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TO TAX OR NOT TO TAX: INTERNAL REVENUE CODE 162(F), TAX LOOPHOLES, AND UNJUST ENRICHMENT

ABSTRACT

In 2017, Congress passed the Tax Cuts and Jobs Act, which substantially modified Section 162(f) of the Internal Revenue Code—the provision which disallowed business deductions for fines or penalties paid for corporate wrongdoing. The new legislation, which went a long way to clarify the obscure passage as originally written, left open an exception to the broad disallowance. Payments paid to victims as a form of restitution would still be allowed, the Restitution Exception. In 2020, the Treasury issued controversial proposed regulations that created a bright line disallowance of forfeiture and disgorgement payments under the Restitution Exception. Both types of payments had been at turns allowed and disallowed over the years under case law interpretations of the old version of Section 162(f). The final regulations issued in early 2021 tried to thread the needle of case law and the original rationale for the "fines and penalties" disallowance, the public policy doctrine.

This Note will address why the new law and final regulations successfully captured the original spirit of the law, clarified the types of payments that are allowed or disallowed, and provided additional transparency to a settlement process that has all too often resulted in deductions beyond the scope of the allowed exception. However, the effects of the new law and regulations may nevertheless create distortions in settlement negotiations and agreements. This Note argues that these distortions can be reduced by increased coordination between the Internal Revenue Service and the governmental agencies responsible for negotiating the settlements.

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INTRODUCTION

In 2006, Senators Chuck Grassley, John McCain, and John Warner protested the potential deductibility of $565 million of a $615 million settlement brokered between the Department of Justice and the Boeing Company ("Boeing") for alleged ethical violations related to Boeing's dealings with the Pentagon.[1] Allowing the huge tax deduction, the senators argued, would be "leaving the American taxpayer to effectively subsidize [Boeing's] misconduct."[2] Boeing did not proceed to deduct the settlement payout,[3] but the mere fact that it *could have* embodies a tension in the area of tax law relating to the deductibility of settlement payments for allegedly illegal behavior under the Internal Revenue Code (the "Code") Section ("Sec.") 162(f).[4] In the aftermath of the 1989 Exxon Valdez oil spill, the settlement negotiated with Exxon, totaling $1.1 billion, reportedly had an after-tax cost to Exxon of only $524 million.[5] In 2010, BP wrote off $37.2 billion in expenses related to the Deepwater Horizon spill in the Gulf of Mexico for an almost $10 billion tax credit.[6]

"Nothing can be said to be certain, except for death and taxes," Benjamin Franklin famously wrote in 1789.[7] Equally certain is the fact that most Americans dislike paying taxes. Generally speaking, Americans also cry foul when they perceive wealthy corporations avoiding taxes via loopholes,

1. *See* Leslie Wayne, *3 Senators Protest Possible Tax Deduction for Boeing in Settling US Case*, N.Y. TIMES (July 7, 2006), https://www.nytimes.com/2006/07/07/business/07boeing.html/ [https://perma.cc/CTW8-FC6K].

2. *Id.*

3. *See* Memorandum from the S. Comm. on Finance, *Grassley: Despite Boeing Decision on Deductibility, Justice Department Must Do Better Job on Tax Piece of Settlements* (July 26, 2006), https://www.finance.senate.gov/chairmans-news/grassley-despite-boeing-decision-on-deductibility-justice-department-must-do-better-job-on-tax-piece-of-settlements [https://perma.cc/QH3D-7KMK].

4. I.R.C. § 162(f) (2018). References to a "section" are to a section of the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

5. Robert W. Wood, *Cleaning Up: Tax Deductions for Restitution, Fines, and Penalties*, TAX NOTES, (Jan. 26, 2009) at 489; *see also* U.S. PIRG EDUCATION FUND, SUBSIDIZING BAD BEHAVIOR: HOW CORPORATE LEGAL SETTLEMENTS FOR HARMING THE PUBLIC BECOME LUCRATIVE TAX WRITE OFFS, WITH RECOMMENDATIONS FOR REFORM 7 n.13 (2013), https://uspirg.org/reports/usp/subsidizing-bad-behavior [https://perma.cc/V5UC-GH5Q] [hereinafter SUBSIDIZING BAD BEHAVIOR] ("Exxon effectively paid less than half of the value of the settlement, but much of this reduction was because the settlement was allowed to be paid over many years when the value of each dollar had been reduced by inflation.").

6. U.S. PIRG EDUCATION FUND, SETTLING FOR A LACK OF ACCOUNTABILITY? WHICH FEDERAL AGENCIES ALLOW COMPANIES TO WRITE OFF OUT-OF-COURT SETTLEMENTS AS TAX DEDUCTIONS, AND WHICH ARE TRANSPARENT ABOUT IT 5 (2015), https://uspirg.org/sites/pirg/files/reports/USPIRG_SettlementsReport.pdf [https://perma.cc/7QPP-ZGWP] [hereinafter LACK OF ACCOUNTABILITY].

7. Letter from Benjamin Franklin to Jean-Baptiste Leroy (Nov. 13, 1789), *in* 12 THE COMPLETE WORKS OF BENJAMIN FRANKLIN (J. Bigelow, ed., 1888).

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particularly when the tax deduction at issue results from a settlement for a corporation's alleged wrongdoing.[8] In other words, the tax laws that allow these deductions result in a tax subsidy for those who break the law.[9]

In 2017, Congress significantly changed the Code provision that addresses those concerns, Sec. 162(f).[10] Another provision, Sec. 162(a), generally allows businesses to deduct ordinary and necessary business expenses from their annual tax return.[11] Sec. 162(f) denies businesses the right to deduct payments to the government for violations of law, such as fines or penalties. However, if an amount paid to the government reflects something else, such as restitution to victims, then it remains deductible.[12] This exception creates a tension in settlement negotiations focused on allocation between nondeductible fines/penalties and other types of deductible payments, like restitution. If a corporation could prove that part of a settlement negotiated with a governmental agency was allocable to such things as restitution to victims harmed by the wrongdoing; to remediation of property; or to payments made to come into compliance with the law (collectively, the "Restitution Exception"), it could deduct that portion of the settlement as an ordinary and necessary business expense.

As is typical when Congress enacts new Code provisions that make up the skeleton of the tax law, corporate taxpayers awaited issuance of regulations by the Treasury Department ("Treasury") to flesh out the procedure and enforcement mechanisms of the new provision. As required by the Administrative Procedure Act, Treasury first issued regulations in proposed form on May 13, 2020.[13] After considering many comments submitted in response to the proposed rules, Treasury revised the rules in the final regulations issued on January 14, 2021.[14] During this rulemaking process, a tension surfaced relating to the Restitution Exception. Should the final regulations adopt a bright-line and narrow definition of restitution that disallows all disgorgement and forfeiture payments (as in the proposed regulations) or a more expansive definition that includes certain types of disgorgement and forfeiture payments (as favored by corporate taxpayers)?[15]

8. *See* SUBSIDIZING BAD BEHAVIOR, *supra* note 5, at 8; Wood, *supra* note 5, at 489; Patricia Cohen, *When Company Is Fined, Taxpayers Often Share Bill*, N.Y. TIMES (Feb. 3, 2015), https://www.nytimes.com/2015/02/04/business/when-a-company-is-fined-taxpayers-often-share-the-punishment.html [https://perma.cc/SYQ8-UEVR].

