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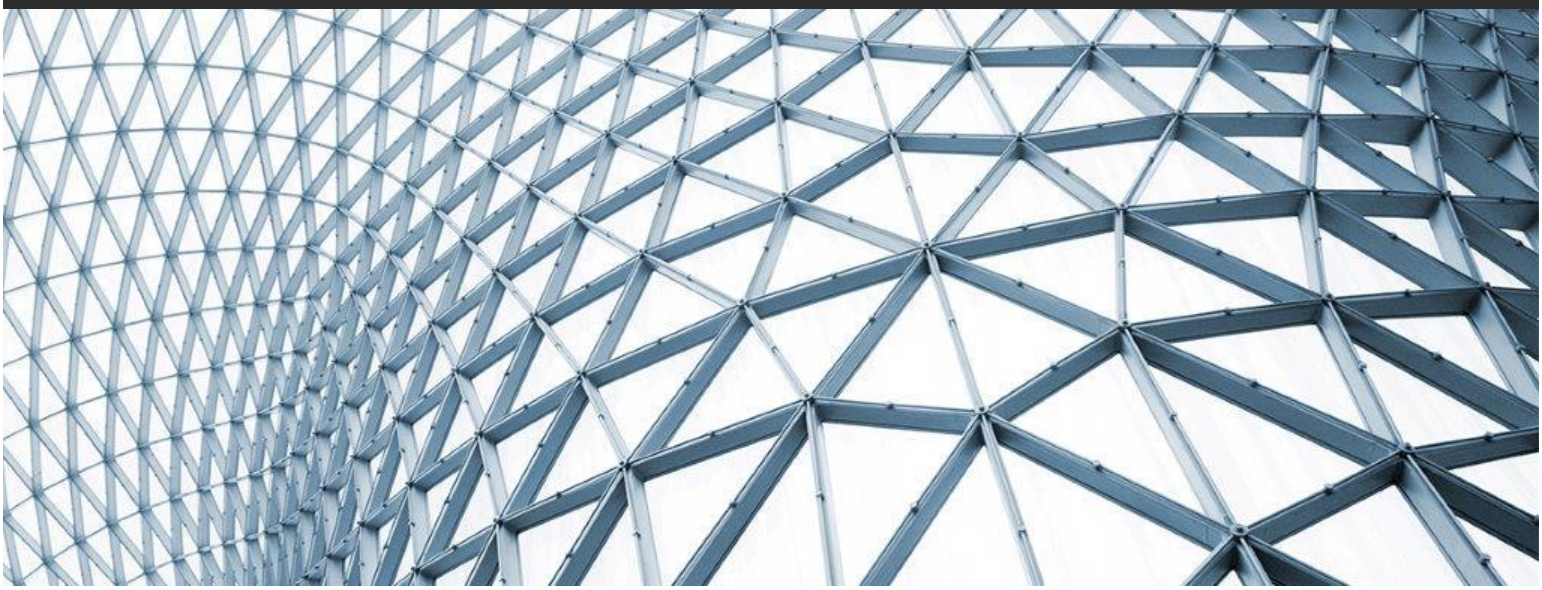
The Taxman (May Not) Cometh: The Deductibility of Environmental 'Penalties'



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Section 162 of the Tax Code allows businesses to deduct "necessary and ordinary" business expenses. But subsection (f) had long forbidden the deduction of "any fine or similar penalty paid to a government for the violation of any law." While that language seems straightforward, courts and the IRS had issued several seemingly conflicting rulings and directives on the provision, necessitating a fine-grained analysis

of whether consent decree payments were truly punitive (and hence nondeductible) or compensatory or remedial.

The TCJA changed Section 162(f) significantly. While maintaining a general prohibition on deducting amounts paid "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," the section now specifically excludes from that prohibition any amount that constitutes restitution or compliance costs—so long as the amounts are so identified in the court order or settlement agreement.

Recognizing the new provision as a departure, the IRS issued transitional guidance in a recent **IRS Bulletin (2018-15)**. Referencing the express statutory language in 162(f)(2)(A), the IRS wrote that taxpayers seeking to deduct certain payments must not only show that the payments are identified in a court order or settlement agreement as constituting restitution or compliance, but also establish that the payments are entitled to that treatment.

In other words, a mere recital in an order or decree is insufficient to transmogrify a payment into an eligible deduction; instead, the taxpayer must show that the payment was made to provide restitution or to bring the regulated entity into compliance. While the statute does not define the term restitution, it specifically states that the term includes, at a minimum, the remediation of property, see Section 162(f)(2)(A)(i)(I). Notably, however, the term does not include investigation or litigation costs paid by the defendant; those costs are expressly not deductible.

The IRS intends to issue regulations implementing revised Section 162(f) and has asked specifically for public comment on how to "define key terms" in that section. Comments are due to the service by May 18. Regulated entities may want to consider submitting comments, either individually or as part of a trade association, to ensure maximum deductibility of these expenses.

In the meantime, companies currently engaged in settlement negotiations with local, state or federal regulators should seek, wherever possible, to include language that describes payments as a form of restitution or compliance costs. Given the IRS's transitional guidance requiring taxpayers to "establish" an

independent basis for any court order or settlement language, it is important to parse statutory penalty provisions for language supporting claims that payments are in the form of restitution or compliance.

This is particularly important in cases where the settlement agreement requires a defendant to pay monies to third parties as injunctive relief. While an attorney general directive issued last year, **Prohibition on Settlement Payments to Third Parties** (June 5, 2017), has dampened DOJ enthusiasm for these payments, they continue to play a vital role in enforcement settlements—particularly in high-profile, big-penalty matters. Indeed, language from the directive may assist companies in establishing that such third-party payments constitute restitution and are, therefore, deductible under the new Section 162(f).

While the directive generally prohibits third-party payments, it provides three exceptions to the prohibition: a "lawful payment or loan that provides restitution to a victim or that otherwise directly remedies the harm that is sought to be redressed, including, for example, harm to the environment or from official corruption"; "payments for legal or other professional services rendered in connection with the case"; and "payments expressly authorized by statute, including restitution and forfeiture." While the IRS has yet to promulgate final regulations under the TCJA, third-party payments falling within these three exceptions would seem to meet any reasonable definition of restitution, as envisioned by Section 162(f).

For local context, the Pennsylvania Department of Environmental Protection (PADEP) has published a **form Consent Assessment of Civil Penalty (CACP) and Consent Order and Agreement (COA)**. These form documents invoke PADEP's administrative enforcement authority.

Notably, neither form document contains language that appears, at first blush, to satisfy the deductibility requirements of Section 162. This may reflect limitations on PADEP and the Environmental Hearing Board's injunctive authority under the applicable Pennsylvania statutes. Nevertheless, the form COA references various compliance tasks the defendant is to undertake.

While no sum of money is specifically identified with those tasks, compliance costs are presumptively deductible. Depending on the regulations the IRS promulgates to implement the TCJA, Pennsylvania

practitioners may want to engage PADEP regulators to ensure inclusion of order and settlement language that maximizes legitimate deductions.

The ability to deduct payments required in environmental enforcement settlements has a huge effect on a company's bottom line. This, in turn, greatly affects the company's settlement posture. A payment that might otherwise seem too rich may seem more reasonable if it can be deducted as a business expense. Companies should thus continue to consult closely with their litigation and tax counsel throughout settlement negotiations.

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