**Feedback for REG-104591-18: Denial of Deduction for Certain Fines, Penalties, and Other Amounts; Information with Respect to Certain Fines, Penalties, and Other Amounts[1]**

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| **Prop. Regs. §1.162–21** | **Denial of deduction for certain fines, penalties, and other amounts** | | | |
| **Prop. Regs. §1.162–21(a)** | **Deduction disallowed** | DCAA audit reports or settlement agreements and restitution | The final regulations should make clear that amounts paid to correct charging errors or items subsequently determined to be disallowed for reimbursement are paid to make the government customer whole by correcting the pricing according to the contract and applicable government contract law. Amounts identified as penalties in connection with these adjustments would continue to be non-deductible under §162(f). | DCAA audit reports or settlement agreements currently do not identify audit deficiencies and corresponding amounts owed as restitution. Thus, taxpayers must determine and establish whether the restitution amount is paid (i) to compensate (which may be deductible), or (ii) to punish or deter (which is not deductible). The provisions of the various procurement laws are similar to tax laws in that they are complicated and are subject to interpretation and available guidance may not address all fact scenarios. Similar to a revenue agent's report, which may propose no changes or adjustments to a taxpayer's tax liability, a DCAA audit report may identify changes to pricing and reimbursements claimed by the contractor. |
| **Prop. Regs. §1.162–21(b)** | **Exception for restitution, remediation, and amounts paid to come into compliance with a law** | Establishment requirement substantiation (Prop. Regs. §1.162-21(b)(3)(ii)) | Section 6050X provides the mechanism to establish deductibility under §162(f) and was enacted by Congress to provide all necessary information to taxpayers and the IRS. As such, the Chamber suggests striking the heightened establishment requirement in the proposed rules.<br><br>To the extent this provision is retained, a safe harbor should be created providing that | The legislative history for §§162(f) and 6050X is written jointly and confirms that Congress recognized that taxpayers may need information from the government to meet the establishment requirement. (H.R. (Conf.) Rep. No. 115-466 (simultaneously addressing "sec. 13306 of the Senate amendment and sec. 162(f) and new sec. 6050X of the Code"). After noting that no deduction is allowed unless the identification requirement is satisfied, Congress next set forth, nearly verbatim, the requirements of §6050X:<br><br>The provision requires government agencies (or entities treated |

[1] Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

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| | | | where (1) an order or settlement agreement requires payment into a restitution or remediation fund, and (2) the governmental entity administering such fund reports pursuant to §6050X that payments to the fund are restitution or remediation, the taxpayer is deemed to have satisfied the establishment requirement under Prop. Regs. §1.162-21(b)(3). The administrators of such a fund have complete knowledge regarding the use and intended use of the payment made into the fund and can be trusted to properly report deductible versus non-deductible amounts. | as such agencies under the provision) to report to the IRS and to the taxpayer the amount of each settlement agreement or order entered into where the aggregate amount required to be paid or incurred to or at the direction of the government is at least $600 (or such other amount as may be specified by the Secretary of the Treasury as necessary to ensure the efficient administration of the Internal Revenue laws). The report must separately identify any amounts that are for restitution or remediation of property, or correction of noncompliance. The report must be made at the time the agreement is entered into, as determined by the Secretary of the Treasury (H.R. (Conf.) Rep. No. 115-466, 115th Cong. (2017).<br><br>This report, required under §6050X, contains precisely the information any reasonable person would provide if asked to "establish" that an amount was paid for the deductible purposes of §162(f). The heightened establishment requirement provided in the proposed rules is unnecessary based on the legislative history above, introduces ambiguity to statutory language that struck a clear balance between different policy considerations, and creates additional administrative and compliance burdens that are unnecessary to effectuate the legislative intent of the relevant Code provisions. |
| | | Use of a Qualified Settlement Fund (QSF) as described in §468B(d)(2) | Frequently court orders and settlement agreements stipulate the use of a QSF for the distribution and administration of restitution or remedial payments to harmed victims. Receipts from Fund administrators operating under direction from court | Use of a Qualified Settlement Fund (QSF) as described in §468B(d)(2) for remedial payments should be included as a recognized form of substantiation. |