9. SUBSIDIZING BAD BEHAVIOR, *supra* note 5, at 12.

10. I.R.C. § 162(f) (2018).

11. I.R.C. § 162(a) (2018).

12. I.R.C. § 162(f) (2018).

13. Prop. Treas. Reg. § 1.162-21, 85 Fed. Reg. 28524, 28524 (May 13, 2020).

14. Treas. Reg. § 1.162-21 (as amended in 2021).

15. Richard Andersen, Julie Hogan Rodgers & Matthew Schnall, *Final Section 162(f) Regulations Liberalize Opportunities to Deduct Disgorgement and Other Payments Made in*

The 2017 Tax Cuts and Jobs Act which amended Sec. 162(f) was silent on whether disgorgement and forfeiture should constitute restitution,[16] and case law has gone back and forth on the issue,[17] with the most recent Supreme Court case to address disgorgement, *Liu v. Securities and Exchange Commission*, appearing to support the argument that disgorgement *can* constitute restitution.[18] Corporate taxpayers ultimately prevailed, ensuring that Treasury substantially modified the proposed regulations' attempt at a *per se* exclusion of disgorgement and forfeiture payments in the final regulations.[19]

Given the focus of disgorgement on returning the wrongdoer to the status quo[20] and the public policy doctrine originally underlying Sec. 162(f),[21] did the final regulations get the rule right, or did Treasury capitulate to corporations' desires to avoid paying taxes? This Note will examine the history of Sec. 162(f) and demonstrate how the Restitution Exception continues in the tradition of both the original public policy doctrine of pre-1969 law and the legislative intent behind Sec. 162(f) as enacted in 1969 (the "1969 Law"). The final regulations' interpretation of the Restitution Exception also indirectly incorporates the judicially-created punitive (nondeductible) versus remedial (deductible) dichotomy introduced in case law. Although courts have argued in the past over whether restitution is punitive or remedial, the recent Supreme Court case of *Liu* indicates that a remedy delineated by the net profits of "ill-gotten gains" and paid directly to victims–whether that be called restitution, disgorgement, or forfeiture–is not punitive and thus remains deductible.[22] The guide rails in the statutory Restitution Exception and the additional requirements for disgorgement and forfeiture in the final regulations are meant to ensure that the purpose of such payments will be remedial. Nevertheless, without improved interagency coordination, the new rules may create, in the settlement negotiation process, perverse incentives for government entities and corporations to inflate the payments allocated to restitution, thereby weakening their deterrent effect.

Government Investigations, JDSUPRA (Feb. 17, 2021), https://www.jdsupra.com/legalnews/final-section-162-f-regulations-6410843/ [https://perma.cc/2NZ4-H3RD].

16. TAX CUTS AND JOBS ACT OF 2017, Pub. L. No. 115-97, 131 Stat 2054; H.R. REP. No. 115-466, at 430 (2017).

17. Stephens v. Comm'r, 905 F.2d 667, 674 (2d Cir. 1990); Nacchio v. United States, 824 F.3d 1370, 1381 (Fed. Cir. 2016), *cert. denied*, 137 S. Ct. 2239 (2017); Kokesh v. S.E.C., 581 U.S. 1, 11 (2017).

18. 519 U.S. 1, 15, 16 (2020); *see also* Jonathan Gifford, *Comments re Sec 162(f) Prop Regs (REG-104591-18)*, CLEARY GOTTLIEB, STEEN & HAMILTON LLP (July 14, 2020), https://www.regulations.gov/comment/IRS-2020-0008-0026.

19. Anderson, *supra* note 15.

20. *See Liu*, 519 U.S. at 7; Philip Urofsky, *Comments on Proposed Regulations under I.R.C. § 162(f)*, SHEARMAN & STERLING LLP (July 14, 2020).

21. *See Stephens*, 905 F.2d at 672; Wood, *supra* note 5, at 492.

22. *Liu*, 591 U.S. at 11–12.

This Note will show that the recent changes to Sec. 162(f) and the promulgation of the final regulations under Sec. 162(f) brought much needed clarity to the deductibility of restitution payments. However, the effects of the new law and regulations may nevertheless create distortions in settlement negotiations and agreements. This paper argues that these distortions can be reduced by increased coordination between the Internal Revenue Service (the "IRS") and the governments and governmental agencies responsible for negotiating the settlements.

In Part I, this Note explores the history of Sec. 162(f) and demonstrates the lack of clarity on the contours of the public policy doctrine and restitution prior to 2017. Part II discusses the proposed regulations initially issued to interpret Sec. 162(f), the effect of the Supreme Court case *Liu v. Security and Exchange Commission*, and the final regulations that were ultimately promulgated. Part III argues that the proposed regulations were ill-advised in their approach to the Restitution Exception and that the final regulations were a needed corrective piece in providing clarity to the deductibility of restitution payments. Last, Part IV argues that the implementation of Sec. 162(f) could be improved further by an increased focus on Sec. 162(f)'s impact as part of the settlement negotiation process. Better coordination between the IRS and federal agencies will help balance the appropriate implementation of deterrence of wrongdoing while not penalizing the public policy of promoting victim restitution in such negotiations.

I. HISTORY OF SEC. 162(F)

A. The Public Policy Doctrine

Businesses have long had the ability to deduct under Sec. 162(a) and its predecessor provisions business expenses that were considered "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."[23] The general justification for such a deduction is that the income tax laws were intended to tax only net income, so the Code allows taxpayers to reduce their gross income by amounts spent to produce that income.[24] Prior to 1969, no accompanying statute disallowed such deductions if associated with illegal behavior, fines, or penalties.[25] However, courts would disallow these expenses on the grounds that they would "frustrate sharply defined national or state policies proscribing particular types of conduct,"[26] which came to be known as the public policy doctrine.[27] The first such

23. Welch v. Helvering, 290 U.S. 111, 113 (1933).

24. Tank Truck Rentals, Inc. v. Comm'r, 356 U.S. 30, 33–34 (1958).

25. F. Philip Manns Jr., *Internal Revenue Code Section 162(f): When Does the Payment of Damages to a Government Punish the Payor?*, 13 VA. TAX REV. 271 (1993).

26. Comm'r v. Heininger, 320 U.S. 467, 474 (1943).

27. Jacob L. Todres, *Internal Revenue Code Section 162(f): An Analysis and its Application to Restitution Payments and Environmental Fines*, 99 DICK. L. REV. 645, 653 (1995).

disallowance occurred in 1924, in *Backer v. Commissioner*, when the Board of Tax Appeals denied a deduction for legal expenses associated with a perjury indictment.[28] The Supreme Court then issued a series of six decisions between 1943 and 1966, including three decisions in 1958, reaffirming the public policy doctrine.[29]

The first Supreme Court case, *Commissioner v. Heininger*, noted that the IRS and the courts have occasionally narrowed the generally accepted meaning of "ordinary and necessary … in order that tax deduction consequences might not frustrate sharply defined national or state policies proscribing particular types of conduct."[30] In *Lilly v. Commissioner*, the Court assumed for the sake of argument that ordinary and necessary business expenses (here, kickback payments made by eyeglasses makers to doctors who prescribed their eyeglasses) could otherwise be deductible but disallowed on the grounds that they would frustrate public policy, as long as the frustrated policies were "national or state policies evidenced by some governmental declaration of them."[31] Since there was no public governmental policy proscribing kickbacks to doctors, the Court held the public policy doctrine did not apply.[32] Two subsequent cases, *Tank Truck Rentals, Inc. v. Commissioner* and *Hoover Motor Express Co. v. United States,* stated that an expense such as a fine was not "necessary" if it would "frustrate state policy in severe and direct fashion by reducing the 'sting' of the penalty prescribed by the state legislature"[33] or was avoidable,[34] thus returning to the definition of "ordinary and necessary" as justification for a disallowance.

