to an evidence-based establishment requirement, makes it unnecessary to exclude the use of terms that are synonymous with "restitution" and "remediation." For example, there will be situations in which a government agency, as a matter of long standing policy or practice, may describe amounts intended as restitution or remediation, using alternative terms such as "compensation," "redress," "refund," "restore," "conform to the law" and similar synonyms. When the agreement or order specifies the effect of the payment, but does not use a term that is synonymous with "fine" or "penalty" and instead uses synonyms for restitution, remediation, or compliance with the law, such terms should be accepted as satisfying the identification requirement.

[20] This clarification would be especially beneficial to small taxpayers that may not be aware the section would otherwise require the use of certain specified terms.

III. A rebuttable presumption is provided for the establishment requirement

Overview

A principal change from prior law under section 162(f) that resulted from the TCJA is the imposition of a dual requirement for sustaining the deductibility of amounts paid to or at the direction of the government as restitution, remediation, or to come into compliance with the law. Under section 162(f), as amended by the TCJA, a taxpayer must meet both: (1) the establishment requirement, and (2) the identification requirement. In contrast, former section 162(f) (i.e., prior to the amendments made by the TCJA) did not apply to disallow a deduction where the taxpayer established that the amount paid was not a fine or penalty. In other words, former section 162(f) did not provide for an identification requirement.

Recommendations

The AICPA recommends that Treasury and the IRS issue final regulations that provide a rebuttable presumption for meeting the establishment requirement provided by section 162(f)(2)(A)(i) when the identification requirement is met with respect to a specified amount, and the taxpayer produces evidence (e.g., a work paper or schedule) that the specified amount is not more than the highest amount of compensation-related damages calculated and sought by the government in the action.

The AICPA also recommends that the final regulations provide a specific example as outlined in the analysis section.

Analysis

The imposition of an identification requirement ensures that the proper characterization of the payment has either been: (1) specifically considered and agreed to by the parties to the settlement, or (2) specifically addressed by the court. The addition of this requirement should eliminate much of the uncertainty that arose under prior law when court orders and settlement agreements were silent with respect to the purpose of the payment. Notwithstanding the existence of the identification requirement, significant controversy may continue if the establishment requirement in section 162(f)(2)(A)(i) is interpreted in a manner that fails to recognize the role of the identification requirement.

Accordingly, the final regulations should provide that if: (1) the identification requirement is met with respect to a specified amount; and (2) that amount is not more than the highest amount of restitution, remediation, or payment to come into compliance with the law sought by the government in the investigation or inquiry, the payment of that amount initially meets the establishment requirement. Creating a rebuttable presumption that the establishment requirement is satisfied under these circumstances will provide additional certainty for many taxpayers, as well as the government.

The AICPA recognizes that section 162(f)(2)(A) provides the establishment requirement is not met solely by meeting the identification requirement. However, the statute does not prohibit Treasury and the IRS from providing a rebuttable presumption in the limited circumstances where an amount specified is not more than the highest amount of restitution, remediation, or payment to come into compliance with the law. The identification of the payment as restitution, remediation, or an amount paid to come into compliance with the law that supports satisfaction of the establishment requirement is not the only factor. The taxpayer must produce valid evidence (e.g., a workpaper or a schedule) to meet the establishment requirement. In addition, the IRS may rebut the initial presumption that the establishment requirement has been met. For instance, the IRS could rebut the presumption by showing that the terms of the court order or settlement agreement were not negotiated at arms' length or in good faith. This approach is consistent with long-standing judicial and IRS guidance that recognizes that the characterization of payments provided by a court order or settlement agreement is normally respected when the terms of the court order or settlement agreement were negotiated at arms-length agreement and in good faith.[21]

> <u>*Proposed example to include in final regulations*</u>
>
> Pursuant to an anti-trust claim, the government alleged that Corporation X failed to properly compensate certain suppliers. During the course of the civil action, the government estimated the underpayments resulting from the alleged conduct using several approaches that resulted in a range of alleged damages. As a result of the civil action, Corporation X and the government reached a monetary settlement. The terms of the settlement agreement provided for the payment of a penalty and an amount specifically designated as restitution. The required amount paid under the agreement and designated as restitution is no more than the highest amount of the government's calculated and claimed estimated underpayments (i.e., damages) to the suppliers. The settlement agreement provides for the payment of the stated restitution amount on a proportional basis to the affected suppliers.
>
> The amount specifically designated as restitution is presumed to meet the establishment requirement provided by section 162(f)(2)(A)(ii) while the amount designated as a penalty is not deductible under section 162(f).