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| | | for remedial payments should be included as a recognized form of substantiation. | approved settlements should be recognized forms of substantiation. Note recent SEC settlement with U.S. Bancorp, https://www.sec.gov/litigation/admin/2020/34-88976.pdf. | |
| | | Identification requirement when a court is not well-positioned to estimate a restitution component and is unwilling to agree to a specific allocation. | Upon written confirmation from a court that it is unable to determine a precise allocation, the taxpayer should be allowed to make a reasonable estimate or provide a 3rd party opinion of the amounts allocable to restitution, remediation, or to come into compliance with law. The taxpayer's estimation and/or 3rd party opinion would be included with the court order. | |
| **Prop. Regs. §1.162–21(e)** | **Material change to order or agreement** | Definition of "material change" | Clarify that a "material change" is defined to mean an amendment to the order or agreement that either: (1) alters the nature or purpose of the taxpayer's existing obligation; or (2) imposes on the taxpayer a new obligation or an obligation that differs in kind from the obligations that exist under the pre-existing order or agreement.<br><br>Further, provide that if a change to a pre-existing order or agreement is determined to impose a new or different kind of obligation | The definition of "material change" is too broad and ambiguous in important respects. The proposed rules suggest that *any* change to a taxpayer's pre-existing obligation (other than a change of payment date or address of a party, which is specifically carved out in the regulations) could constitute a material change that would subject amounts paid after the effective date of the final regulations to §162(f).<br><br>The definition of "material change" in the proposed regulations is also ambiguous because the defined term "material change" is followed by the words "may include" rather than the word "means." Thus, the proposed rules could be construed to create a rule with no limits as to what constitutes a "material change." Under this interpretation, the only "changes" that would |

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| | | | on the taxpayer that did not exist under the pre-existing order or agreement, only amounts paid by the taxpayer pursuant to the new or different kind of obligation will be governed by amended §162(f).<br><br>Finally, provide that where a pre-existing obligation is assumed by another taxpayer (for example, pursuant to a transfer of assets or a reorganization) and the order or agreement contains terms governing such an assumption, the assumption will not be considered to be a material change with respect to the taxpayer that assumes the obligation. Such an assumption alone would not change the nature or purpose of the pre-existing obligation. Further, if an order or agreement contains terms governing such assumptions the IRS and Treasury should not be concerned about continuing to apply prior the rules of former §162(f) to payments made under the order or agreement by the assuming taxpayer. Further, if a party that assumes a pre-existing obligation in such an assumption is denied a deduction because the payments it makes will be subject to the stricter rules of amended §162(f), it will likely have a | not be considered "material" are the two that are specifically mentioned in the regulations, i.e., a change of payment date or address of the payee. The rules should spell out the types of changes that do, and do not, constitute material changes.<br>These requested clarifications are consistent with the intent of the transition rule to ensure that payments made under pre-existing obligations as of the effective date of the Act remain deductible (to the extent they were deductible under former §162(f)). Further, they are consistent with public policy. When parties to an order or agreement disagree about how the existing terms of the order or agreement should be interpreted, they can resolve those disagreements through either (i) negotiation and settlement, or (ii) litigation or arbitration. Without the clarifications to the term "material change," many businesses likely would be discouraged from negotiating and resolving, out of court, disputes with governmental counterparties about the interpretation of provisions in pre-effective date settlement agreements for fear of losing the ability to deduct settlement payments they make going forward. This, in turn, would likely lead to unnecessary litigation and an increased burden on the court system. Indeed, it would be contrary to the spirit of the transition rule if the same interpretation of, or amendment to, a pre-existing agreement had dramatically different tax consequences depending on whether it was agreed upon by the parties or ordered by a court or arbitration panel. The requested clarifications would give businesses and governments (or governmental entities) the flexibility to make necessary modifications to their settlement agreements.<br><br>To clearly illustrate these rules, and provide clarity and certainty for affected taxpayers and governments and governmental entities, the following examples should be included in the regulations: |

