



June 13, 2018

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**Re: Notice 2018-23 – Transitional Guidance Under Sections 162(f) and 6050X with Respect to Certain Fines, Penalties and Other Amounts**

Dear Messrs. Dinwiddie and Moriarty:

The American Institute of CPAs (AICPA) is pleased to submit comments as requested by Internal Revenue Service (IRS) Notice 2018-23 (the “Notice”), regarding changes to the disallowance of fines and penalties under Internal Revenue Code (IRC or “Code”) section 162(f)<sup>1</sup> and the new reporting requirement in section 6050X as enacted under Public Law No. 115-97, commonly referred to as the Tax Cuts and Jobs Act (TCJA).

The AICPA recommends that the Department of the Treasury (“Treasury”) and the IRS issue guidance in the form of proposed regulations, providing safe harbors to reduce the burden on taxpayers, governments and nongovernmental entities subject to the reporting requirements in section 6050X, and on the IRS during examinations. Specifically, we recommend that the IRS and Treasury issue guidance providing:

- 1) A safe harbor or bright-line rule limiting the application of an “inquiry” into a “potential” violation of the law, to not include amounts paid in the ordinary course of business to comply with the law;
- 2) An exception, under section 162(f)(2), for amounts constituting restitution or paid to come into compliance with the law; and
- 3) A rebuttable presumption for certain specific circumstances, in favor of a taxpayer for purposes of section 162(f)(1), that the requirements of section 162(f)(2) are satisfied.

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<sup>1</sup> All references herein to “section” or “§” are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder.

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We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. If you have any questions, please contact Jennifer Kennedy, Chair, AICPA Tax Methods and Periods Technical Resource Panel, at (703) 918-6951, or [jennifer.kennedy@pwc.com](mailto:jennifer.kennedy@pwc.com); Ogochukwu Eke-Okoro, Senior Manager – AICPA Tax Policy & Advocacy, at (202) 434-9231, or [ogo.eke-okoro@aicpa-cima.com](mailto:ogo.eke-okoro@aicpa-cima.com); or me at (408) 924-3508, or [annette.nellen@sjsu.edu](mailto:annette.nellen@sjsu.edu).

Sincerely,



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Chair, AICPA Tax Executive Committee

cc: Mr. Christopher Call, Attorney-Advisor, Office of Tax Legislative Counsel, Department of the Treasury  
Ms. Ellen Martin, Tax Policy Advisor, Office of Tax Legislative Counsel, Department of the Treasury  
Mr. Christopher Wrobel, Attorney, Office of the Associate Chief Counsel, (Income Tax & Accounting), Internal Revenue Service

## AMERICAN INSTITUTE OF CPAs

### Comments on Notice 2018-23 – Transitional Guidance Under Sections 162(f) and 6050X with Respect to Certain Fines, Penalties and Other Amounts

June 13, 2018

#### I. General Background

Section 162(f) was significantly modified by the TCJA, which also added a new reporting requirement related to fines and penalties in section 6050X. As revised by the TCJA, section 162(f)(1) disallows a deduction for amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government or governmental entity in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law. Section 162(f)(2) provides an exception to the general rule for amounts constituting restitution or for amounts paid to come into compliance with the law.

To meet the exception, section 162(f)(2)(A)(i) requires that the taxpayer establish that the amount paid or incurred:

- 1) constitutes restitution (including remediation of property) for damage or harm that was or may be caused by the violation of any law or the potential violation of any law, or
- 2) is paid to come into compliance with any law that was violated or otherwise involved in the investigation or inquiry described in paragraph (1).<sup>2</sup>

Section 162(f)(2)(A)(ii) provides that the amount paid or incurred is identified as restitution or as an amount paid to come into compliance with the law in the court order or settlement agreement (the “identification requirement”). The language in section 162(f)(2)(A) further provides that meeting the identification requirement alone is not sufficient to meet the establishment requirement. Section 162(f)(2)(A)(iii) provides that in the case of any amount of restitution for failure to pay any tax imposed under the Code, the amount is treated as if it were such tax if it would have been allowed as a deduction had it been timely paid.