IV. Eliminate Prop. Reg. § 1.162-21(f)(3)(iii)(D) addressing payments to a fund.

<u>Overview</u>

Proposed Reg. § 1.162-21(f)(3)(iii)(D) provides that "regardless of whether an order or agreement identifies them as such, restitution, remediation, and amounts paid to come into compliance with law do not include any amount paid or incurred to the extent the payment or contribution does not meet the requirements of paragraph (f)(3)(i) or (ii), to any entity; fund, including a restitution, remediation, or other fund; group; government, or governmental entity." Proposed Reg. § 1.162-21(f)(3)(i) provides a definition for restitution and remediation and Prop. Reg. § 1.162-21(f)(3)(ii) defines an amount paid to come into compliance with a law. The preamble to the proposed regulations explains that "restitution, remediation, and amounts paid to come into compliance with a law do not include any amount paid or incurred to an entity; to a fund, including a restitution,

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[21] *See, e.g.*, *Fresenius Medical Care Holdings, Inc. v. U.S.*, 763 F.3d 64 (1st Cir. 2014) ("If the government and a defendant settle a False Claims Act (FCA) claim and specifically agree as to how the settlement will be treated for tax purposes, it is hard to envision any reason why a reviewing court should not honor that agreement.").

remediation, or other fund; to a group; or to a government or a governmental entity, to the extent it was not harmed by the taxpayer's violation or potential violation of a law."[22]

Recommendation

The AICPA recommends that Treasury and the IRS issue final regulations that do not include Prop. Reg. § 1.162-21(f)(3)(iii)(D). An amount paid to a government or governmental entity, including an entity or fund established by a government or governmental entity that does not meet the definition of restitution, remediation, or that is paid to come in compliance with a law, is disallowed under Prop. Reg. § 1.162-21(a).

However, if additional clarification is required when an amount is paid to a fund, the AICPA recommends that Treasury and the IRS should refine Prop. Reg. § 1.162-21(f)(3)(iii)(D) to reflect that a deduction is not allowed for an amount paid to an entity or a fund established by a government or governmental entity, including a restitution or remediation fund, unless the amount is paid as restitution, remediation, or as an amount paid to come into compliance with a law.

Analysis

Proposed Reg. § 1.162-21(f)(3)(iii)(D) as drafted, combined with the explanation provided by the preamble, may create confusion as taxpayers can read this section as not allowing a deduction for an amount paid to an entity or a fund even if the amount is paid as restitution, remediation, or to come into compliance with a law. Although a specific fund or entity may not be harmed by a taxpayer's violation or potential violation of a law, many types of funds, including qualified settlement funds (QSFs) provided by section 468B, are used to provide restitution to harmed persons. For example, in the context of an opt-out class action suit, class members often remain unidentified at the conclusion of the suit. A QSF established pursuant to an order of, or approved by, the government is paid restitution by the taxpayer/defendant so that the QSF may pay restitution to class members as they are identified. The AICPA does not believe that Treasury and the IRS meant to provide that all amounts paid to an entity or a fund are *per se* disallowed under section 162(f). Rather, the IRS and Treasury likely meant to provide that an amount paid to an entity or a fund is disallowed under section 162(f) if the amount paid to the entity or fund does not meet the definition of restitution, remediation, or an amount paid to come in compliance with a law.

V. Clarify how section 6050X reporting obligations apply to "all orders . . . and agreements . . . with respect to a violation, investigation, or inquiry" as provided in Prop. Reg. § 1.6050X-1(a)(1)

Overview

Under section 6050X(a)(2)(A)(ii), the reporting threshold is satisfied if the aggregate amount involved in all court orders and agreements with respect to the violation, investigation, or inquiry is $600 or more. However, as discussed above, section 6050X(a)(2)(B) provides that the threshold

[22] Preamble to Prop. Reg. § 1.162-21, 85 Fed. Reg. 28,524, 28,527 (May 13, 2020).

amount may be adjusted "as necessary in order to ensure the efficient administration of the internal revenue laws."