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| | | | significant detrimental impact on some taxpayers' ability to reorganize and to transfer the assets of their businesses.<br><br>Below is a redline of changes that could effectuate the above recommendations:<br><br>(e) *Material change to order or agreement* - (1) *In general.* If the parties to an order or agreement, entered before December 22, 2017, make a material change to the terms of that order or agreement on or after the applicability date in paragraph (h) of this section, then except as provided in paragraph (e)(3) of this section, 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.<br><br>(2) *Material change.* (i) A material change to the terms of an order or agreement under paragraph (e)(1) of this section means a change that either: (*a*) alters ~~may include: changing~~ the nature or purpose of an ~~payment~~ obligation ~~or changing, adding to, or removing a payment obligation, an obligation to provide services, or an~~ | Examples. Assume for purposes of each example that G is a government or governmental entity within the meaning of paragraph (f)(1) of this section, and that the binding order or settlement agreement giving rise to the taxpayer's obligation was entered into prior to December 22, 2017.<br><br>Example 1. A and B are each obligated under a settlement agreement with G to pay $1,000,000 of restitution each year for 10 years. Sometime after the applicability date in paragraph (h) of this section, A and G amend the agreement to provide that A will no longer be required to pay $1,000,000 per year as restitution, but instead must provide certain services as restitution, which are estimated to cost A $1,000,000 each year. The change to the agreement does not alter the nature or purpose of A's obligation, but it does impose on A an obligation that differs in kind from the obligation than A had under the agreement prior to the amendment. Thus, the change is a material change within the meaning of paragraph (e)(2) of this section. Accordingly, paragraph (a) of this section will apply to future payments made by A under the agreement. However, the change is not a material change as to B. Accordingly, paragraph (a) of this section will not apply to future payments made by B under the agreement.<br><br>Example 2. C is obligated under a court order to pay G $1,000,000 of damages per year, for 15 years arising out of a violation by C of certain environmental laws. Sometime after the applicability date in paragraph (h) of this section, the court amends the order to require that C, for the remaining portion of the 15-year period, pay only $600,000 per year to G, and in addition pay $400,000 per year to an environmental charity selected by G. The change to the order imposes a new obligation on C that did not |

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| | | | ~~obligation to provide property. A material change does not include changing a payment date or changing the address of a party to the order or agreement.~~ under the order or agreement; or (*b*) imposes on the taxpayer a new obligation or an obligation that differs in kind from the obligations that existed under the order or agreement prior to the change.<br><br>(ii) The fact that a change requires court approval is not relevant to the determination of whether the change is a material change. A material change does not include the assumption of one taxpayer's obligation by another taxpayer pursuant to a provision of an order or agreement that contemplates such assumptions. A material change also does not include a change to a formula provided in an order or agreement that is used to compute the amount of a required payment under such order or agreement.;<br><br>(3) *New or different obligation*. An obligation to pay money is an obligation that differs in kind from an obligation to provide property (or services), and an | exist under the original order. Accordingly, paragraph (a) of this section will apply to future payments made by C to the charity. However, under paragraph (e)(3) of this section, paragraph (a) of this section will not apply to future payments made by C to G.<br><br>Example 3. D is obligated under a court order to pay G $1,000,000 of damages per year, on or before December 31, for 20 years. D is required under the order to remit the payment to G's office in Washington, D.C. Sometime after the applicability date in paragraph (h) of this section, the court amends the order (pursuant to the joint petition of D and G) to: (i) change the required payment date from December 31 to November 30, and (ii) to require that payment be made to G's office in Los Angeles, CA. The changes do not alter the nature or purpose of D's obligations under the order, or create a new or different kind of obligation on the part of D. Thus, the changes are not material changes within the meaning of paragraph (e)(2) of this section. Accordingly, paragraph (a) of this section will not apply to future payments made by D under the order, as amended.<br><br>Example 4. E is a corporation obligated under a settlement agreement to pay G $1,000,000 of damages per year for 10 years. The agreement contains terms that govern assumptions of E's obligation by another person. Sometime after the applicability date in paragraph (h) of this section, F acquires certain assets of E and, in connection with that acquisition, assumes E's obligation under the agreement. The assumption of E's obligation by F does not alter the nature or purpose of the obligation under the agreement. Further, although F had no previous obligation under the agreement, the assumption of the obligation by F does not create a new or different kind of obligation from the obligation that existed under the agreement prior to F's |

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| | | | obligation to provide services is an obligation that differs in kind from an obligation to provide property. In the case of a change that imposes on the taxpayer a new obligation or an obligation that differs in kind from the obligations that existed under the order or agreement prior to the change, paragraph (a) of this section applies only to amounts paid or incurred in satisfaction of such new or different kind of obligation. | assumption of E's obligation. Thus, F's assumption of E's obligation is not a material change within the meaning of paragraph (e)(2) of this section. Accordingly, paragraph (a) of this section will not apply to future payments made by F under the agreement. The result would be the same if instead F had been a party to the agreement, and had its own obligation under the agreement, prior to assuming E's obligation in addition to F's own pre-existing obligation.<br><br>Example 5. H and I are obligated under a settlement agreement to pay G a certain amount of damages every year, for 15 years. The total amount of the annual payment is determined according to a formula. A second formula (the allocation formula) determines how H and I will share the payment obligation each year. Under the allocation formula, H and I have historically been required to pay 40% and 60%, respectively, of the total annual amount owed to G. Sometime after the applicability date in paragraph (h) of this section, H, I, and G agree to change the allocation formula. Applying the new allocation formula, H and I each are responsible for 50% of the next annual payment obligation to G. The changes to the agreement do not alter the nature or purpose of H's or I's obligation under the agreement, or create a new or different kind of obligation on the part of H or I. Thus, the changes are not material changes within the meaning of paragraph (e)(2) of this section. Accordingly, paragraph (a) of this section will not apply to future payments made by H or I to G, under the agreement, as amended.<br><br>Example 6. J is a party to a settlement agreement that provides a formula for computing the amount of damages that J owes G each year for 25 years. The formula is based in part on J's sales for the preceding year. J and G have previously disagreed about whether the term "sales" in the agreement |

