CCTP UPDATES—IMPORTANT DEVELOPMENTS: CRIMINAL

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DEDUCTIBILITY AND INFORMATION REPORTING OF RESTITUTION PAYMENTS: TRANSITIONAL GUIDANCE ISSUED

The Tax Cuts & Jobs Act made significant changes to Section 162(f) with respect to the deductibility of certain fines, penalties, and other amounts, including restitution payments. Previously, Section 162(f) barred a deduction for fines or penalties paid to a government for the violation of any law. There was much debate over whether restitution payments for unpaid taxes were compensatory/remedial in nature/constituted reimbursement to government and therefore deductible versus punitive and therefore non-deductible.

As it pertains to tax restitution, new Section 162(f) now has an explicit carve-out for restitution payments made (or amounts paid to come into compliance with the law) provided that such restitution amounts (or amounts paid to come into compliance with the law) are identified as restitution or as an amount paid to come into compliance in the court order or settlement agreement.

The new statute provides that restitution amounts do not include amounts paid or incurred as reimbursement to government for costs of any investigation or litigation. The new law also explicitly states that the prohibition on a deduction for a fine or fee paid to the government does not apply to any amount paid or incurred as taxes due. The statute does not define "taxes due" or indicate whether it includes penalties and additions to state and federal taxes. At bottom, the statute ushers in significant changes with respect to the deductibility of restitution payments.

The other big change initiated by the statute is that it imposes information reporting obligations on the government regarding restitution amounts agreed upon, to be filed with the IRS at time any agreement is entered into. New Section 162(f) added a new section to the Code, Section 6050X, to implement and enforce the new information reporting.

Although regulations have not yet been proposed or issued, on March 27, the IRS issued transitional guidance under new Sections 162 and 6050X in Notice 2018-23. As an initial matter, the Notice makes clear that no information reporting under Section 6050X will be required until whatever date is specified in the proposed regulations, which in any event will not be before January 1, 2019. Thus, any agreements entered into before the specified date do not have the reporting requirement.

However, Section 162(f) has already taken effect so, to ensure a restitution payment is deductible, any taxpayer desiring to take a deduction for a restitution payment must meet the terms of the statute establishing

that (1) any restitution payment is specified or identified as such in a settlement agreement or court order (the "identification" requirement); and (2) that such payment was in fact restitution paid to come into compliance with an actual or potential violation of law or was restitution for harm caused by actual or potential violation of law.

The Notice provides further elucidation on the "identification" requirement. Specifically, the Notice states that the identification requirement will be deemed "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."

Although clear language indicating a payment amount as restitution will aid with the deductibility, once the reporting requirements are implemented, practitioners will need to take care to read Section 6050X and whether it aligns with Section 162(f), as problems could arise based on discrepancies between what the government considers an amount to be restitution versus some other type of payment. And if a restitution amount is not reported as such by the government, its deductibility will inevitably be called into question.

The text of Section 162(f) is as follows:

> (f) Fines, penalties, and other amounts.—
>
> (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.
>
> (2) Exception for amounts constituting restitution or paid to come into compliance with 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 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).
>
> (B) Limitation.—Subparagraph (A) shall not apply to any amount paid or incurred as reimbursement to the government or entity for the costs of any investigation or litigation.
>
> (3) Exception for amounts paid or incurred as the result of certain court orders.—Paragraph (1) shall not apply to any amount paid or incurred by reason of any order of a court in a suit in which no government or governmental entity is a party.
>
> (4) Exception for taxes due.—Paragraph (1) shall not apply to any amount paid or incurred as taxes due.
>
> (5) Treatment of certain nongovernmental regulatory entities.—For purposes of this subsection, the following nongovernmental entities shall be treated as governmental entities:
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> (A) Any nongovernmental entity which exercises self-regulatory powers (including imposing sanctions) in connection with a qualified board or exchange (as defined in Section 1256(g)(7)).
>
> (B) To the extent provided in regulations, any nongovernmental entity which exercises self-regulatory powers (including imposing sanctions) as part of performing an essential governmental function.

