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4 Tax Questions To Ask Before Signing An Enviro Settlement

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Companies resolving government environmental enforcement actions must consider a 2017 tax law change, as well as recently proposed regulations, before finalizing any settlement agreement or court order. Failure to do so could result in a company being unable to deduct payments made under the agreement or order.

This is not something that should be taken lightly. Failure to ensure that a $10 million payment is deductible could mean that your company pays $2.1 million or more in additional federal and state tax income tax.

This article explains the tax law at issue, and walks environmental lawyers through the four questions that they should consider before resolving environmental enforcement actions.

Background

Companies are generally allowed to deduct expenses they incur carrying on their business. For many years, however, companies could not deduct fines or similar penalties paid to a government for the violation of any law.[1]

In December 2017, Congress amended the tax law so that companies cannot deduct payments made to, or at the direction of, a government in relation to a violation or potential violation of law.[2] This rule potentially bars companies from deducting payments made to or at the direction of the U.S. Environmental Protection Agency, the U.S. Department of Justice, or state and local environmental agencies in connection with environmental actions.

Fortunately, there is an exception for payments made for restitution or remediation, or to come into compliance with law.[3] To qualify for the exception, companies must (1) have documentary evidence showing the payment was restitution or remediation, or made to come into compliance with law — the establishment requirement — and (2) include specific language in the settlement agreement or court order — the identification requirement.[4]

Although this law was enacted in 2017, it is still considered new, partly because there are so many unanswered questions — e.g.: What is "restitution"? And what is a "violation of law"? On May 12,

the IRS issued proposed regulations implementing the new law.[5] The proposed regulations attempt to answer some of the questions left by the statute, and taxpayers may rely on the proposed regulations until final regulations issue.

Nevertheless, commentators disagree with some of the answers provided in the proposed regulations. It remains to be seen whether the U.S. Department of the Treasury and the IRS will revise their positions or address additional unanswered questions in the final regulations.

It is unknown when the final regulations will be issued. It is normally difficult to predict how long it will take the Treasury Department to issue final regulations, and it is unclear what impact the coronavirus has had on the release of final regulations.

Until additional guidance is developed, companies evaluating payments to resolve government investigations and litigation should consider the following four questions.

- Does Section 162(f) apply to a payment?
- Is the payment for restitution or remediation, or to come into compliance with a law?
- Is the establishment requirement satisfied?
- Is the identification requirement satisfied?

If the answer to question one is yes, companies may not deduct the payment unless the restitution exception applies and the establishment and identification requirements are satisfied. The restitution exception applies if the payment is restitution or remediation, or is made to come into compliance with a law; the establishment requirement is met; and the identification requirement is met.

1. Does Section 162(f) apply?

Section 162(f)(1) applies to any amount (1) paid or incurred, whether by suit, investigation or otherwise; (2) to, or at the direction of, a government or governmental entity;[6] and (3) in relation to violation of law or an investigation or inquiry into a potential violation of law. If these three things are true, a company cannot deduct the payment unless the restitution exception applies.

A critical issue for environmental lawyers, which the proposed regulations leave open, is what constitutes a violation of law. Just because the EPA or a state or local agency brings an environmental enforcement against a company does not mean the company itself violated the law or caused environmental harm.

For example, under the Comprehensive Environmental Response, Compensation and Liability Act, or CERCLA, a taxpayer may be responsible for cleaning up harm that it did not cause. In 2018, the EPA requested that the IRS provide guidance that Section 162(f) "does not apply to the majority of settlements relating to [CERCLA]."[7]

The EPA explained that "CERCLA is a remedial statute under which liability generally does not depend on a violation of law."[8] Despite the EPA's request, the proposed regulations do not address whether Section 162(f) applies to remedial statutes like CERCLA.

Until further guidance is available on the treatment of payments in CERCLA litigation, whether from the IRS or the courts, environmental lawyers will need to be vigilant in negotiating settlements and court

orders to ensure that these documents contain the right magic words to qualify their payments for deduction under Section 162(f). They should consult with their tax advisors when drafting and negotiating these provisions.

If the answer to question one is yes, environmental lawyers need to evaluate whether they are eligible for the restitution exception, and, if so, whether they have satisfied the establishment requirement and the identification requirement.

2. Is the payment for restitution or remediation, or to come into compliance with a law?

If Section 162(f)(1) applies, taxpayers may still be able to deduct a payment made in relation to a violation of law, if the payment is restitution or remediation, or is made to come into compliance with law.

Under the proposed regulations, an amount is paid or incurred for restitution or remediation if it restores, in whole or part, the person, government or governmental entity, or property harmed by the violation or potential violation of law.[9] For example, if a company agrees to clean up a hazardous waste spill, and it costs the company $50,000, the $50,000 payment would be restitution.

A payment for the purpose of taking a specific corrective action, or providing specific property for the purpose of coming into compliance with law, is treated as an amount paid to come into compliance with a law.[10]

The proposed regulations specifically provide that the following are not restitution, remediation or payments to come into compliance with law: (1) payments to reimburse the government or government entity for investigation or litigation costs; (2) payments the taxpayer elects to pay in lieu of fine or penalty; or (3) forfeiture or disgorgement.[11]

In the proposed regulations, the IRS offers examples that illustrate the IRS's intention to narrowly define restitution. In one example, a company agrees to resolve its violation of local air pollution laws in a community by building a park for the benefit of the community.[12] Although the company may be building the park to restore the harm it caused the local community, the IRS says the company cannot deduct the costs of building the park.