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| | | | | was intended to mean gross sales or net sales. While the parties have been negotiating a resolution to the dispute, J has been making annual payments to G on the basis of net sales. Separately, the formula also provides for a payment adjustment to account for inflation. J and G do not disagree about how the inflation adjustment factor applies. Sometime after the applicability date in paragraph (h) of this section, J and G agree that the term "sales" should be interpreted to mean gross sales, rather than net sales, and they amend the settlement agreement accordingly to apply the formula on a gross-sales basis to all future payments. The change has the effect of increasing the amount that J owes to G each year going forward. Further, they agree that J is required to make a "catch up" payment to G equal to the difference between the aggregate amount J paid in all prior years based on applying the formula using net sales and the aggregate amount J would have been required to pay had the formula been applied using gross sales. J and G further agree to amend the agreement to remove any adjustment for inflation going forward. The changes to the settlement agreement are approved by the court with jurisdiction over the agreement. The changes to the agreement do not alter the nature or purpose of J's obligation under the agreement or create a new or different kind of obligation on the part of J. Further, for this purpose, the fact that court approval was required and obtained is irrelevant. Thus, the changes are not material changes within the meaning of paragraph (e)(2) of this section. Accordingly, paragraph (a) of this section will not apply to future annual payments made by J to G, or to the catch-up payment made by J to G. The result would be the same if instead J and G historically had been applying the formula on a gross sales basis, and sometime after the applicability date in paragraph (h) of this section, J and G amend the agreement to provide that the term "sales" means net sales, with the result that the amount of J's future annual payments to G |

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| | | | | decreases. The results would also be the same if instead of removing an inflation adjustment factor that had been part of the formula under the existing agreement, J and G instead decide to change how the factor is calculated, or to add an inflation adjustment factor to the formula that previously did not exist. |
| **Prop. Regs. §1.162–21(f)** | **Definitions** | Disgorgement (Prop. Regs. §1.162-21(f)(3)(iii)(C)) | Remove disgorgement as a required exception to treatment as remediation or restitution. | Disgorgement, which in substance represents restitution or remediation to a harmed victim, not simply a punitive payment by an enriched wrongdoer, should not be treated by definition as a non-deductible penalty as found in *Kokesh v. SEC, 137 S.Ct. 1635, 1643(2017)* and further discussed in *Liu et.al. v. SEC* released by the Supreme Ct. June 22, 2020 holding the SEC may seek disgorgement to the extent of ill-gotten net profits. The court remanded the case back to the 9th Circuit with respect to the requirement to return the funds to victims. Thus, the lower court may clarify whether payments which otherwise satisfy the establishment requirement in §162(f)(2)((A)(i) should be respected as amounts constituting restitution or paid to come into compliance with the law. |
| | | Other payments (Prop. Regs. §1.162-21(f)(3)(iii)(D)) | Clarify other "payment or contribution" as a required exception to treatment as a deductible ordinary and necessary business expense | Payments not made to a government, governmental entity, or at their direction, and otherwise meeting the requirements as a deductible expense under the Code should be clearly distinguished from amounts defined in Prop. Regs. §1.162-21(f)(3)(iii)(A).<br><br>Consider clarifying additional language in -21(f)(3)(iii)(D) as follows:<br>(D) To the extent the payment or contribution to, or at the direction of, a government or governmental entity does not meet the requirements of paragraph (f)(3)(i) or (ii).<br><br>The concern here is that internal or external costs incurred in connection with an alleged violation, e.g. outside counsel, etc. could be tainted as |