However, the Supreme Court in *Commissioner v. Tellier*, the last of the six cases, affirmed that expenses such as legal fees for defending criminal prosecution could be "ordinary and necessary" within the meaning of Sec. 162(a).[35] In rejecting the reasoning of *Backer v. Commissioner*, the Court held that the IRS could not disallow business deductions on general public policy grounds,[36] explaining that "the federal income tax is a tax on net income, not a sanction against wrongdoing," with only a few limited exceptions.[37] Only where

28. 1 B.T.A. 214 (1924); *see also* Manns, *supra* note 25, at 276.

29. *See* Comm'r v. Sullivan, 356 U.S. 27 (1958); Tank Truck Rentals v. Comm'r, 356 U.S. 30, 34 (1958); Hoover Motor Express Co., Inc. v. United States, 356 U.S. 38 (1958); Lilly v. Comm'r, 343 U.S. 90 (1952); *see generally* Wood, *supra* note 5, at 493–94.

30. 320 U.S. 467, 473 (1943).

31. 343 U.S. 90, 96–97 (1952).

32. *Id.*

33. 356 U.S. 30, 36 (1958).

34. 356 U.S. 27, 39 (1958).

35. 383 U.S. 687, 689 (1966).

36. *Id.* at 691, 693–94 (1966) (holding "that the federal income tax is a tax on net income, not a sanction against wrongdoing" and therefore "illegal income is taxed the same as lawful income"); *see* Treas. Reg. § 1.162-1(a) (as amended in 1993).

37. *Tellier*, 383 U.S. at 691.

national or state policies, evidenced by some governmental declaration, were "sever[ely] and immedia[tely]" frustrated would the Court permit a disallowance on public policy grounds be upheld.[38]

B. 1969 Law, 1975 Regulations, and Pre-2017 Case Law

Following *Tellier*, in 1969, Congress passed the Tax Reform Act of 1969 and enacted a new statutory exception to Sec. 162(a) that disallowed businesses from deducting certain fines and penalties—Sec. 162(f).[39] Congress intended the provision to be "all inclusive," codifying and replacing entirely the public policy doctrine exemplified by *Tank Truck Rentals*.[40] Notably, the legislative history clarified that "it was not intended that deductions be denied in the case of sanctions imposed to encourage prompt compliance with requirements of law … in this area, the committee did not intend to liberalize the law in the case of fines and penalties."[41]

Sec. 162(f) in its 1969 iteration was deceptively simple and "vague."[42] The provision provided that "[n]o deduction shall be allowed under [Sec. 162(a)] for any fine or similar penalty paid to a government for the violation of any law."[43] However, from the plain meaning of the text, it was unclear what was a "fine" and "penalty," whether both civil and criminal penalties were covered, what was meant by a "similar" penalty, and whether payments paid to victims of wrongdoing were included.[44]

In 1975, Treasury issued Treasury Regulation ("Treas. Reg.") Sec. 1.162-21 (the "1975 Regulations"), which clarified that both civil and criminal penalties were included in the disallowance.[45] It also provided that the statute included both a taxpayer's actual or potential liability for a fine or penalty and amounts forfeited as collateral posted in connection with a proceeding potentially resulting in a fine or penalty.[46] Treasury left out a subsection of the 1975

38. *Id.* at 694.

39. I.R.C. § 162(f) (2012); *see also* Wood, *supra* note 5, at 493.

40. S. REP. No. 91-552 (1969), *as reprinted in* 1969-3 C.B. 423 at 596–98 ("allowance of the deduction would frustrate sharply defined national or state policies proscribing the particular types of conduct evidenced by some governmental declaration thereof") (quoting Tank Truck Rentals Inc. v. Comm'r, 356 U.S. 30, 33 (1958)); *id.* ("The provision for the denial of the deduction for payments in these situations which are deemed to violate public policy is intended to be all inclusive. Public policy, in other circumstances, generally is not sufficiently clearly defined to justify the disallowance of deductions."); *see also* Todres, *supra* note 27, at 647–49.

41. S. REP. NO. 92-437 (1971), *as reprinted in* 1971-72 C.B. at 600.

42. Lydia O'Neal, *Tax Law Still Leaves Room for Companies to Write off Settlements*, BLOOMBERG TAX (July 18, 2018, 7:01 AM), https://news.bloombergtax.com/daily-tax-report/tax-law-still-leaves-room-for-companies-to-write-off-settlements [https://perma.cc/X55E-ZPAX].

43. I.R.C. § 162(f) (1969).

44. Manns, *supra* note 25, at 272–73.

45. Treas. Reg. § 1.162-21(b)(1) (1969).

46. *Id.*

Regulations when initially issuing them in February 1975.[47] It went back and forth on whether to allow "sanctions imposed to encourage prompt compliance with filing or other requirements if the sanction was more in the nature of a late charge or interest charge than a fine."[48] However, it ultimately ruled that legal fees and compensatory damages paid to a government were the only exceptions to the general disallowance.[49] The regulations, however, did not define what would be considered a penalty "similar" to a fine.[50]

Following a series of court decisions interpreting the 1969 Law and 1975 Regulations, the dichotomy between non-deductibility and deductibility seemed to hinge on whether the payment was punitive, akin to a fine or penalty (nondeductible), or remedial, akin to the category of compensatory damages paid to a government that was excluded from the disallowance (deductible).[51] In *Middle Atlantic Distributors, Inc. v. Commissioner,* the Tax Court first indicated that a punitive purpose was necessary for disallowance: "[i]t is clear that, if the deduction of a civil fine (or similar penalty) is to fall within the proscription of Sec. 162(f), the fine must be one which punishes and/or deters."[52] A year later, the Tax Court expanded on the punitive-versus-remedial distinction in *Southern Pacific Transportation Co. v. Commissioner*.[53] In that case, the taxpayer argued that payments made for the violations of two laws pertaining to the railroad business should not be disallowed because they were not "similar" to criminal fines.[54] The court noted that congressional intent was to disallow deductions based on the purpose that the statutory penalties serve:

> If a civil penalty is imposed to enforce the law and as punishment for the violation thereof, its purpose is the same as a fine exacted under a criminal statute, and it is "similar" to a fine. However, if the civil penalty is imposed to encourage prompt compliance with a requirement of the law or as a remedial measure to compensate another party for expenses incurred as a result of the violation, it does not serve the same purpose as a criminal fine and is not "similar" to a fine within the meaning of section 162(f).[55]

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47. Notice of Proposed Rule Making, 40 FR 7453-01 (Feb. 20, 1975); Treas. Reg. § 1.162-21(b)(2) (as amended on July 11, 1975, by T.D. 7366, 1975-2 C.B. 64).

48. Notice of Proposed Rule Making, 40 FR 7453-01 (Feb. 20, 1975).

49. Treas. Reg. § 1.162-21(b)(2) (as amended on July 11, 1975, by T.D. 7366, 1975-2 C.B. 64).

50. Todres, *supra* note 27, at 669.

51. *See generally* Robert W. Wood, *IRS Cracking Down on Government Settlements*, TAX ADVISER (Nov. 30, 2007), https://www.thetaxadviser.com/issues/2007/dec/irscrackingdownongovernmentsettlements.html [https://perma.cc/88GW-TETS].

52. 72 T.C. 1136, 1143 (1979).

53. 75 T.C. 497, 652–53 (1980).

54. *Id.* at 650–51.

55. *Id.* at 652.