MARINELLO V. UNITED STATES: SUPREME COURT ISSUES TAXPAYER-FAVORABLE DECISION HOLDING THAT SECTION 7212(A) OMNIBUS CLAUSE REQUIRES KNOWLEDGE OF PENDING INVESTIGATION

Marinello v. United States, 138 S.Ct. 1101 (2018), involved a conviction under 26 U.S.C. Section 7212(a), which provides as follows:

> Whoever corruptly or by force or threats of force (including any threatening letter or communication) endeavors to intimidate or impede any officer or employee of the United States acting in an official capacity under this title, or in any other way corruptly or by force or threats of force (including any threatening letter or communication) obstructs or impedes, or endeavors to obstruct or impede, the due administration of this title, shall, upon conviction thereof, be fined not more than $5,000, or imprisoned not more than three years, or both, except that if the offense is committed only by threats of force, the person convicted thereof shall be fined not more than $3,000, or imprisoned not more than one year, or both. The term "threats of force," as used in this subsection, means threats of bodily harm to the officer or employee of the United States or to a member of his family.

More specifically, the Marinello case involved the Section 7212(a) omnibus clause, which prohibits any act that either corruptly obstructs or impedes, or endeavors to obstruct or impede, the due administration of the Internal Revenue Code. United States v. Bostian, 59 F.3d 474, 477 (4th Cir. 1995); United States v. Popkin, 943 F.2d 1535, 1539 (11th Cir. 1991); United States v. Williams, 644 F.2d 696, 699 (8th Cir. 1981).

Marinello was convicted under Section 7212(a), and his conviction was upheld in the Second Circuit, which, like other courts, took a broad, expansive view of Section 7212(a)'s omnibus clause. Marinello again challenged the conviction, arguing to the Supreme Court that an omnibus clause conviction requires the government to establish the existence of a pending IRS investigation and the defendant's knowledge of that investigation.

The Supreme Court agreed with Marinello, holding that "To convict a defendant under the Omnibus Clause, the Government must prove the defendant was aware of a pending tax-related proceeding, such as a particular investigation or audit, or could reasonably foresee that such a proceeding would commence." The Court significantly narrowed other courts' (and prosecutors') broad reading of the statute and use of the statute, and in the process, set forth specifically what the government must show to obtain a Section 7212(a) omnibus conviction.

First, the government must prove a nexus to the administrative proceeding, i.e. a nexus between the defendant's conduct and a particular administrative proceeding like an audit or investigation. The Court was clear that an administrative proceeding does not include every act carried out by an IRS employee, and that simply because an IRS employee could review a taxpayers' tax return annually every filing and potential tax crimes does not turn into an obstruction charge. Second, the government must show that the proceeding was pending at the time the defendant engaged in the obstructive conduct alleged, or at minimum that the administrative proceeding was reasonably foreseeable by the defendant, so that a defendant has "fair warning" if a "certain line" is crossed.

Without these limitations, the Court was concerned that the obstruction statute could transform misdemeanors into felonies and give too much discretion to prosecutors. Accordingly, Marinello secured a legal victory for defendants charged with obstruction counts. It remains to be seen how this will impact charging decisions going forward but it could result in prosecutors deciding not to charge some of these offenses depending on the facts of a particular case.

It has at least resulted in the government's moving to dismiss a Section 7212 charge, after a jury found a defendant guilty, in a Reno, Nevada case that Steve Toscher and Evan Davis took over after the verdict. This also had the effect of the Probation Office issuing a revised PSR that reduced the calculated Guideline level by two points, having removed an obstruction enhancement. The defendant had also been found guilty of Section 7206(1) false-return counts, which were unaffected by Marinello. See also United States v. Gentle, 721 Fed. Appx. 91 (2d Cir. May 9, 2018) (government conceded on appeal that defendant's 7212 conviction could not stand in light of Marinello, remanding for de novo sentencing for other unaffected tax charges); United States v. Lawson, 2018 WL 3375170 (D. Alaska July 5, 2018) (after court indicated government must dismiss 7212 indictment count or amend after Marinello due to failure to plead nexus and pending proceeding as Marinello required, government issued second superseding indictment with different allegations).

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