Informal Opinion

BY DOUGLAS E. ROBERTS

©ellagrin | AdobeStock

More Than Just Taxes: Considering the Effects of the New Government Reporting Requirements

The sprawling new federal tax law, enacted early this year, has engendered great controversy about systemic issues like wealth distribution, deficit expansion, and job creation. Hidden in the maelstrom is a rather uncontroversial provision that attempts to bring predictability and efficiency to the process of seeking tax deductions for payments made to the government in satisfaction of a settlement agreement or judgment. The U.S. Department of Justice (DOJ) and other agencies already have begun to apply this provision to civil defendants. As this article explains, practitioners must not only understand the tax consequences of the new law, but also its potential effect on the availability of insurance coverage for their clients.

Breaking Down the Text

Payments to a private party in settlement of a claim or to satisfy a judgment are typically deductible as business expenses under Section 162 of the Internal Revenue Code. When the payment is made to a government entity, however, the picture changes: Any part of a settlement or judgment considered a "fine or similar penalty" historically was not a deductible business expense for public policy reasons.[1] In other words, a deduction would not be permitted if it "would frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof."[2] Treasury regulations (circularly) define a "fine or similar penalty" to include amounts "[p]aid as a civil penalty imposed by Federal, State, or local law … or in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal)."[3] However, the regulations exclude "compensatory damages … paid to a government" from the definition.[4]

The new tax law, which sports the snappy title, "An act to provide for reconciliation pursuant to Titles II and V of the concurrent resolution on the budget for fiscal year 2018," maintains that distinction. But it shifts the burden of proof from the IRS to the claimant. Previously, after a taxpayer deducted a civil settlement with, or judgment in favor of, the government, the IRS had to establish that a payment — or portion of a payment — constituted a fine or penalty to foreclose deductibility. Now, the IRS must only show the payment was made to a government unit in response to an allegation that the taxpayer violated some law. The taxpayer must then demonstrate that the payment is for "restitution" or to "come into compliance with any law that was violated or otherwise involved in the investigation or inquiry."[5]

How does a taxpayer make that showing? The new law provides a mechanism. In each "suit or agreement," the government must report (1) the amount of the "suit or agreement" that constitutes restitution, remediation of property, or a payment to "come into compliance" with the law that was violated or involved in the investigation; and (2) the portion that constitutes a "fine, penalty, or other amount."[6] While the IRS will be able to contest any categorization, the new reporting requirement was designed to bring tax predictability to the settlement process.

A few definitional notes: First, while there is some ambiguity in the definition of "suit or agreement," it certainly encompasses settlement agreements, dispositive court orders in the government's favor, and sanctions in which the aggregate amount exceeds $600. Second, "fine, penalty, and other amount" is defined only as anything other than restitution, remediation, and the costs of "com[ing] into compliance" with whatever law was violated. Such costs would include, for example, money expended to implement a compliance program that satisfies the terms of a corporate integrity agreement.

Third, "fines and penalties" reflects the traditional language describing the punitive, as opposed to compensatory (i.e., restitutory or remedial), nature of a payment. Though it is not entirely clear, "other amounts" appears to refer to "any amount paid or incurred as reimbursement to the government or entity for the costs of any investigation or litigation."

Implementation and Defense Strategy

As the reporting requirements apply to all government units, and even some nongovernmental regulatory entities, questions abound regarding implementation. Will the various players report consistently with one another? Will each entity report in the same manner in each settlement agreement?

Anecdotal evidence suggests that the DOJ — the agency that will most frequently apply the new law — will expressly designate within the body of the settlement agreement what portion of the settlement amount constitutes restitution, but not what constitutes "fines, penalties, and other amounts." The DOJ's strategy for identifying restitution only is unclear; perhaps the agency is leery of foreclosing the IRS from later arguing that the undefined portion of a settlement is something other than a fine or penalty. However, such an argument likely would not travel far. Except, perhaps, for reimbursement for the cost of the investigation, the noncompensatory portion of a settlement amount must represent fines and penalties.

In any event, the DOJ's tactic represents a dramatic change from past prac-

tice, where agreements were silent as to the composition of the settlement amount. Under statutes like the False Claims Act, where treble damages are available and the government typically requires double damages for settlement, the fines and penalties can be substantial.

