Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

# Developments In Environmental Enforcement Since TCJA

By **Peter Condron, Monty Cooper and Teresa Abney** (July 24, 2018, 7:39 PM EDT)

Peter Condron

Monty Cooper

Teresa Abney

The 2017 Tax Cuts and Jobs Act has made it more difficult for companies facing environmental enforcement to deduct payments to the government. The TCJA imposes new hurdles on companies seeking to deduct those 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. The Internal Revenue Service is in the process of drafting regulations instructing taxpayers and governmental agencies on how to comply with the new identification requirement.

Environmental and tax attorneys need to keep these changes in mind while negotiating enforcement and compliance agreements for their clients with environmental agencies at all levels of government.

This article will discuss (1) the prior law governing environmental enforcement payments, (2) the new requirements under TCJA, (3) the IRS' rulemaking and public comments on that rulemaking and (4) how the U.S. Environmental Protection Agency and the U.S. Department of Justice are responding to the new law in current enforcement actions.

**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 Internal Revenue Code, 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. The law did not require the parties to specify in a settlement agreement or consent order whether a particular payment was punitive or compensatory. The lack of identification of type of payment, of course, led to numerous disputes between taxpayers and the IRS about whether a payment was punitive or compensatory.

**Tax Reform: Restricting 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 by itself 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 Revenue 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 Jan. 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.

**IRS Request for Comments**

In April, the U.S. Department of Treasury and the IRS announced that they planned to issue proposed regulations implementing the new Section 162(f). To assist in the development of these rules, the IRS asked interested parties to offer comments on several important issues, including the threshold amount for reporting under the governmental reporting requirement, any anticipated administrative difficulties in securing information needed to report the amount and how to define key terms under the statute.

Several entities — including the EPA, the DOJ, the New York City Law Department, the National Association of Chain Drug Stores (NACDS), the Retail Industry Leaders Association (RILA) and the America's Health Insurance Plans (AHIP) — sent letters in response to the IRS's request. For example, in

its comments, the EPA urged the IRS not to require government agencies to report the value of settlements — i.e., a specific dollar figure. Instead, the EPA advocated having any new rule shift the reporting burden to the company altogether or allow agencies to identify specific provisions in the agreement that describe the performance meant to constitute restitution or compliance — e.g., remediation of property or installation of a pollution-control technology. As the EPA explained in its letter, the EPA and similar agencies generally do not know and cannot verify the total amount that a company will spend to remediate property or achieve compliance, even after the case concludes. Also, the EPA suggested that the new law should not apply to the majority of settlements relating to the Comprehensive Environmental Response, Compensation and Liability Act. CERCLA, the EPA explained, is a remedial statute under which liability generally does not depend on a violation of law. Because Section 162(f) applies "to the violation of any law," the new law does not seem to apply in the CERCLA settlement context.

In its letter, the DOJ, among other things, added that the $600 reportable amount was too low and should be raised to $10 million. The DOJ contended that such a small threshold would make the reporting obligation burdensome to federal and state agencies. The larger amount, said the DOJ, appropriately reflected the more significant matters that the department handled. Likewise, in its letter, the New York City Law Department agreed with the DOJ that the payment threshold was too low, adding that in fiscal year 2017 alone, New York City received over 130,000 payments of $600 or more. Thus, as the DOJ stated, it would be extremely burdensome for the city, with its limited resources, to collect and report the required information for such a large number of payments.

Finally, although the statute states that "restitution" can include property remediation, NACDS, RILA and AHIP noted that the statute does not define restitution, despite the fact that deductibility here hinges on the term. As a result, the IRS should define the term in the regulations. These organizations suggested that the IRS define restitution to include, among other things, awards measured by the enrichment of the defendant. Defining restitution in this way — based on the defendant's gains, as opposed to the government's losses — would be consistent with the law's requirements for deductibility in that a defendant can independently establish the amount that it was enriched as a result of any alleged legal violations. By contrast, a defendant would not necessarily be able to independently establish the amount that the governmental entity was harmed because the entity would control such information. In sum, clarity as to what restitution means here would be helpful to all.