Additionally, section 162(f)(3) provides an exception for amounts paid or incurred by reason of any order of a court in a suit in which no government or governmental entity is a party. Section 162(f)(4) provides an exception that the provision shall not apply to any amount paid or incurred as taxes due. Section 162(f)(5) provides the definitions of when a nongovernmental entity is considered a governmental entity for purposes of the disallowance.

Section 6050X(a)(1) requires the appropriate official of any government or applicable nongovernmental entity that is involved in a suit or agreement described in section 6050X(a)(2) to make a return in such form as determined by the Secretary of the Treasury setting forth:

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<sup>2</sup> IRC section 162(f)(2)(A)(i).

- 1) the amount required to be paid as a result of the suit or agreement to which paragraph (1) of section 162(f) applies;
- 2) any amount required to be paid as a result of the suit or agreement that constitutes restitution or remediation of property; and
- 3) any amount required to be paid as a result of the suit or agreement for the purpose of coming into compliance with any law which was violated or involved in the investigation or inquiry.<sup>3</sup>

Under section 6050X(a)(2), the taxpayer must report the amounts they are required to pay as a result of a suit or agreement, if the suit or agreement is of a type described below and the aggregate amount involved in all court orders and agreements with respect to the violation, investigation, or inquiry is \$600 or more. The reporting requirement applies to:

- 1) a suit with respect to a violation of any law over which the government or entity has authority and with respect to which there has been a court order, or
- 2) an agreement that is entered into with respect to a violation of any law over which the government or entity has authority or with respect to an investigation or inquiry by the government or entity into the potential violation of any law over which such government or entity has authority.<sup>4</sup>

Notice 2018-23 provides transitional guidance that reporting is not required under section 6050X until the date specified in future proposed regulations. The Notice further provides that, until proposed regulations under section 162(f) are issued, the identification requirement in section 162(f)(2)(A)(ii) is treated as satisfied for an amount if the settlement agreement or court order specifically states on its face that the amount is restitution, remediation, or for coming into compliance with the law. However, the Notice states that even if the identification requirement is treated as satisfied, taxpayers must also meet the establishment requirement to qualify for the section 162(f)(2) exception.

## **II. AICPA Recommendations**

The AICPA recommends that the IRS and Treasury issue guidance that provides safe harbors to reduce the burden on taxpayers in complying with section 162(f), governments and nongovernmental entities subject to the reporting requirements in section 6050X, and the IRS to examine these issues.

### **A. Section 162(f)(1) – Disallowance of amounts paid for inquiry by government or governmental entity into the potential violation of any law**

#### Recommendations

The AICPA recommends that the IRS and Treasury issue guidance providing a safe harbor or bright-line rule limiting the application of an “inquiry” into a “potential” violation of the law, to not include amounts paid in the ordinary course of business to comply with the law.

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<sup>3</sup> IRC sections 6050X(a)(1)(A), (B) and (C).

<sup>4</sup> IRC sections 6050X(a)(2)(A)(i)(I) and (II).

The safe harbor should state that a taxpayer is not subject to section 162(f) if the taxpayer does not receive a Form 1099, *Miscellaneous Income*, for purposes of section 6050X.

We further recommend that the IRS and Treasury include a requirement that for the applicability of section 162(f) in this context:

- 1) an inquiry is required in writing; and
- 2) such written documentation must specify that a potential violation of law is asserted or otherwise investigated.

### Analysis

Section 162(f)(1), as modified by the TCJA, represents a shift in the language for the disallowance of fines and penalties. Prior to the TCJA, section 162(f) stated that no deductions are allowed for “any fine or similar penalty paid to a government for the violation of any law.” The regulations under Treas. Reg. § 1.162-21(b)(1) further provided that the statute denied a deduction for criminal and civil penalties, as well as for sums paid in settlement of potential liability for a fine or penalty. Thus, prior to the TCJA, it was clear that the statute was intended only to disallow fines and penalties, even though controversy surrounded the origin of the claim of certain types of settlements.