Proposed Reg. § 1.6050X-1(a) requires that the appropriate official must file an information return if the aggregate amount the payor is required to pay exceeds the threshold amount provided in the regulations. The information provided includes the aggregate amount paid to or at the direction of a government or governmental entity and provides separate disclosure of amounts required as restitution, remediation or to come into compliance with the law.

Proposed Reg. § 1.6050X-1(e) requires that the appropriate official take into account payment amounts that are not identified in the order or agreement in determining if the threshold amount for information reporting is met.

Proposed Reg. § 1.6050X-1(g) provides that the appropriate official responsible for the information reporting requirement, if not assigned in the order or agreement, is the officer or employee of the government or governmental entity that has control of the suit, investigation or inquiry. If there are multiple governments or governmental entities that are parties to the order or agreement, it is the appropriate official of the government or governmental entity listed first that is responsible for the information reporting requirement.

Recommendation #1

Treasury and the IRS should clarify that the reporting obligation applies on an order-by-order or agreement-by-agreement basis where the amounts provided by each order or agreement exceed the threshold amount, unless multiple settlements arise as a result of proceedings for the same violation or potential violation of law initiated by the same party or parties.

Analysis

The proposed regulations do not provide rules for what is meant by "all orders . . . and agreements . . . with respect to a violation, investigation, or inquiry." The final regulations should clarify how the reporting obligation applies to each order or agreement where multiple settlements arise as a result of proceedings for the same violation or potential violation of law initiated by the same party or parties. Furthermore, it is burdensome to require a governmental official to estimate or anticipate what amounts are paid for restitution or remediation, or to come into compliance with the law if specified amounts are not specifically paid to, or at the direction of the government (e.g., if the settlement agreement or order merely provides that an unspecified amount must be spent to come into compliance with the law).

In addition, the final regulations should clarify that only the amounts that require payment to the same government or entity, or group of governments or entities, that brought the proceeding resulting in the settlement are aggregated. Amounts paid for the same or a similar violation or potential violation of law to a party that did not participate in the same proceeding as the filer should not be included in determining the aggregate amount. Without clarifying the identity of matter and parties, it will be difficult for filers to determine which amounts are taken into account to determine whether the threshold is satisfied.

Recommendation #2

The final regulations should provide that governments or governmental entities are only required to report amounts on Form 1098-F if a specified amount is provided for in the order or agreement with the government or governmental entity, or is known and paid at the direction of the government or governmental entity.

Analysis

Focusing on only having to report the amounts that are known on the Form 1098-F would limit the government's burden of having to determine amounts paid outside of the agreement.

Recommendation #3

The AICPA agrees with establishing a single appropriate official and welcomes the ability to assign that official for information reporting purposes.

Analysis

The proposed regulations allow for flexibility in determining which government or governmental entity will be responsible for fulfilling the information reporting requirements under section 6050X. Where there is more than one government or governmental entity that is a party to an order or agreement, an appropriate official may be appointed under the agreement or will be the government or governmental entity listed first on the most recently executed order. This provision provides clarity regarding which party has the ultimate responsibility for the information reporting requirement to the IRS and the payor(s) under the order or agreement.

VI. Clarify the definition of the term "material change" provided by the transition rule in Prop. Reg. § 1.162-21(e)(1) to include only a transformation of the purpose of a taxpayer's payment obligation(s) or the addition of a new obligation different from the taxpayer's existing obligation(s)

Overview

Section 162(f), as amended, provides that it "shall not apply to amounts paid or incurred under any binding order or agreement entered into before [December 22, 2017]." However, the proposed regulations appear to expand the applicability of amended section 162(f) beyond the intent of Congress. Absent very limited exceptions, Prop. Reg. § 1.162-21(e)(1) appears to generally apply to parties who entered into a binding order or agreement before December 22, 2017 and modified their pre-existing order or agreement on or after December 22, 2017. Specifically, Prop. Reg. § 1.162-21(e)(1) provides, "[i]f the parties to an order or agreement… make a **material change** to the terms of that order or agreement on or after the applicability date…, paragraph (a) of this section applies to any amounts paid or incurred, or any obligation to provide property or services, after the date of the material change." A material change is broadly defined to include, "[c]hanging the nature or purpose of a payment obligation; or changing, adding to, or removing a payment obligation, an obligation to provide services, or an obligation to provide property."[23] However, "[a] material change does not include changing a payment date or changing the address of a party to the order or agreement."[24]

Recommendation

Treasury and the IRS should clarify the definition of "material change" to include only a transformation of the purpose of a taxpayer's payment obligation(s), or the addition of a new obligation different from the taxpayer's existing obligation(s). If a modification to an order or agreement requires new obligation(s), Treasury and the IRS should subject the new obligation(s) to amended section 162(f).