However, in order to determine whether the purpose of a fine or penalty was "punitive," courts have often had to interpret the underlying statute at issue in an "origin of the liability analysis" whereby the "characterization of a payment for purposes of Sec. 162(f) turns on the origin of the liability giving rise to it."[56] The Tax Court, Sixth Circuit, and Ninth Circuit all looked to the "origin of the liability,"[57] adopting the earlier Supreme Court test set forth in *United States v. Gilmore*.[58] The Sixth Circuit analyzed in *Bailey v. Commissioner* whether a restitution payment was in lieu of a fine or penalty.[59] In *Bailey,* the taxpayer violated a consent decree with the Federal Trade Commission and was fined about $1 million.[60] The taxpayer requested the fine be paid as restitution in settlement of another pending lawsuit against his business arising from the same set of facts and claimed a corresponding deduction on his federal income tax return.[61] The Sixth Circuit found the payment arose from his violation of the consent order and was punishment for the violation, even though the money ultimately was dispersed as restitution to the victims.[62]

If the court deciding the deductibility of a payment under Sec. 162(f) could not determine punitive intent from the legislative history of a statute, or if the statute had both punitive and non-punitive intent (a "dual purpose" statute), the courts would often proceed with a "facts and circumstances" test.[63] As a result, courts did not consistently treat payments, such as restitution, as punitive or remedial. In *Stephens v. Commissioner*, the Second Circuit reversed the Tax Court's decision that had relied on the earlier decision in *Waldman v. Commissioner*, which had disallowed a deduction for restitution payments made as a condition of a stay on his sentence.[64] Part of the rationale of the Second Circuit was that the restitution was paid to the victims, not the government.[65] Additionally, the court stressed that the particular restitution at issue was "primarily a remedial measure to compensate another party, not a 'fine or similar penalty.'"[66] Conversely, in *Allied-Signal v. Commissioner* – another case where the purpose of the payment was determined based on the facts and circumstances–the Tax Court, affirmed by the Third Circuit, determined that an

56. Bailey v. Comm'r, 756 F.2d 44, 47 (6th Cir. 1985).

57. *See* Uhlenbrock v. Comm'r, 67 T.C. 818, 823 (1977); Middle Atl. Distributors, Inc. v. Comm'r, 72 T.C. 1136, 1144–45 (1979); *Bailey*, 756 F.2d at 44; Waldman v. Comm'r, 88 T.C. 1384, 1389 (1987), *aff'd*, 850 F.2d 611 (9th Cir. 1988); Kraft v. United States, 991 F.2d 292, 298 (6th Cir. 1993).

58. 372 U.S. 39, 49 (1963); *see also* Todres, *supra* note 27, at 701–02.

59. 756 F.2d at 45.

60. *Id.* at 46.

61. *Id.*

62. *Id.*

63. Manns, *supra* note 25, at 289; *see* Todres, *supra* note 27, at 681.

64. *Stephens*, 905 F.2d at 674; *Waldman*, 88 T.C. at 1389–90.

65. *Stephens*, 905 F.2d at 674.

66. *Id.* at 672–73.

$8 million payment to a charitable trust with the guarantee that the sentencing judge would reduce the criminal fine by the same amount was a fine or penalty, even if not part of the underlying statute.[67]

In two cases leading up to the 2017 Tax Cuts and Jobs Act, the Federal Circuit Court in *Nacchio v. United States* and the Supreme Court in *Kokesh v. Securities and Exchange Commission* looked at the nature of forfeiture and disgorgement payments, determining that both were akin to penalties, although in *Kokesh* the analysis did not directly apply to Sec. 162(f).[68]

Nacchio addressed the punitive aspects of forfeiture that the taxpayer was required to pay as a result of insider trading violations.[69] In instituting the lawsuit, the taxpayer sought a credit on the income tax paid on the net proceeds from his trading profits, which he had later been ordered to forfeit.[70] Since the forfeited proceeds were ultimately used to compensate the victims, the taxpayer argued that the forfeiture payment was tantamount to restitution.[71] However, the court disagreed, arguing that the Attorney General's decision to transfer the funds to the victims was discretionary and did not change the nature of the payment from a fine or penalty.[72] In reaching its conclusion that the proposed deduction would be disallowed under both Sec. 162(f) and Sec. 165 (which allows deductions for business losses), the court examined decisions in criminal law by the Eleventh and Fourth Circuits that indicated that forfeiture is meant to punish a defendant by transferring his ill-gotten gains to the government, whereas restitution focuses on the victim.[73]

Kokesh held that disgorgement could be viewed as a penalty for purposes of the federal securities law 28 U.S.C. § 2462's statute of limitations. However, it left open the possibility that disgorgement would not always be categorized as such.[74] Prior to the Supreme Court granting certiorari, the Tenth Circuit had affirmed the district court's ruling that "disgorgement is not a penalty, nor is it forfeiture."[75] The Supreme Court categorized a penalty as a sanction sought "for the purpose of punishment, and to deter others from offending in like manner– as opposed to compensating a victim for his loss."[76] Notably, the Court noted that disgorgement is not compensatory if the district court has the discretion to

67. 63 T.C.M 2572 (1992), *aff'd*, 54 F.3d 767 (3d Cir. 1995).

68. 824 F.3d 1370 (Fed. Cir. 2016), *cert. denied*, 137 S. Ct. 2239 (2017); 137 S. Ct. 1635 (2017).

69. *Nacchio*, 824 F.3d at 1375.

70. *Id.* at 1370–71.

71. *Id.* at 1380.

72. *Id.*

73. *Id.* at 1379.

74. Kokesh v. S.E.C., 137 S. Ct. 1635, 1639, 1644 (2017) (under this statute, a five-year statute of limitations applies to any "action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise").

75. *Id.* at 1641.

76. *Id.* at 1642.

determine how and to whom the money will be distributed, and if disgorged funds go to the United States Treasury rather than to victims.[77] Additional factors the Court considered in its assessment of whether disgorgement could be viewed as a penalty included a determination of whether the disgorgement: exceeds the profits gained as a result of the violation, accounts for any costs, or goes to some third party other than the victims.[78] However, the Court declined to provide an absolute rule, acknowledging that disgorgement serves compensatory goals in some cases.[79]

C. 2017 Tax Cuts and Jobs Act Changes

The Tax Cuts and Jobs Act of 2017 substantially amended Sec. 162(f) (the "2017 Law"), following over a decade of pressure from legislators such as Senator Chuck Grassley, who perceived that corporations such as Exxon and BP had exploited both the 1969 Law's lack of clarity as to what constituted a "fine or any similar penalty" and the fact that governmental agencies responsible for negotiating the settlements were wholly unaccountable when it came to negotiating settlements that failed to restrict or limit the deductibility of corporate taxpayers' settlement payouts.[80] As a result, Congress essentially rewrote Sec. 162(f) by broadening its scope and removing all references to "fine or penalty":

> (1) In General.— Except as provided in the following paragraphs of this subsection, no deduction otherwise allowable shall be allowed under this chapter for any amount 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.[81]

The revised statute then provided for an exception to the general disallowance:

> (2) Exception for amounts constituting restitution or paid to come into compliance with the law.— (A) In general.— Paragraph (1) shall not apply to any amount that— (i) the taxpayer establishes— (I) constitutes restitution (including remediation of property) for damage or harm which was or may be caused by the violation of any law or the potential violation of any law, or (II) is paid to come into compliance with any law which was violated or otherwise involved in the investigation or inquiry described in paragraph (1), (ii) is identified as restitution or as an amount paid to come into compliance with such law, as the case may be, in the court order or settlement agreement, and (iii) in the case of any amount of restitution for failure to pay any tax imposed under this title in the same manner as if such

77. *Id.* at 1644.
78. *Id.* at 1644–45.
79. *Id.* at 1645.
80. *See* SUBSIDIZING BAD BEHAVIOR, *supra* note 5, at 7–9.
81. I.R.C. § 162(f)(1) (2018).