Section 162(f)(1), as amended by the TCJA, no longer specifically refers to “fines” or “penalties.” Instead, the statute now presumes that any amount, even amounts paid in the ordinary course of business to comply with the law, is nondeductible unless the taxpayer proves that the origin of the claim for the amount is otherwise deductible, and obtains the appropriate reporting under section 6050X from the government or governmental entity to support the deduction.

The statute, as written, could inadvertently disallow amounts paid in the ordinary course of business to comply with the law that Congress did not intend to disallow. The statute disallows amounts paid for an “inquiry” by a government or governmental entity into “potential” violations of any law. We do not believe that Congress intended to subject ordinary inspections and similar types of inquiries, for instance, to ensure everyday compliance with the law.

The introduction of new terms in the statute, such as “inquiry” and “potential,” could cause controversy. For example, it is unclear whether a local governmental authority inspection, to ensure compliance with local building codes, is considered an “inquiry” into a “potential” violation of the law. If the local inspector requires the taxpayer to make changes/additions to its building to ensure compliance, such as additional fire safety features, additional sprinkler heads, additional fire extinguishers, and additional signs, we do not believe that this requirement is a “potential” violation of the law.

A safe harbor would relieve the government or governmental entity from the burden of reporting amounts paid in the ordinary course of business to comply with the law. The governmental entity often would not know the amount that the taxpayer spent on compliance. The inclusion of a written documentation requirement, as part of the safe harbor, ensures clarity regarding the nature and purpose of governmental/governmental entity inquiries. Further, such contemporaneous

documentation will help prevent hindsight by both parties in asserting facts related to the inquiry and the evolution thereof over time.

For example, the IRS and Treasury could provide a safe harbor stating that a government or governmental entity is not required to issue a Form 1099 for inspections related to ordinary compliance with the law. That is, the safe harbor would state that an “inquiry” does not include inspections related to ordinary compliance. The safe harbor should also provide that a taxpayer is not subject to section 162(f) if the taxpayer does not receive a Form 1099 under section 6050X. This safe harbor, in addition to the implementation of the aforementioned framework, would reduce the burden on the governmental entities from reporting requirements for ordinary compliance.

The safe harbor would also relieve taxpayers from the burden of having to gather the data to provide to the governmental entities for reporting, and further having to prove that ordinary compliance was in fact compliance and not a fine or penalty. This safe harbor would also provide taxpayers with certainty that they are not required to expend resources to document amounts paid under \$600. Without such a safe harbor, both governmental entities and taxpayers may incur a substantial increase in costs to comply with local laws.

The above discussion is not intended to infer that all routine inquiries other than inspections relate to a potential violation of law. Forthcoming guidance should indicate expressly that any reference to inspections is not exhaustive.

#### **B. Section 162(f)(2) – Exception for amounts constituting restitution or paid to come into compliance with law**

##### Recommendation

The AICPA recommends that the IRS and Treasury issue guidance that creates a rebuttable presumption in favor of the taxpayer for purposes of section 162(f)(2)(i) in situations where the requirements of section 162(f)(2)(ii) are satisfied. In cases when a settlement agreement or court order specifically identifies the amount as restitution, this fact would create a rebuttable presumption that the taxpayer has established that the amount constitutes restitution for purposes of section 162(f)(2)(i).

##### Analysis

Section 162(f)(2)(A)(ii), under the TCJA, provides that amounts described in section 162(f)(2) are included in the exception provided in section 162(f)(2) only to the extent the amounts are specifically “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...” This new requirement ensures that the proper characterization of the payment has either (1) been specifically considered and agreed to by the parties to the settlement, or (2) specifically addressed by the court. The new requirement will eliminate much of the uncertainty that arose under prior law wherein settlement agreements were often silent with respect to the intended characterization of the payment by the parties.

Nonetheless, there is a concern about undermining the certainty provided for in section 162(f)(2)(A)(ii), to the extent the provisions of section 162(f)(2)(A)(i) are interpreted to place an additional burden on the taxpayer with respect to establishing that the amount constitutes either restitution or a payment made to come into compliance with any law.