Commentators have expressed concern with the IRS's narrow definition of restitution. Unless the IRS makes significant changes to the proposed regulations, there is expected to be litigation over the definition of restitution. Until the issue is resolved, environmental lawyers considering such settlements should consult with their tax advisors.

If the answer to question two is yes, a company may be able to deduct the payment if it satisfies the establishment requirement and the identification requirement.

3. Is the establishment requirement satisfied?

The proposed regulations provide that a taxpayer satisfies the establishment requirement by showing the following: (1) that the taxpayer was legally obligated to pay the amount identified as restitution or remediation, or to come into compliance with law; (2) the amount paid or incurred; and (3) the date on which the amount was paid or incurred.[13]

To meet the establishment requirement, the proposed regulations require a company to produce documentary evidence. Examples of such documentary evidence include receipts; the legal or regulatory provision related to the violation or potential violation of a law; documents issued by the government or governmental entity relating to the investigation or inquiry; documents describing how the amount to be paid was determined; and correspondence exchanged between the taxpayer and the government or governmental entity before the order or agreement became binding under applicable law.[14]

A settlement agreement or court order is insufficient evidence to meet the establishment requirement. As discussed in question four, a settlement agreement or court order must label the relevant payment as restitution, remediation or compliance.

However, under the proposed regulations, such a label is not sufficient to meet the establishment requirement. Companies must have documentary evidence in addition to the settlement agreement or court order.[15]

If the answer to question three is yes, a company may deduct the payment made in relation to the violation of law if the identification requirement is satisfied.

4. Is the identification requirement satisfied?

To qualify for the restitution exception, the settlement agreement or court order must identify the payment as restitution or as an amount paid to come into compliance with law, per Section 162(f)(2)(A)(iii). The proposed regulations provide that an order or agreement identifies a payment by (1) stating the nature of, or purpose for, each payment each taxpayer is obligated to pay, and (2) the amount of each payment.[16]

Of course, companies may not always know the exact amount of the payment when the settlement agreement is signed or court order entered — e.g., a company agrees to remediate property but does not know how much it will cost to do so. In that case, the order or agreement must (1) identify the payment as restitution or remediation, or as made to come into compliance with law; (2) describe the damage done, harm suffered or manner of noncompliance with law; and (3) describe the action required of the taxpayer (e.g., paying costs to provide services or property).[17]

Some environmental attorneys may be worried about whether the EPA, the DOJ or a state or local agency will agree to include the language required to support a deduction under Section 162(f). Historically, government agencies have been hesitant to include any tax classification language in settlement agreements.

However, because the Tax Cuts and Jobs Act of 2017 specifically required this language, and requires governments to classify and report to the IRS payments received, they will need to change this historic position of avoiding classification of payments. Early reports are that government agencies have been willing to add language to meet the identification requirement to settlement agreements and proposed court orders. In the last couple of years, the DOJ and the EPA, in particular, have entered into numerous settlement agreements that have included the Section 162(f)(2) identification language.

In addition to ensuring the agreement or order contains the necessary language, environmental attorneys should confirm with the government agency involved what information the agency will report to the IRS. When Congress revised Section 162(f), it required governments to report the amount of restitution payments agreed to or entered by court order.

The IRS has suspended the Section 6050X reporting requirement until at least Jan. 1, 2022.[18] Once the reporting requirement is in effect, companies should confirm that the government will report the agreed amount as restitution.

Conclusion

Because of the new Section 162(f)(1) and the proposed regulations, companies resolving environmental enforcement actions must consider the tax consequences before resolution of environmental enforcement actions. Otherwise, they will risk being permanently barred from deducting the related payments — which can result in significant increased taxes.

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[1] 26 USC 162(f) (before Dec. 21, 2017).

[2] Tax Cuts and Jobs Act.

[3] 26 USC 162(f)(2).

[4] 26 USC 162(f)(2)(A).

[5] Fed. Reg. Vol 85, No. 93; Prop. Reg. 1.162-21.

[6] Government is defined as any federal, state, local, foreign, Indian tribal or U.S. territory government, any agencies of those governments, nongovernmental entities that exercise self-regulatory powers in connection with a qualified board or exchange, and a nongovernmental entities that exercise self-regulatory powers as part of performing an essential governmental function. Prop. Treas. Reg. 1.162-21(f)(1).

[7] EPA Letter to Christopher Wrobel, Office of IRS Chief Counsel, dated May 17, 2018. p. 2-3.

[8] Id.

[9] Treas. Reg. §1.162-21(f)(3)(i).

[10] Treas. Reg. §1.162-21(f)(3)(ii).

[11] Treas. Reg. §1.162-21(f)(3)(iii)(A)-(C).

[12] Treas. Reg. §1.1162-21(g)(3).

[13] Treas. Reg. §1.162-21(b)(3)(i).

[14] Treas. Reg. §1.162-21(b)(3)(ii).

[15] Treas. Reg. §1.162-21(b)(3)(i).

[16] Treas. Reg. §1.162-21(b)(2)(ii).

[17] Treas. Reg. §1.162-21(b)(2)(iii).

[18] Treas. Reg. §1.6050X-1(h).