> amount were such tax, would have been allowed as a deduction under this chapter if it had been timely paid. The identification under clause (ii) alone shall not be sufficient to make the establishment required under clause (i).[82]

The provision thus made explicit the Restitution Exception that courts, and occasionally the IRS,[83] previously recognized. Thus, the burden falls on the taxpayer to show both that the settlement agreement brokered with the U.S. or governmental entity adequately identified the payment as restitution (the "identification requirement"), and that there was documentary evidence that the payment was in fact made in restitution to harmed or potentially harmed parties, for remediation of property, or to come into compliance with the law (the "establishment requirement").[84] The provision did not address compensatory payments more broadly, nor did it reference disgorgement or forfeiture.[85] This oversight would lead to a struggle between corporate taxpayers and Treasury over the propriety of excluding disgorgement and forfeiture from the Restitution Exception when the regulations were first proposed two and half years later.[86]

II. TREAS. REG. 1.162-21

A. Proposed Regulations

In May 2020, Treasury issued the proposed regulations to supplement and clarify the amended Code provision and requested comments on the proposed rulemaking.[87] Unlike the 1975 Regulations, the proposed regulations removed the reference to "compensatory damages."[88] Instead, the regulations provided that "regardless of whether the order or agreement identifies them as such, restitution, remediation, and amounts paid to come into compliance with a law do not include any amount paid or incurred […] as forfeiture or disgorgement" (the "bright-line disallowance").[89] The preamble to the proposed regulations explained that forfeiture and disgorgement, unlike restitution, focus on the unjust enrichment of the lawbreaker rather than on the harm to the victim.[90] As support for the disallowance of both disgorgement and forfeiture, it cited *Kokesh v. S.E.C.*, which held that disgorgement could be viewed as a penalty for purposes of 28 U.S.C. § 2462's statute of limitations, and *Nacchio v. United*

82. *Id.* at 162(f)(2) (2018).
83. Wood, *supra* note 5, at 491–92.
84. I.R.C. § 162(f)(2) (2018).
85. *Id.*
86. Wood, *supra* note 5, at 495.
87. Prop. Treas. Reg. § 1.162-21, 85 Fed. Reg. 28524, 28524 (May 13, 2020).
88. *Id.* at 28525.
89. *Id.* at § 1.162-21(f)(3)(iii)(C), 85 Fed. Reg. at 28536.
90. *Id.* at § 1.162-21, 85 Fed. Reg. at 28527.

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States, which addressed the punitive aspects of forfeiture.[91] It further characterized the language of Sec. 162(f)'s Restitution Exception as focused on the victim's harm rather than the unjust enrichment of the wrongdoer.[92]

B. *Liu v. Securities and Exchange Commission*

On June 22, 2020, the Supreme Court issued its decision in *Liu v. Securities and Exchange Commission.*[93] The Court held that a disgorgement award that does not exceed a wrongdoer's net profits and that is awarded to victims qualifies as "equitable relief" allowed by the Securities Exchange Act of 1934.[94] In *Liu*, the petitioners, who were developers of a cancer treatment center, were convicted of a scheme to defraud foreign investors.[95] The Securities and Exchange Commission (the "SEC") brought a civil action against the petitioners, alleging that they had misappropriated millions of dollars of the investors' funds.[96] The district court in California found for the SEC, granting an injunction, imposing a civil penalty, and ordering disgorgement in an amount equal to the total amount raised from investors less any outstanding corporate accounts, but without taking into account the petitioners' business expenses.[97] The Ninth Court affirmed the ruling and concluded it would be unfair to offset any business expenses attributable to the defrauding of investors, noting that *Kokesh* did not reach the issue of whether disgorgement qualified as an equitable remedy.[98]

In taking up the issue, the Supreme Court analogized to traditional equitable principles to address whether disgorgement qualifies as an equitable remedy.[99] Firstly, the Court acknowledged a long history in equity of depriving wrongdoers of their ill-gotten gains, albeit called different names by different courts.[100] Importantly, the Court noted that in order to avoid transforming an equitable remedy into a penalty, courts restricted the amount awarded to an individual wrongdoer's net profits to be awarded to the victims after deducting "legitimate expenses."[101] In order to return the wrongdoer to the *status quo ex ante* (the status prior to any wrongdoing), courts recognized a foundational

91. *Id*.; Kokesh v. S.E.C., 137 S. Ct. 1635, 1643 (2017); Nacchio v. United States, 824 F.3d 1370, 1379 (Fed. Cir. 2016), *cert. denied*, 137 S. Ct. 2239 (2017).

92. Prop. Treas. Reg. § 1.162-21, 85 Fed. Reg. at 28527.

93. Liu v. S.E.C., 140 S. Ct. 1936, 1936 (2020).

94. *Id.* at 1940; 15 U.S.C. § 78u(d)(5).

95. *Liu*, 140 S. Ct. at 1941.

96. *Id.* at 1942.

97. *Id.*

98. *Id.*

99. *Id.*

100. *Id.* at 1942–43 ("Restitution measured by the defendant's wrongful gain is frequently called 'disgorgement.' Other cases refer to an 'accounting' or an 'accounting for profits.'").

101. *Id.* at 1944, 1946.

principle in equity: "[a]t the same time courts recognized that the wrongdoer should not profit 'by his own wrong,' they also recognized the countervailing equitable principle that the wrongdoer should not be punished by 'pay[ing] more than a fair compensation to the person wronged.'"[102] Furthermore, the Court asserted that although *Kokesh* evaluated a version of the SEC's disgorgement remedy that was punitive in nature in order to determine that disgorgement could constitute a "penalty" for the purposes of a statute of limitations, *Kokesh* expressly declined to address the question of whether disgorgement is necessarily a penalty.[103] By addressing that unresolved question in *Liu*, the Court found that remedies such as disgorgement *could* be considered equitable when circumscribed in multiple ways–e.g., limited to the wrongdoer's net profits and paid out to victims–to avoid transforming them into penalties.[104]

C. Final Regulations

In response to numerous comments received following the issuance of the proposed regulations and the Supreme Court decision in *Liu*, which was decided a mere month after the issuance of the proposed regulations, Treasury made several changes in the final regulations. It included in the establishment requirement an "origin of the liability" element, similar to the judicial focus of pre-2017 case law, where the burden was on the taxpayer to prove that the nature and purpose of both the underlying statute and the settlement amount were *actually* attributable to restitution, remediation, or an amount paid to come into compliance with any law, not just merely labeled as such.[105] Additionally, Treasury substantially revised the bright-line disallowance of disgorgement and forfeiture and instead provided that disgorgement and forfeiture, if subject to certain restrictions, *could* constitute restitution:

> (B) Disgorgement or forfeiture. Provided the identification and establishment requirements of paragraphs (b)(2) and (b)(3) of this section are met, restitution may include amounts paid or incurred as disgorgement or forfeiture, if paid or incurred at the direction of a government or governmental entity directly to the person, as defined in section 7701(a)(1), harmed by the violation or potential violation of any law or to, or at the direction of, the government or governmental entity, to establish a segregated fund or account for the benefit of such harmed

102. *Id.* at 1943 (citing Tilghman v. Proctor, 125 U.S. 136, 145–46 (1888)).

103. *Id.* at 1946.

104. *Id.* at 1944.

105. Treas. Reg. § 1.162-21(b)(3)(i) (as amended in 2021); *see* Susan Grais, Rayth Myers & Kristen Martin, *Final Regulations Under Sections 162(F) and 6050X Have Broad Application Across Industries*, 134 J. TAX'N 7, 13 (2021) ("Under this analysis, a taxpayer will need to consider not only the settlement agreement or order, for example, but also the underlying legal claim and statutory provisions that give rise to the liability and determine whether the purpose of such claim is compensatory or related to compliance with the law or, alternatively, punitive in nature (or whether both aspects are involved in more complex, diversified controversies).").