Analysis

The definition of the term "material change" in the proposed regulations is overly broad and inconsistent with the effective date provided under amended section 162(f), as arguably any change to a payment obligation or change to the taxpayer's obligation to provide services or property is subjected to amended section 162(f). Additionally, the proposed regulations' inclusion of the term "may include" indicates that the list is not all-inclusive and does not provide meaningful parameters on the definition to assist taxpayers in determining whether an item outside the list provided constitutes a material change. This concern is further evident in that the specific exclusions from a material change only provide two very narrow examples (e.g., change in payment date or change of address).

Congress did not intend to broadly subject payments attributable to binding orders or agreements entered into before December 22, 2017 to amended section 162(f). Congress, in amending section 162(f), stated that new section 162(f) is to apply only to amounts paid or incurred under an order or agreement entered into after December 22, 2017. Thus, for example, if an agreement is amended to increase the total dollar amount of restitution paid in exchange for a deferral of the payment date, only the increase in the total amount would be considered paid or incurred after December 22, 2017. The plain statutory language is also supported by Congress' explanation on the effective date, which provides, "[t]he provision denying the deduction and the reporting provision are effective for amounts paid or incurred on or after the date of enactment, except that it would not apply to amounts paid or incurred under any binding order or agreement entered into before such date."[25] Additionally, the Joint Committee on Taxation's interpretation of the effective date reiterated Congress' plain intent, "[t]he provision denying the deduction… [is] effective for amounts paid or incurred on or after the date of enactment (i.e., December 22, 2017), except that [it] do[es] not apply to amounts paid or incurred under any binding order or agreement entered into before such date."[26]

[23] Proposed Reg. § 1.162(a)-21(e)(2).
[24] *Id*.
[25] H.R. Rep. 115-466, at 431 (2017).
[26] JOINT COMM. ON TAX., 115TH CONG., GENERAL EXPLANATION OF PUBLIC LAW 115-97, at 194 (Comm. Print 2018).

VII. Clarify Example 3 provided by Prop. Reg. § 1.162-21(g)

Overview

Proposed Reg. § 1.162-21(b) provides, in part, that the disallowance under section 162(f) does not apply to amounts paid to come into compliance with a law. An amount paid or incurred to come into compliance with a law is defined under Prop. Reg. § 1.162-21(f)(3) to include the performance of services; taking action, such as modifying equipment; providing property; or doing any combination thereof.

Example 3 of Prop. Reg. § 1.162-21(g) describes a taxpayer under investigation by an environmental enforcement agency for a potential violation of law governing emission standards. As part of the agreement with the agency, the taxpayer is required to bring certain machinery that is already in compliance with the law up to a standard higher than that which the law requires. The analysis concludes that the costs associated with bringing the taxpayer's machinery up to a higher standard are not deductible, because "no facts exist to establish that either amount was paid to come into compliance with a law or as restitution or remediation."

Recommendation

Treasury and the IRS should clarify Example 3 in Prop. Reg. § 1.162-21(g) by revising the conclusion and/or adding new facts or analysis to support the tax treatment of the expenditure. Specifically, Treasury and the IRS should revise the example to clarify that amounts paid to bring machinery up to a higher standard than that which the law requires are not automatically disallowed under section 162(f).

Analysis

As currently drafted, Example 3 in Prop. Reg. § 1.162-21(g) concludes that the amounts paid to bring machinery up to a higher standard are not deductible under section 162(f). However, the example does not elaborate on the analysis giving rise to the conclusion. As currently drafted, Example 3, without further clarification or elaboration, would result in potential misapplication of the statute.