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| | | | | nondeductible under the current language as a payment to a "group", etc. |
| | | Restitution, remediation of property, and amounts paid to come into compliance with a law (Prop. Regs. §1.162-21(f)(3)) | Clarify that the term "property" may include the environment, such that amounts paid or incurred to restore, in whole or in part, the harm caused to the environment by the violation or potential violation of a law may be deductible under §162. | Restitution, remediation of property, and amounts paid or incurred to come into compliance with a law are not defined under the statute, and therefore should be given their reasonable meaning. Prop. Regs. §1.162-21(f)(3) defines these terms as amounts paid or incurred to restore, "in whole or in part, the person, as defined in section 7701(a)(1); the government; the governmental entity; or property harmed by the violation or potential violation of a law." To the extent that harm to "property" does not include environmental harm, Prop. Regs. §1.162-21(f)(3) is too narrow in scope. Similar to persons, governments and governmental entities, and property, the environment may be harmed and, at least to a degree, restored. Amounts paid or incurred for the purpose of environmental restoration, therefore, should be deductible under §162. |
| **Prop. Regs. §1.162–21(g)** | **Examples** | Non-deductibility of other payments required by a settlement agreement or court order (e.g., agreement to fund building a nature center) | Example 3 of the proposed rules denies a deduction for expenses related to bringing equipment/property (e.g., a fleet of vehicles) to a higher standard than required by law because the payment did not fit under the narrow definitions of restitution, remediation, or coming into compliance with a law. Deductions related to these types of payments should be permitted under Prop. Regs. §1.162–21(b) because it represents good public policy. | |
| | | Audits that are not the investigation of a potential violation of law | Provide an example to clarify that a contractor's cost for managing routine audits by U.S. Government (USG) agencies (such as Defense Contract Audit Agency | Under pre-Tax Cuts and Jobs Act (TCJA) law, no deduction was allowed under §162 for any fine or similar penalty paid to a government for the violation of any law. Under §162(f)(1) as amended by the TCJA, except as provided below, no otherwise allowable deduction is allowed for any amount |

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| | | | (DCAA) or IRS) are deductible under §162 and they are not an investigation or inquiry by a government into the potential violation of any law which would make them non-deductible under §162(f)(1). | paid or incurred (whether by suit, agreement, or otherwise) 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.<br><br>Section 162(f)(2)(A) provides the following exceptions to the general rule and allows a taxpayer to deduct certain otherwise deductible amounts paid or incurred for restitution, remediation, or paid to come into compliance with a law:<br>**1.** If the taxpayer establishes the amounts were paid or incurred as restitution (including remediation of property) or to come into compliance with a law ("establishment requirement");<br>**2.** Those amounts are identified in the court order ("order") or settlement agreement ("agreement") as restitution, remediation, or amounts paid or incurred to come into compliance with a law ("identification requirement") and<br>**3.** In the case of any amount of restitution for failure to pay any tax imposed by the Code, if the payment would have been allowed as a deduction if it had been timely paid.<br><br>Companies that sell products or services to the USG and meet certain requirements are subject to various federal acquisition laws such as the Truth in Negotiation Act (TINA), the Federal Acquisition Regulations (FAR), or the Cost Accounting Standards (CAS). These procurement laws include requirements on how material costs, labor cost, and overhead costs allocations are charge to contracts. Procurement laws are similar to tax laws in that they are complicated and are subject to interpretation and available guidance may not directly address all sets of facts. |

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| | | | | Federal agencies such as the DCAA perform routine audits of contract costs and compliance with TINA (not unlike the continuous income tax audits to which large corporations are routinely subject). Defense contractors support these audits by responding to auditor inquiries and by providing supporting documentation to items under review. The auditor will propose adjustments or propose no changes in a process that is similar to the completion of a tax audit. The time period required to complete the audit cycle may span more than one taxable year depending on the complexity of the issues reviewed and the time required to exhaust all available appeal procedures.<br><br>A contractor's costs for managing USG procurement audits are an ordinary and necessary business expense that have been traditionally deductible under §162. |
| **Prop. Regs. §1.6050X–1** | **Information reporting for fines, penalties, and other amounts by governments, governmental entities, and nongovernmental entities treated as governmental entities** | | | |
| **Prop. Regs. §1.6050X–1(b)** | **Requirement to file return** | Taxpayers' recourse if the governmental entity refuses to include identification | A governmental entity's accurate submission of an information return creates the presumption that the taxpayer has, in fact, paid amounts related to restitution, | |

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| | | language in the return/statement | remediation, or to come into compliance with a law. If the governmental entity refuses to submit an information return, or to include identification language in the return, even though the payment is for restitution, remediation, or to come into compliance with a law, the taxpayer should not be refused a deduction. Accordingly, under these circumstances, the taxpayer should be allowed to make a reasonable estimate of the amounts allocable to restitution, remediation or to come into compliance with a law, or to provide a report from a 3rd party regarding the same. | |