> person. This paragraph (e)(4)(i)(B) does not apply if the order or agreement identifies the payment amount as in excess of the taxpayer's net profits or, pursuant to the order or agreement, the amounts are disbursed to the general account of the government or governmental entity for general enforcement efforts or other discretionary purposes.[106]

This expanded definition of restitution was what corporate taxpayers sought in their response to the proposed regulations.[107]

In the preamble to the final regulations, Treasury noted that in order for the disgorgement or forfeiture payment to meet the Restitution Exception, the payments, consisting of net profits, would need to be disbursed to a segregated account or fund that would benefit the harmed individual, rather than be generally available to the government for general enforcement purposes.[108] Treasury clearly fashioned these requirements to be consistent with the holding in *Liu* that suggested that disgorgement could be either a form of penalty (as in *Kokesh*) or a form of restitution (as in *Liu*).[109] In the latter case, the amount to be disgorged was not to exceed the net profits and was to be awarded to the harmed individuals.[110] Adding the "origin of the liability" claim to the establishment requirement in the final regulations buttresses the establishment requirement that prevents a taxpayer from arguing that restitution, disgorgement, or forfeiture are deductible merely by virtue of a statutory or court-ordered label.

III. THE FINAL REGULATIONS WERE THE FINAL MISSING PIECE

The expanded definition of restitution and the circumscribed disgorgement and forfeiture rules are compatible with the general deterrence rationale of Sec. 162(f), notwithstanding a congressional intent to broaden the scope of the Sec. 162(f) disallowance.[111] The Senate Budget Committee indicated that the primary purpose of the 2017 Law was to act as a deterrent to bad behavior:

> The Committee believes that taxpayers should not be able to deduct as normal business expenses settlement payments that are intended to punish bad behavior. Allowing these deductions forces other taxpayers to subsidize a part of their wrongdoing and blunts the deterrent effect of the penalty. The Committee believes denying these deductions will help deter taxpayers from violating the standards Congress has enacted to protect the American public, and ensure that wrongdoers fully pay their penalties.[112]

106. *Id.* at § 1.162-21(e)(4)(B).

107. Urofsky, *supra* note 20.

108. Treas. Reg. § 1.162-21 (as amended in 2021 by T.D. 9946, 86 Fed. Reg. 4970, 4974).

109. *Liu*, 140 S. Ct. at 1940; Kokesh v. S.E.C., 137 S. Ct. 1635, 1643 (2017).

110. Treas. Reg. § 1.162-21 (as amended in 2021).

111. I.R.C. § 162(f).

112. COMM. ON THE BUDGET, 115TH CONG., RECONCILIATION RECOMMENDATIONS PURSUANT TO H. CON. RES. 71, at 187–88 (Comm. Print 2017); *see also* CA DOJ, Comment Letter on IRS REG-104591-18: Denial of Deduction for Certain Fines, Penalties, and Other Amounts;

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The changes made to Sec. 162(f), including the change from "any fine or penalty" to "any payment paid or incurred" and adding nongovernmental entities as a qualifying category, speak to a congressional desire to liberalize the law's application.[113] The statute is silent regarding the treatment of disgorgement and forfeiture, as are the congressional reports discussing the amendment.[114] However, the statute's explicit inclusion of "restitution" implies that exclusion of disgorgement and forfeiture from the Restitution Exception is contrary to legislative intent, based on the plain meaning of "restitution" and in light of *Liu*.[115]

Restitution–and disgorgement and forfeiture (as circumscribed by the final regulations, which essentially transforms them into restitution payments)–should be deductible for fairness reasons. The 2017 Law's more liberal scope for the disallowance does not encompass restitution because it would otherwise obliterate the punitive versus remedial distinction present since the 1970s. Moreover, disallowing restitution does not serve the purpose of the original public policy doctrine because restitution is not meant to punish the wrongdoer, but make the victim whole.[116] Accordingly, deductions for such payments will not necessarily reduce the "sting" of a penalty imposed by the national or state legislature.[117] Instead, a disallowance of restitution, disgorgement, or forfeiture would result in a "double sting" tax penalty, aptly described in *Stephens v. Commissioner*, that results when a corporation pays income tax on profits that it would be required to repay in settlement agreements, without the ability to deduct the payment.[118] The corporation's net profits would have been initially taxed as income, regardless of whether they violated the law intentionally.[119] For example, a corporation has a net income of $1 million in year one attributable to a violation of law and (simplifying the income tax calculation) is required to pay $200,000 in income tax for year one. If the corporation were

Information with Respect to Certain Fines, Penalties, and Other Amounts (July 14, 2020), https://www.regulations.gov/comment/IRS-2020-0008-0013 ("[T]he purpose of the legislation […] is to avoid having bad behavior rewarded and forcing law abiding taxpayers to subsidize the wrongdoing of others.").

113. I.R.C. § 162(f)(1); § 162(f)(5); Treas. Reg. § 1.162-21 (In the preamble, Treasury notes that "section 162(f)(1) contemplates a broader disallowance, as demonstrated by the disallowance of any amount paid or incurred, to, or at the direction of, a government or governmental entity in relation to the 'investigation or inquiry' into the 'potential violation of any law.'").

114. *Id.* at § 162(f); *see* J. COMM. ON TAXATION, GENERAL EXPLANATION OF PUBLIC LAW 115-97 (JCS-1-18) at 193–94 (2018); *see* H.R. REP. No. 115-466, at 430–31 (2017) (Conf. Rep.); *see* COMM. ON THE BUDGET, 115TH CONG., RECONCILIATION RECOMMENDATIONS PURSUANT TO H. CON. RES. 71, at 187–88 (Comm. Print 2017).

115. Urofsky, *supra* note 20, at 4, 6.

116. Liu v. S.E.C., 140 S. Ct. 1936, 1943 (2020).

117. Manns, *supra* note 25, at 297, 302, 319.

118. Stephens v. Comm'r, 905 F.2d 667, 671 (2d Cir. 1990); Urofsky, *supra* note 20, at 5.

119. Urofsky, *supra* note 20, at 5.

required in year two to disgorge $1 million, under the proposed regulations, the corporation not only would be unable to deduct the disgorgement payment, but it would also have paid $200,000 in taxes for income it would no longer be entitled to keep, for a total $1.2 million out of pocket.

The Supreme Court has previously held that income resulting from illegal activity should not be taxed more or less than income from law-abiding activity.[120] Under the Supreme Court holding in *James*, a taxpayer who had embezzled money would need to pay taxes due on such amount but could be entitled to a reduction in income when the amount had been repaid in restitution.[121] Thus, an embezzler who reported $1 million in net income in year one and paid $200,000 in income taxes for year one would be entitled to a $200,000 credit (dollar for dollar offset) from his tax bill for year two, provided that he had paid the $1 million back to the original owner. In theory, the subsequent tax reduction would essentially eliminate any tax owed on the illegally obtained funds. However, in practice, there is no proper mechanism for the credit described in *James* without relying on an existing deduction (which reduces gross income but not by a dollar for dollar amount) present in the Code.[122] In the case of embezzled funds, a taxpayer can usually turn to Sec. 165(c)(2) as an allowable loss deduction occurring in the context of a transaction entered into for profit, and thereby deduct it under Sec. 165(a) as a loss not compensated by insurance or otherwise.[123]

The proposed regulation, however, goes a "step too far" in its *per se* disallowance of disgorgement and forfeiture, as disgorgement's purpose is to return a wrongdoer to the status quo before the receipt of illicit gains, whereas the proposed regulation's bright-line disallowance–without providing a mechanism to reimburse the previously collected income tax on said profits–

120. United States v. Sullivan, 274 U.S. 259, 263 (1927); *see* Boris I. Bittker, *Taxing Income From Unlawful Activities*, 25 CASE W. RES. L. REV. 130, 137 (1974).