In essence, the new law removes the option to settle the underlying dispute with the government and litigate the tax consequences later. Agencies will be compelled to consider tax issues concerning enforcement actions during the investigation and litigation stages. Thus, defense counsel must consider the tax implications of potential settlements early in the representation, when he or she has the greatest opportunity to shape the government's damage theory. If the objective is to maximize the client's tax deduction, counsel might press a theory in which compensatory damages are larger, in exchange for a discount on the punitive portion of the settlement.

Don't Forget Insurance

Perhaps less intuitively, defense counsel also should evaluate the *insurance* consequences of the new tax law. Business entities and professionals, such as physicians, may well have policies that permit recovery for restitution or compensatory damages that flow from a regulatory action. Such policies, which often foreclose recoupment for fines and penalties, provide an even stronger incentive for counsel to advocate for the maximum apportionment of the settlement amount as restitution.

The calculus changes, however, when the policy in question expressly insures for civil or regulatory fines and penalties. These policies, while less common than those that *exclude* fines and penalties, exist in many insurance markets, including the environmental and medical spaces. Where this kind of policy excludes restitution, counsel may be put in the unusual position of arguing for damages theories that weigh heavy on the punitive side of the balance. That kind of pitch may appeal to government attorneys, given the presumed general deterrent value of stiff fines and penalties.

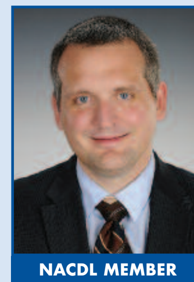
As is true with the tax consequences of a potential settlement, it is imperative that defense counsel assess the relevant insurance coverage issues early in the representation.[7] Knowing what policies are applicable will help counsel shape the most favorable resolution for the client.

Notes

1. 26 U.S.C. § 162(f).
2. *Tank Truck Rentals v. Comm'r*, 356 U.S. 30, 33-34 (1957) (citations omitted).
3. 26 C.F.R. § 1.162-2(b)(1).
4. 26 C.F.R. § 1.162-2(b)(2).
5. 26 U.S.C. § 162(f)(2)(A)(i)(II).
6. 26 U.S.C. § 6050X(a)(1).
7. If the client is fortunate enough to have a policy that provides insurance for fines and penalties, counsel should ensure that the applicable law does not prohibit the enforcement of the provision as contrary to public policy. ■

About the Author

Douglas E. Roberts is a Senior Associate at Pietragallo Gordon Alfano Bosick & Raspanti, LLP. His practice focuses on government enforcement and compliance, white collar litigation, and qui tam litigation.



Douglas E. Roberts
Pietragallo Gordon Alfano
Bosick & Raspanti, LLP
Philadelphia, Pennsylvania
215-988-1431
WEBSITE www.pietragallo.com
EMAIL DER@Pietragallo.com

UNITED STATES POSTAL SERVICE® **Statement of Ownership, Management, and Circulation (All Periodicals Publications Except Requester Publications)**

1. Publication Title: The Champion
2. Publication Number: 0 7 4 4 - 9 4 8 8
3. Filing Date: 25 Sept 2018
4. Issue Frequency: 10 issues per year — Jan/Feb and Sept/Oct are combined
5. Number of Issues Published Annually: 10
6. Annual Subscription Price: $100.00
7. Complete Mailing Address of Known Office of Publication (*Not printer*) (*Street, city, county, state, and ZIP+4®*): National Association of Criminal Defense Lawyers, 1660 L St NW FL 12, Washington DC 20036 — Contact Person: Quintin Chatman — Telephone (*Include area code*)
8. Complete Mailing Address of Headquarters or General Business Office of Publisher (*Not printer*): National Association of Criminal Defense Lawyers, 1660 L St NW FL 12, Washington DC 20036
9. Full Names and Complete Mailing Addresses of Publisher, Editor, and Managing Editor (*Do not leave blank*)
   - Publisher (*Name and complete mailing address*): Norman L. Reimer, 1660 L St NW FL 12, Washington DC 20036
   - Editor (*Name and complete mailing address*): Quintin Chatman, 1660 L St NW FL 12, Washington DC 20036
   - Managing Editor (*Name and complete mailing address*): N/A
10. Owner (*Do not leave blank. If the publication is owned by a corporation, give the name and address of the corporation immediately followed by the names and addresses of all stockholders owning or holding 1 percent or more of the total amount of stock. If not owned by a corporation, give the names and addresses of the individual owners. If owned by a partnership or other unincorporated firm, give its name and address as well as those of each individual owner. If the publication is published by a nonprofit organization, give its name and address.*)