Creating a rebuttable presumption in favor of the taxpayer for purposes of section 162(f)(2)(i) in situations where the requirements of section 162(f)(2)(ii) are satisfied will resolve this issue. While the IRS could rebut this presumption by showing that the agreement or court order was not entered into in good faith, the presumption would remove the uncertainty that taxpayers are required to provide additional evidence (other than providing the settlement agreement or court order) to establish the payment constitutes restitution for damage or harm. Such an approach is consistent with long-standing judicial and IRS recognition that courts have tended to uphold the characterization or allocations provided for in a settlement agreement where the record indicates that there was a negotiated arms-length agreement arrived at in good faith.

### **C. Rebuttable presumption safe harbor**

#### Recommendation

The AICPA recommends that the IRS and Treasury issue guidance providing a rebuttable presumption safe harbor in the following circumstances:

- If a settlement agreement or court order specifically designates an amount as restitution, and the taxpayer produces evidence (e.g., in a work paper or schedule) that the amount designated is not more than the highest amount of compensation-related damages calculated and sought by the government in the action and prior to the settlement, that the amount designated as restitution is presumed to satisfy the exception in section 162(f)(2). The presumption is not altered even if evidence exists that the government had or may have had multiple purposes in pursuing and settling the action, including deterring similar conduct and/or punishing the taxpayer's alleged conduct.
- In the case of a settlement or court order resolving an action under the False Claims Act (FCA),<sup>5</sup> an amount designated as restitution is presumed as compensatory.
- In the case of a settlement or court order involving a disgorgement of profits, an amount designated as restitution is presumed as compensatory if it equates to the calculated amount of financial injury to victims and is disbursed to the class of victims giving rise to the action.

#### Analysis

The following examples illustrate the operation of the proposed safe harbor and the recommended outcome under section 162(f) as amended by the TCJA:

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<sup>5</sup> 31 U.S.C. §§ 3729 – 3733.

### *Example 1*

As a result of a civil action against Corp X alleging anti-trust violations in the supply market, Corp X and the government reach a monetary and injunctive settlement. The terms of the settlement provide for the payment of a penalty and an amount specifically designated as restitution. During the lawsuit, the government estimated the underpayments resulting from alleged conduct using several approaches which resulted in a range of alleged damages. The amount paid under the agreement and designated as restitution is no more than the highest amount of the government's calculated and claimed estimated underpayments to suppliers during the period alleged. The settlement agreement provides for the payment of restitution on a proportional basis to the class of financially harmed wholesalers.

Based on the safe harbor, the amount specifically designated as restitution is presumed to meet the exception in section 162(f)(2) while the amount designated as a penalty is not presumed to meet the exception.

### *Example 2*

The facts are the same as in Example 1, except the allegations involve violations of consumer protection law in the retail market and the injured parties are retail consumers. The settlement agreement also provides for the restitution payment to a consumer protection fund which is used to promote consumer protection safeguards and finance the monitoring and investigation of false advertising claims of consumer products. As in Example 1, during the lawsuit, the government estimated the impact of the alleged conduct on the retail market price of the product using several approaches which resulted in a range of alleged damages. The amount paid under the agreement does not exceed the highest amount of the government's calculated and claimed estimated overcharges to customers during the period of the alleged conduct.

Based on the safe harbor, the amount specifically designated as restitution is presumed to satisfy the exception in section 162(f)(2).

### *Example 3*

The facts are the same as in Example 1, except that, due to the taxpayer's cooperative behavior throughout the lawsuit, the government did not ultimately pursue payment of any fine and therefore, the settlement agreement contains only the amount labeled as restitution. The fact that the ultimate settlement agreement does not contain a penalty where one was sought in the original complaint does not negate the presumption that the settlement payment is compensatory and therefore restitution.

Based on the safe harbor, the amount specifically designated as restitution is presumed to satisfy the exception in section 162(f)(2).



*Example 4*

In an SEC action involving alleged violations of securities laws by the taxpayer, a settlement is reached and the terms of the settlement provide for the payment of an amount specifically designated as restitution. This amount represents the calculated amount of the taxpayer's profits attributable to the violation and the corresponding amount of financial injury to the victims, and is paid to a designated class of injured victims.

Based on the safe harbor, the amount specifically designated as restitution is presumed to satisfy the exception in section 162(f)(2).