121. James v. United States, 366 U.S. 213, 220 (1961).

122. Nacchio v. United States, 824 F.3d 1370, 1374 (Fed. Cir. 2016), *cert. denied*, 137 S. Ct. 2239 (2017). Under the claim of right doctrine, a taxpayer can utilize I.R.C. § 1341 to recover for taxes paid for income she thought she was entitled to but ended up not having a proper claim over if she also qualifies for a deduction under another Code section. Claim of right does not apply to illegally obtained funds. *Id.* ("Section 1341 provides special relief to a taxpayer who is required to restore funds to a third party where the taxpayer included the funds in his income in a prior taxable year when it then 'appeared that the taxpayer had an unrestricted right' to the funds. I.R.C. § 1341. Thus, a taxpayer must establish that he reasonably believed he had an unrestricted right to the funds at issue at the time he included those funds in his income.").

123. I.R.C. § 165(a), (c); *see* Wood, *supra* note 5, at 492; Rev. Rul. 65-254, 1965-2 C.B. 15 ("[A] deduction is allowable under section 165(a) of the Code, for the repayment of the embezzled funds for the taxable year in which the repayment is made. The allowable loss is deductible from adjusted gross income in computing taxable income provided the taxpayer does not elect to use the standard deduction or optional tax table."); *Stephens*, 905 F.2d at 670–71.

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amounts to taxing more than the net gains.[124] Similarly, under the proposed regulation, forfeiture, which results when the property obtained or used in conjunction with criminal activity is seized by the government, could also lead to double taxation, as in *Nacchio*, where the wrongdoer was required to pay income tax on the trading profits he was ordered to forfeit.[125]

Furthermore, allowing for disgorgement and forfeiture payments to qualify under the Restitution Exception is in the best interest of the victims of any alleged violation of law, as corporations will be incentivized to shift more of the payment to restitution in their negotiations instead of the nondeductible fines and penalties paid to the U.S. government.[126] This outcome is consistent with a congressional intent to favor settlements and awards that compensate individuals harmed by violations of law.[127] Conversely, disallowing disgorgement payments could potentially harm victims. As the SEC disgorgement payment is calculated net of any business costs or expenses such as taxes, a reduction for "legitimate expenses" attributable to taxes paid could reduce their award amount.[128] For example, in the case where a wrongdoer is required to disgorge $1 million of gross profits to victims, if the SEC factored in the $200,000 previously paid in income tax as a "legitimate expense," the award to victims would be reduced to $800,000.

In addition, in the absence of express legislative intent on the deductibility of disgorgement and forfeiture, the most recent case law seems to support the view that both can be a form of restitution. While *Liu* was not a tax opinion, the Supreme Court decision recognized that disgorgement *may* constitute an equitable remedy, rather than strictly a penalty, provided that the disgorgement amount does not go beyond the wrongdoer's net profits and the award is clearly demarcated for the victims.[129] The final regulations' specifications that disgorgement and forfeiture must be disbursed to a segregated fund dedicated to the harmed individuals, not be in excess of the net profits, and have the "origin of the liability" characterized as restitution appear to follow that line of reasoning.[130] Furthermore, *Liu* recognizes that "disgorgement" and "restitution" have overlapped or been used interchangeably throughout recent history.[131] The final regulations' requirement that disgorgement and forfeiture must not be

124. Philip Urofsky & Richard Gagnon, *Insight: A Step Too Far? The IRS Proposes Non-Deductibility of Disgorgement*, BLOOMBERG TAX (July 7, 2020, 3:00 AM), https://www.bloomberglaw.com/product/tax/bloombergtaxnews/daily-tax-report/X6RV5E5O000000 [https://perma.cc/W4Q5-J7LX].

125. *Id.*; *Nacchio*, 824 F.3d at 1372.

126. O'Neal, *supra* note 42.

127. Gifford, *supra* note 18.

128. *Id.*

129. Liu v. S.E.C., 140 S. Ct. 1936, 1942–43 (2020).

130. Treas. Reg. § 1.162-21 (as amended in 2021).

131. *Liu*, 140 S. Ct. at 1942–43.

disbursed to the government or at the government's discretion for general enforcement purposes also addresses the holding in *Nacchio*, where the forfeiture payment was disallowed in part because the decision to disburse to victims was made at the Attorney General's discretion.[132]

IV. INCREASED INTERAGENCY COORDINATION IS NEEDED TO AVOID DISTORTIONS TO SEC. 162(F)

Additional measures may nevertheless be necessary to fulfill the desired deterrent function of the law. In the lead up to the 2006 Boeing settlement, Senators Chuck Grassley and Max Baucus, upset by the possibility of Boeing being able to deduct settlement payments despite allegations of illegality, requested a Government Accountability Office (GAO) report on how federal agencies address the taxability of civil settlements and whether companies deduct their civil settlement payments for federal tax purposes.[133] According to the GAO report, published prior to the enactment of the 2017 Law, the deterrence effect of civil settlements is lessened if corporations can deduct payments from their income taxes.[134] After examining more than $1 billion in settlements made by thirty-four companies, the GAO found that twenty had deducted some or all of the money from their tax bills.[135] The GAO report indicated that settlements must be sufficiently large to deter future violations.[136] A government agency or jury would need to correspondingly increase the overall size of the settlement or damages award in anticipation of tax deductions.

However, under the 2017 Law, the federal agencies and governments responsible for negotiating settlements with corporations may not be incentivized to ensure that the payment allocable to restitution—a deductible expense—is properly limited to an amount representative of harm to victims. For instance, a foreign, state, or local government negotiating with a U.S. company not based in that jurisdiction may not be overly concerned that a substantial part of a settlement payment is deductible from the company's taxes if the company does not pay taxes to that government.[137] Instead, the former's incentives to get a larger overall settlement payout and the latter's incentives to get as large of a portion as possible categorized as restitution may align, even though a substantial portion of the overall settlement is deductible.[138]

132. *Id.*; Nacchio v. United States, 824 F.3d 1370, 1380–81 (Fed. Cir. 2016).

133. LACK OF ACCOUNTABILITY, *supra* note 6, at 7.

134. U.S. GOV'T ACCOUNTABILITY OFF., *Tax Administration: Systematic Information Sharing Would Help IRS Determine the Deductibility of Civil Settlement Payments,* GAO-05-747 1 (2005) [hereinafter GAO REPORT].

135. *Id.* at 4.

136. *Id.* at 1.