Full Name	Complete Mailing Address
National Association of Criminal Defense Lawyers	1660 L St NW FL 12, Washington DC 20036

11. Known Bondholders, Mortgagees, and Other Security Holders Owning or Holding 1 Percent or More of Total Amount of Bonds, Mortgages, or Other Securities. If none, check box → ☒ None

Full Name	Complete Mailing Address

12. Tax Status (*For completion by nonprofit organizations authorized to mail at nonprofit rates*) (*Check one*)
The purpose, function, and nonprofit status of this organization and the exempt status for federal income tax purposes:
☐ Has Not Changed During Preceding 12 Months
☐ Has Changed During Preceding 12 Months (*Publisher must submit explanation of change with this statement*)

PS Form 3526, July 2014 (*Page 1 of 4 (see instructions page 4)*) PSN: 7530-01-000-9931 PRIVACY NOTICE: See our privacy policy on www.usps.com.

13. Publication Title: The Champion
14. Issue Date for Circulation Data Below: July, 2018

15. Extent and Nature of Circulation	Average No. Copies Each Issue During Preceding 12 Months	No. Copies of Single Issue Published Nearest to Filing Date
a. Total Number of Copies (*Net press run*)	13,121	20,176
b. Paid Circulation (*By Mail and Outside the Mail*) (1) Mailed Outside-County Paid Subscriptions Stated on PS Form 3541 (Include paid distribution above nominal rate, advertiser's proof copies, and exchange copies)	9,929	9,618
(2) Mailed In-County Paid Subscriptions Stated on PS Form 3541 (*Include paid distribution above nominal rate, advertiser's proof copies, and exchange copies*)		
(3) Paid Distribution Outside the Mails Including Sales Through Dealers and Carriers, Street Vendors, Counter Sales, and Other Paid Distribution Outside USPS®		
(4) Paid Distribution by Other Classes of Mail Through the USPS (e.g., First-Class Mail®)	152	151
c. Total Paid Distribution (*Sum of 15b (1), (2), (3), and (4)*)	10,081	9,769
d. Free or Nominal Rate Distribution (*By Mail and Outside the Mail*) (1) Free or Nominal Rate Outside-County Copies included on PS Form 3541	2,820	10,179
(2) Free or Nominal Rate In-County Copies Included on PS Form 3541		
(3) Free or Nominal Rate Copies Mailed at Other Classes Through the USPS (e.g., First-Class Mail)		
(4) Free or Nominal Rate Distribution Outside the Mail (*Carriers or other means*)	158	125
e. Total Free or Nominal Rate Distribution (*Sum of 15d (1), (2), (3) and (4)*)	2,978	10,304
f. Total Distribution (*Sum of 15c and 15e*)	13,059	20,073
g. Copies not Distributed (*See Instructions to Publishers #4 (page #3)*)	62	103
h. Total (*Sum of 15f and g*)	13,121	20,176
i. Percent Paid (*15c divided by 15f times 100*)	77.2%	50.5%

* If you are claiming electronic copies, go to line 16 on page 3. If you are not claiming electronic copies, skip to line 17 on page 3.

16. Electronic Copy Circulation	Average No. Copies Each Issue During Preceding 12 Months	No. Copies of Single Issue Published Nearest to Filing Date
a. Paid Electronic Copies		
b. Total Paid Print Copies (Line 15c) + Paid Electronic Copies (Line 16a)		
c. Total Print Distribution (Line 15f) + Paid Electronic Copies (Line 16a)		
d. Percent Paid (Both Print & Electronic Copies) (16b divided by 16c × 100)		

☐ I certify that 50% of all my distributed copies (electronic and print) are paid above a nominal price.

17. Publication of Statement of Ownership
☒ If the publication is a general publication, publication of this statement is required. Will be printed in the Sept/Oct 2018 issue of this publication. ☐ Publication not required.

18. Signature and Title of Editor, Publisher, Business Manager, or Owner: Norman L. Reimer, Publisher — Date: 20 Sept 2018

I certify that all information furnished on this form is true and complete. I understand that anyone who furnishes false or misleading information on this form or who omits material or information requested on the form may be subject to criminal sanctions (including fines and imprisonment) and/or civil sanctions (including civil penalties).