

**Office of Chief Counsel
Internal Revenue Service
memorandum**

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to: Kevin Coy, Senior Counsel
(Small Business/Self-Employed)

from: Sharon Y. Horn, Senior Counsel
(Income Tax & Accounting)

subject: Application of § 162(f)¹

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
Government Agency =
Date =
Payments =

Tax Year =

ISSUES

1. Whether § 162(f)(1) disallows Taxpayer's deduction for amounts (including amounts from the sale of Taxpayer's surrendered assets) Taxpayer paid to Government Agency, pursuant to a court order, for Taxpayer's violation of Government Agency laws if Government Agency may use the money for consumer redress and pays any remaining amount to the U.S. Treasury.

¹ § 162(f) as amended by the Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2126, § 13306(a) (2017).

2. Whether § 162(f) disallows Taxpayer's deduction for the forgiveness, by Taxpayer's wholly owned S corporation, of debt issued to Taxpayer's customers as required by the court order.

CONCLUSIONS

1. Section 162(f)(1) disallows Taxpayer's deductions for amounts paid to Government Agency, pursuant to the order, in relation to the violation of any law.
2. Section 162(f)(1) disallows Taxpayer's deduction for the forgiveness, by Taxpayer's wholly owned S corporation, of debt issued to Taxpayer's customers.

The exception, under § 162(f)(2), to the general disallowance rule does not apply because the order does not identify Payments as restitution or an amount paid to come into compliance with the law and Taxpayer failed to establish that either the amount paid or the debt forgiven constitutes restitution.

FACTS

Pursuant to a Date court order, (1) Taxpayer made Payments to Government Agency and (2) Taxpayer's wholly owned S corporation forgave debt issued to Taxpayer's customers. On Taxpayer's Form 1040 for Tax Year, Taxpayer claimed a deduction for Payments and the debt forgiveness.

The court order states:

All money paid to the Government Agency pursuant to this Order may be deposited into a fund administered by the Government Agency or its designee to be used for equitable relief, including consumer redress and any attendant expenses for the administration of any redress fund. If a representative of the Government Agency decides that direct redress to consumers is wholly or partially impracticable or money remains after redress is completed, the Government Agency may apply any remaining money for such other equitable relief (including consumer information remedies) as it determines to be reasonably related to Defendants' practices alleged in the Complaint. Any money not used for such equitable relief is to be deposited to the U.S. Treasury as disgorgement.

Taxpayer did not provide any documents to the Service with respect to how Government Agency used the amounts Taxpayer paid pursuant to the court order.

LAW

Section 162(f)(1) provides:

[N]o deduction otherwise allowable shall be allowed [under chapter 1] 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.

Section 162(f)(2)(A) provides an exception from the general disallowance rule for an amount that (in relevant part):

(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), [and]

(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.

On January 19, 2021, the Treasury and the IRS issued final regulations under § 1.162-21, implementing § 162(f). The final regulations apply to taxable years beginning on or after that date but do not apply to amounts paid under any order or agreement, pursuant to a suit, agreement, or otherwise, that became binding under applicable law before such date. Although § 1.162-21(e)(4)(A)(4)(B) of the regulations contains rules for treating disgorgement as restitution, the final regulations do not apply to Taxpayer's deduction because Taxpayer's Payments and the debt forgiveness were pursuant to the Date court order.

In Zirolì v. Commissioner, T.C. Memo. 2022-75, the Tax Court considered whether pre-TCJA § 162(f)² and the related regulations³ disallowed petitioner's § 162(a) ordinary and necessary business expense deduction for disgorgement paid to the United States Treasury to settle civil liabilities for violations of federal securities law. Petitioner argued that the disgorgement was intended to be compensatory and therefore deductible. Zirolì, slip op. at 7. The court disallowed the deduction because petitioner did not prove that the intent of disgorgement was compensatory, not a "fine or similar penalty." Id., slip op. at 12.

ANALYSIS

The court order required Taxpayer to make Payments to Government Agency and required Taxpayer's S Corporation to forgive consumer debt with respect to Taxpayer's violation of Government Agency laws. Therefore, unless an exception under § 162(f)(2)

² Pre-TCJA § 162(f) provides that "[n]o deduction shall be allowed under subsection (a) for any fine or similar penalty paid to a government for the violation of any law."

³ § 1.162-21(b), T.D. 7345, 40 FR 7437 (1975); 40 FR 8948 (1975), as amended by T.D. 7366, 40 FR 29290 (1975).

applies, both Payments and the debt forgiveness, which otherwise may have given rise to allowable deductions under chapter 1 of the Internal Revenue Code and the Regulations thereunder, fall squarely within the general disallowance rule of § 162(f)(1).

Taxpayer argues that the restitution exception under § 162(f)(2) applies to allow Taxpayer's deduction for Payments because the court order "made reference to equitable monetary relief and consumer redress, and no reference to either a fine or penalty, and further that the amount of the settlement itself was reduced as a result of consumer debt relief."

Taxpayer is mistaken. The court order does not meet the identification requirement under § 162(f)(2)(A)(ii) because it does not specifically state that Payments or the debt forgiveness constitute "restitution" or an amount "paid to come into compliance with any law." Moreover, assuming, but not conceding, that the order's use of the word "redress" could meet the identification requirement, the court order still fails to meet the requirement because the court order provides that Government Agency may, but does not have to, use Payments to provide consumer redress. Amounts paid to the government for its discretionary use do not constitute restitution. See Zirolì, T.C. Memo. 2022-75, slip op. at 7 (the court stated that, even if the SEC distributed the disgorged amounts to harmed investors, "courts have held that any post hoc exercise of discretion by the government to use the disgorged funds to compensate victims does not transform the payment from a penalty into compensatory damages.").

In addition, Taxpayer failed to meet the establishment requirement under § 162(f)(2)(A)(i) because Taxpayer did not provide documentation to support Taxpayer's claim that Government Agency's use of the Payment, or the debt forgiveness, provided restitution to the victims harmed by Taxpayer's actions. Further, pursuant to the court order "[a]ny money not used for such equitable relief is to be deposited to the U.S. Treasury as disgorgement." Disgorged amounts deposited to the general account of the government do not constitute restitution. See id., slip op. at 10-11 (the court in Zirolì found no support for petitioners' argument that disgorgement to the United States Treasury compensated the government and, thus, "presume[d] that the disgorgement was imposed by the government to protect the general welfare, not to compensate itself for any losses.").

Because the court order does not meet the identification requirement and Taxpayer has not met the establishment requirement, the exception under § 162(f)(2) does not apply to allow the deduction. Therefore, § 162(f)(1) disallows Taxpayer's deductions for Payments and the debt forgiveness, as required by the court order, for Taxpayer's violation of Government Agency law.

CASE DEVELOPMENT AND POTENTIAL HAZARDS

Case Development

Based on the documents we reviewed, we suggest the Service confirm the following: (1) the amount of Taxpayer's deduction, (2) the amount the liquidator received from the

sale of the surrendered assets and the amount it turned over to Government Agency; and (3) the amount of debt forgiven.

Potential Hazards

Although § 162(f) applies to the tax year at issue, the related regulations under § 1.162-21, providing rules for treating disgorgement as restitution, do not.

[REDACTED]

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[REDACTED]

[REDACTED]

4 [REDACTED]