137. O'Neal, *supra* note 42.

138. *Id.*

In the past, the hands-off approach of federal agencies such as the Department of Justice (the "DOJ") regarding the taxability of settlement payments resulted in settlements that were either silent on the deductibility of portions of the payment or ambiguous as to whether or not they were deductible.[139] In the 2005 GAO report, the four agencies responsible for negotiating the largest settlements–the Environmental Protection Agency (the "EPA"), the SEC, the DOJ, and Health and Human Services ("HHS")–did not previously negotiate with companies about whether payments were tax-deductible.[140] Instead, they claimed it was the IRS's role to determine deductibility.[141] Only two of the agencies, the EPA and the DOJ, calculated the impact of tax deductibility in the amounts proposed in the settlement payments.[142] They factored in tax-deductible payments that would have been made to stay in compliance with the law, in order to determine the economic impact of non-compliance with the law.[143] As of 2005, when the EPA negotiated with violators about the size of penalty payments, EPA officials would consider the strength of the agency's position rather than the violator's ability to claim a tax deduction.[144] Contrast this with the fact that the SEC–one of the few agencies at the time to explicitly label civil penalties as nondeductible–remained silent in its settlement agreements on the tax-deductibility of disgorgement.[145] The DOJ, in particular, neither considered nor discussed any aspect of taxes in its negotiations, and it was the official policy of the agency not to address the tax treatment of settlement payments.[146] Because these government agencies failed to explicitly define which portions were punitive and which were remedial, corporations would often deduct a large part of the entire settlement as "compensatory" payments.[147]

In addition, past practice of government agencies was to limit information shared about the settlements, as found in a U.S. PIRG report from 2015.[148] The DOJ was the least transparent about its settlements and the least likely to explicitly limit tax deductions in public settlement agreements, even ten years

139. SUBSIDIZING BAD BEHAVIOR, *supra* note 5, at 4.

140. GAO REPORT, *supra* note 134, at 2, 4.

141. *Id.* at 4.

142. *Id.* at 4, 9.

143. *Id.* at 4.

144. *Id.* at 12.

145. *Id.* at 14.

146. *Id.* at 16.

147. SUBSIDIZING BAD BEHAVIOR, *supra* note 5, at 4.

148. LACK OF ACCOUNTABILITY, *supra* note 6, at 13; *see id.* at 9 (The U.S. PIRG Education Fund report from 2015 notes that "[o]ur findings are not directly comparable to the GAO's data from a decade ago because we lack the same access to the confidential settlements and company tax information that was available to GAO researchers. We instead focus on those cases where agencies have published press releases publicly and we limit analysis to settlements that have the legal text of those settlements available online.").

after the GAO report was published.[149] The agency additionally lacked a clear, publicly available policy on its approach to negotiations and failed to disclose the tax status of payments in press releases, despite being responsible for most of the largest corporate settlements negotiated by the federal government.[150]

Given the previous hands-off approach of government agencies such as the DOJ, a willingness to agree to allocate a larger part of settlement payments as restitution could result in distortions to the 2017 Law and may require the IRS to expend more resources and time in enforcement on the back-end. Although the agencies and corporations now need to explicitly label settlement agreements and report restitution payments to the IRS,[151] there is a risk that the agencies may concede tax consequences to reach a settlement agreement.[152] This factor played into the IRS's previous reluctance to cede authority to the agencies to determine the taxability of settlements.[153] Previously, the DOJ and the IRS mutually agreed that the DOJ's "tax-neutral" practices concerning the deductibility of settlement payments were appropriate.[154] Part of the rationale for this "tax-neutral" policy was to prevent additional complexity in the negotiation process.[155] Now that agencies are required to, at a minimum, explicitly identify payment amounts as restitution, there may be a risk that agencies will continue to avoid adding complexity or contention to negotiations by inadequately accounting for the deductibility of these payments in the overall negotiation process.[156]

The IRS needs to engage in formal interagency coordination, including developing policies that promote the mutual goals of agencies such as the DOJ and the IRS. The IRS typically does not coordinate willingly with other agencies unless Congress directs it to do so,[157] and it is not often willing to expand its mission beyond tax collection.[158] In addition, as evident from prior policy on the tax treatment of settlement payments, most other agencies do not want to address tax matters, often claiming a lack of expertise.[159] Agency coordination addresses the challenges associated with, among other issues, agencies acting at cross-

149. LACK OF ACCOUNTABILITY, *supra* note 6, at 13.

150. *Id.* at 20, 23.

151. *See* I.R.C. § 162(f) (2018); I.R.C. § 6050X.

152. GAO REPORT, *supra* note 134, at 11.

153. *Id.*

154. *Id.* at 16.

155. *Id.*

156. There has been no updated GAO Report since 2005; *see* LACK OF ACCOUNTABILITY, *supra* note 6, at 13–14 for a limited update on agency practice (finding improvements made to overall information sharing and that some agencies, such as the EPA, better addressed tax deductibility, whereas the DOJ had moved in the opposite direction in terms of transparency).

157. Blaine G. Saito, *Tax Coordination*, 38 GA. S. U. L. REV. 735, 758 (2022).

158. David A. Weisbach, *Tax Expenditures, Principal-Agent Problems, and Redundancy*, 84 WASH. U. L. REV. 1823, 1845 (2006).

159. Saito, *supra* note 157, at 760; GAO REPORT, *supra* note 134, at 9, 11.

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purposes to resolve public problems.[160] Coordination problems in federal agencies are similar to problems in organizations that focus on specialization by "product line," e.g., tax collection or national security.[161] Such divisional specialization can be problematic in a government context when there is no clear demarcation of the "product line"[162]–such as an overlap between two government agencies on the issue of settlement payments–or when there is no precise measure for the effectiveness of government policy.[163]

Absent another amendment to Sec. 162(f) providing a congressional impetus for coordination between the IRS and the respective federal agencies, the IRS should consider adopting a Memorandum of Understanding (MOU). An MOU is an agreement used by government agencies to determine each agency's responsibility, resources, and expertise to coordinate proper administration of the law.[164] After the passage of Sec. 6050X—which requires agencies to report the timing of settlement agreements and the amounts allocated to restitution to the IRS—in tandem with the amendment to Sec. 162(f),[165] the resulting information sharing undoubtedly addressed some of the recommendations from the 2005 GAO Report.[166] Additionally, establishing procedures and protocols for negotiating settlement amounts would avoid unintended consequences of having other agencies responsible for the ultimate deductibility of settlement payments. By coordinating with agencies on the front-end, the IRS can also more efficiently conserve resources otherwise expended in policing the restitution payments in challenges to corporate taxpayer settlements.[167]

CONCLUSION

Restitution is rightly recognized in the 2017 Law and final regulations as compensation to victims and merits an exception to the non-deductibility of corporate settlement payments paid to or at the direction of the government. The Restitution Exception, as embodied in the statute and final regulations, does not detract from the original public policy doctrine to not reduce the "sting" of national and state laws. Furthermore, the Restitution Exception resolves the split in the circuits from the post-1969/pre-2017 case law regarding the deductibility of restitution payments. The final regulations closely follow the Supreme Court's reasoning in *Kokesh* and *Liu* that viewed restitution and compensatory-

160. Blaine G. Saito, *Agency Coordination and Opportunity Zones*, 48 FORDHAM URB. L.J. 1203, 1212 (2021).

161. David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 987–89 (2004).

162. *Id.*

163. *Id.* at 992–93.

164. *See* Saito, *supra* note 157, at 804–05.

165. I.R.C. § 6050X.

166. GAO REPORT, *supra* note 134, at 22–26.

167. Saito, *supra* note 160, at 1213.

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like disgorgement/forfeiture as a remedial—non-punitive—measure. The additions in the final regulations additionally address the ambiguities in disgorgement/forfeiture as a dual-purpose remedy by circumscribing the payments to such an extent that they become "restitution" for all intents and purposes.

Nevertheless, the effects of the 2017 Law and the regulations promulgated thereunder could be distorted by other governments and federal agencies who negotiate settlements with corporate wrongdoers without further coordination between the IRS and the respective agencies. In order to avoid the possibility that corporations will shift settlements toward restitution and reduce the "sting" of penalties as a result of countervailing negotiation incentives, the IRS should coordinate a comprehensive strategy with the federal agencies and state governments primarily responsible for negotiating settlements. Only then will the congressional goal of deterrence be ensured, and the mutual goals of the respective governmental bodies be considered.

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