

What We Learned from ... South Carolina (Part Two): IRS Regulations Affecting Consumer Protection Settlements

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Jared Libet, Assistant Deputy Attorney General in the Consumer Protection Unit, recently joined a Kelley Drye webinar to discuss IRS regulations and their impact on consumer protection settlements.

The New Default. Traditionally, settlement payments made to the government, such as those arising from consumer protection enforcement, were deductible for tax purposes unless classified as civil penalties. However, the Tax Cuts and Jobs Act of 2017 significantly changed that landscape by revising 26 U.S.C. § 162(f). Under the new default, settlement payments are no longer deductible unless they meet specific statutory exceptions. Libet offered his interpretation of these revisions and the accompanying IRS regulations, highlighting key considerations for companies navigating consumer protection settlements with government entities.

How to Qualify for an Exception. The statute outlines three exceptions under which settlement payments may still be deductible: (1) restitution, (2) remediation, and (3) cost of compliance. Libet emphasized that qualifying for an exception involves a two-part test:

1. The taxpayer must *establish* that the payment fits one of the three categories.
2. The payment must be *identified* as such in a court order or settlement agreement.

Importantly, the IRS regulations make clear that establishment and identification are distinct requirements, and one does not satisfy the other. As Libet put it: “[A]nyone seeking to get a tax deduction for money that they’re paying as part of consumer protection settlement needs to make sure that they’ve checked both boxes.”

Restitution and Remediation. The first category of expenses eligible for the exception is restitution, which under state consumer laws, is a legal remedy wherein businesses return money, property, or benefits obtained through unlawful practices to affected consumers. Libet noted that payments made toward a third-party restitution fund administrator qualify under this category.

Libet also addressed a common question: What happens if restitution funds go unclaimed? If the money is deposited into a state’s general fund, the IRS will allow the deduction. However, if the money is returned to the company, it will be treated as income.

The second category, remediation, is defined narrowly as payments for environmental restoration. To qualify, the purpose of the payment must have a “strong nexus” to the environmental harm caused. Because case law has yet to clearly define the parameters of this nexus, Libet recommended prioritizing alternative classifications when seeking tax deductions.

Compliance Costs. The third and final category are compliance costs. According to IRS regulations, compliance costs are defined as money “paid or incurred to come into compliance with a law that the taxpayer has violated or is alleged to have violated.” Libet drew attention to the phrase “paid or incurred,” noting that this language suggests deductible expenses are not limited to direct payments to government entities. Internal expenditures also qualify. However, Libet also emphasized a critical limitation: the expense must be directly tied to compliance with the law itself, not merely compliance with the terms of a settlement. “Am I spending money to comply with a settlement” is not the test, he explained. “The test is: am I spending money to comply with the law.”

To illustrate this distinction, Libet offered examples that are likely to qualify as compliance costs:

- Correcting deceptive advertising
- Replacing defective products
- Implementing a “know your customer” program

Conversely, he noted that the following expenses are less likely to qualify:

- Creating a document repository
- General employee training
- Lost revenue from foregone product sales as part of a settlement

Libet also pointed to a gray area of expenses that may not clearly meet the IRS’s definition. These include:

- Retaining an independent monitor
- Hiring a compliance officer
- Preparing compliance reports

While these activities may support broader compliance efforts, Libet cautioned that they appear more aligned with general compliance procedures rather than specific legal requirements, and therefore may not qualify as deductible compliance costs under the statute.

The Exception to the Exception. Reimbursements to a government entity for investigation or litigation costs do not qualify under any of the deductible categories. For example, Libet pointed to attorney’s fees as a common expense that falls outside the scope of the exceptions. The regulations emphasize that regardless of how an order or agreement identifies such costs, they are not deductible.

For additional insight into these IRS regulations and their effect on consumer protection settlements, watch the full webinar [here](#). If you are currently negotiating or anticipate negotiating settlement terms with a government entity, it’s important to understand these key tax regulations as they may influence your settlement. And make sure to address these issues during the negotiations; waiting until after a settlement is finalized could lock you into an unfavorable outcome.