Crowell

CLIENT ALERT

Tax Reform Impacts Governmental Environmental Enforcement

April 11, 2018

The 2017 Tax Cuts and Jobs Act (TCJA) has made it more difficult for companies facing environmental enforcement to deduct payments to the government. The TCJA narrowed the scope of deductible payments and, for certain eligible payments (*e.g.*, property remediation expenses or compliance costs), requires that specific language be included in settlements and court orders for those payments to be deductible. Given that environmental attorneys regularly negotiate enforcement and compliance agreements for their clients with environmental agencies at all levels of government, these changes may have a significant impact on settlement negotiations at cleanup sites across the country.

The prior law

Although a company generally is allowed to deduct the expenses it incurs in its trade or business, section 162(f) of the Tax Code[1] has historically barred companies from deducting any "fines or penalties" paid to a government for the violation of any law. Under old section 162(f), determining whether a payment was deductible depended on whether the payment was punitive (*e.g.*, a fine or penalty) or compensatory. Compensatory payments (*e.g.*, remediation expenses) were deductible, but the law did not require the parties to specify in a settlement agreement or consent order whether a particular payment was punitive or compensatory. This, of course, led to numerous disputes with the IRS about whether a payment was punitive or compensatory.

Tax reform: narrowing the scope of deductible payments

New section 162(f) is more restrictive. It generally prohibits the deduction of payments made to a government or at a government's direction to resolve a violation or potential violation of any law. A "government" includes any federal, state, or local government or governmental entity and, in some circumstances, now includes certain nongovernmental entities.

There are three exceptions to the general prohibition: (1) amounts constituting restitution (including remediation of property) or paid to come into compliance with the violated or potentially violated law, (2) amounts paid or incurred pursuant to court orders in cases in which no government was a party, and (3) amounts paid or incurred as taxes due. An amount constitutes "restitution" if it is for damage or harm that was or may have been caused by the violation of any law or the potential violation of any law. Restitution or compliance payments do not include any payments to reimburse the government for investigation or litigation costs.

"Restitution" or "compliance" label necessary but not sufficient

In an important change from the prior law, to be eligible for new section 162(f)'s restitution or compliance payment exception, a payment must be identified as "restitution" or a "compliance payment" in the relevant court order or settlement agreement. If

the court does not identify a payment as restitution or a compliance payment in its order, or the parties do not so identify a payment in their settlement agreement the payment will not be deductible under new section 162(f).

Although identifying the payment as "restitution" or a "compliance payment" is necessary, it is not sufficient to ensure deductibility. Regardless of the designation, the taxpayer still must show that the payment was restitution or for the purpose of coming into compliance with the law.

New governmental reporting obligation

The TCJA also imposes a new reporting requirement on the governmental entity. Under Code section 6050X, if the government entity receives a payment exceeding $600 pursuant to a court order or settlement agreement, it must report the amount to the IRS and the taxpayer. The report also must separately identify any amounts that are for restitution, remediation of property, or correction of noncompliance. On March 27, 2018, the IRS issued a Notice that suspended this reporting requirement until at least January 1, 2019. The IRS Notice stated that governmental officials requested more time to comply with the new reporting requirement and that the IRS needed additional time to make administrative changes to implement section 6050X.

Conclusion

Companies making restitution or compliance payments should be sure to include in their settlement agreements, and if possible have courts include in their orders, appropriate language characterizing payments for purposes of section 162(f). That language should specifically refer to section 162(f) and identify the payments as "restitution" or "compliance payments." Because this language is necessary but not sufficient to defend a deduction under new section 162(f), companies should also compile other evidence that such payments are for restitution or to come into compliance with legal obligations.

---

[1] Internal Revenue Code of 1986, as amended.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

Peter C. Condron
Partner – Washington, D.C.
Phone: +1.202.624.2558
Email: pcondron@crowell.com

Monty Cooper
Counsel – Washington, D.C.
Phone: +1.202.624.2617
Email: mcooper@crowell.com