Treasury and the IRS should provide context as to why the taxpayer and the environmental enforcement agency agreed for the taxpayer to upgrade machinery that was already in compliance with the law, as the underlying motive is unclear. Was the required action punitive in nature, or did the taxpayer offer to perform additional work on its own accord? If the latter, it would appear that the amounts are excluded from the scope of section 162(f).

Further, if a taxpayer voluntarily upgrades machinery that was previously not in compliance with the law to a standard higher than that which the law requires, it is unclear from Example 3 whether the entire amount would be disallowed under section 162(f). Assuming the taxpayer otherwise meets the identification and establishment requirements, the appropriate conclusion is to allow a deduction, at least for the cost attributable to bring the machinery into compliance. The additional amounts paid by the taxpayer to bring the machinery to the higher standard are potentially subject to the capitalization rules under section 263(a) and the regulations thereunder.

VIII. Clarify that payments not subject to regulatory review and made during the ordinary course of a taxpayer's trade or business in accordance with its internal compliance and risk procedures are not made to or at the direction of the government

Overview

Businesses subject to supervision by a regulatory agency periodically undergo examination or review by the agency to ensure compliance with regulatory requirements regarding the pricing of products and services. For example, the Federal Trade Commission (FTC) may investigate a taxpayer to ensure compliance with consumer protection laws. The investigation may result in determinations of specific violations and consent agreements that require the taxpayer to pay specific restitution or remediation to customers for specific transactions that involved an overpayment or other financial harm to the customer, as approved by the regulatory body. These agreements may also result in a consent order or similar agreement by the taxpayer to revise internal compliance and risk procedures in order to self-monitor on a prospective basis to prevent future violations, and to discover and remediate future violations.

The resulting revised action plan to self-monitor and remediate future violations may require that such uncovered future violations are required to be reported to, reviewed by, and ultimately agreed to by the regulators before the business makes the payments to a specific customer. The adopted action plan may provide that a regulator's review is limited to violations exceeding certain volume and/or dollar thresholds. Remediation payments that fall below the thresholds are still required to be made to affected customers but are not subject to a requirement of prior regulatory review.

Recommendations

Treasury and the IRS should clarify that payments not subject to regulatory review, made during the ordinary course of a taxpayer's trade or business in accordance with its internal compliance and risk procedures, are not made to or at the direction of the government.

Further, the rule should provide that such payment is not made at the direction of the government even if the taxpayer's internal compliance and risk procedures were modified as a result of a past governmental investigation.

The AICPA also recommends that the regulations include an illustrative example that defines whether payments are considered made to or at the direction of the government.

Analysis

Although the requirement to develop and implement revised procedures results from the initial consent order or settlement, the payments below the regulatory (or other agreed-upon) threshold that are made to remediate future violations result from the taxpayer's revised procedures, not from the initial consent order or settlement. Accordingly, Treasury and the IRS should not consider payments to customers below such a threshold in connection with the revised procedures within the scope of section 162(f) and the regulations thereunder. Even though the consent order or settlement agreement was a catalyst for the revised internal monitoring and compliance procedures, the remediation to customers results from the taxpayer's ordinary compliance procedures and are not amounts paid to or at the direction of the government. If such payments are deemed to or at the direction of the government for purposes of section 162(f) (and, by extension, section 6050X), additional burden and complexity is imposed on both the taxpayer and on the regulator. Future compliance would become frustrated and section 162(f) would serve as a disincentive to self-monitoring and ongoing compliance initiatives.

Proposed example to include in final regulations

> Corporation Y is subject to periodic supervisory examinations by a regulator in connection with business practices. One such examination results in a finding of significant deficiencies in Corporation Y's past pricing and customer transaction practices. Corporation Y enters into a consent agreement that requires it to: (i) make remediation to customers for past violations; and (ii) develop a compliance and remediation process to monitor for and remediate any future violations. Under the revised compliance plan, future violations meeting certain dollar and/or customer volume thresholds are required to be reported to, reviewed by, and agreed to by the regulators. The company is required to make remediation payments that fall below the thresholds, but these are not subject to regulatory approval. Although the revised procedures result from the consent agreement, future payments made by the taxpayer in regard to violations identified under its revised procedures that fall below the regulatory threshold are not considered to be made to or at the direction of the government and therefore are not subject to section 162(f).