**DOJ and EPA in Action: How They are Complying with the Identification Requirement**

On May 25, the DOJ filed what appears to be the first consent decree with Section 162(f)'s identification language. In United States, et al. v. Columbian Chemicals Company, the U.S. and state agencies from Louisiana and Kansas alleged Clean Air Act violations against a carbon-black producer. The parties reached a settlement that required the company to install state-of-the-art pollution controls estimated to cost $100 million, pay civil penalties of $650,000 and perform environmental remediation projects valued at $375,000.

The parties filed the consent decree for the court's approval on Dec. 22, 2017, — the same day that President Donald Trump signed the TCJA into law. Under the new law, the company would not be able to deduct the cost of installing the controls because the decree did not identify the payments as restitution or compliance payments under Section 162(f). On May 25, the DOJ filed an unopposed motion to enter a revised consent decree. The DOJ stated that the revised consent decree was identical to the original decree except that it added language complying with Section 162(f)'s identification requirement. The DOJ explained that the addition of this language did not change the substance of the consent decree.

The consent decree states that:

"For purposes of the identification requirement of Section 162(f)(2)(A)(ii) of the Internal Revenue Code, 26 U.S.C. § 162(f)(2)(A)(ii), performance of [various paragraphs in the consent decree and appendices] is restitution or required to come into compliance with law."

The consent decree does not identify the specific amount of the restitution payments or compliance payments.

In United States, et al. v. Exxon Mobil Corp. & ExxonMobil Oil Corp., on June 6, 2018, the DOJ requested that a U.S. District Court in Texas approve its consent decree. There, the EPA and the Louisiana Department of Environmental Quality filed an action against Exxon alleging violations of the Clean Air Act. Pursuant to the terms of the consent decree, Exxon agreed to compliance requirements that were estimated to cost approximately $300 million. The Exxon consent decree contains the same language as in the Columbian Chemicals Company consent decree — except for the citations to the specific paragraphs in each consent decree. Like the Columbian Chemicals Company consent decree, the Exxon consent decree does not identify the specific amount of the restitution payments or compliance payments. The court granted the government's request the same day it was filed and entered the consent decree as final.

**Modified Consent Decree: Unclear How Estimated Amounts Will be Reported to the IRS**

The lack of a specific amount in the Columbian Chemicals Company and Exxon consent decrees illustrates one of the issues with the new law: How are estimated amounts reported to the IRS? For example, as mentioned, the government must file an information return with the IRS for payments above $600 and separately report the amounts that the taxpayer paid for restitution,

The DOJ did not have to file an information return with respect to the Columbian Chemicals Company and Exxon settlements because the IRS has temporarily suspended the filing requirement until at least Jan. 1, 2019. If the reporting requirement had not been suspended, it is unclear what amounts the DOJ would report to the IRS or the tax consequence if Columbian Chemicals Company or Exxon ultimately pay a different amount than reported. For Columbian Chemicals Company, would the DOJ report the estimated amount of $100 million? If the DOJ reports $100 million but Columbian Chemicals Company pays $110 million to install the pollution controls, is it limited to a deduction of $100 million? The IRS will hopefully answer these questions in the upcoming regulations. Depending on these rules, taxpayers should have agreements with the DOJ that it will amend any information returns in the event the payment exceeds the estimated amount.

**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.

Companies will need to pay attention as the IRS proposes and finalizes the new Section 162(f) regulations,

specifically with respect to the identification and reporting requirements and for definitions for terms like restitution. In the meantime, based on the revised consent decrees in Columbian Chemicals Company and Exxon, it appears that the DOJ and the EPA are willing to work with companies to include Section 162(f)'s identification requirement.

---

*Peter Condron is a partner at Crowell & Moring LLP.*

*Monty Cooper is counsel at Crowell & Moring LLP.*

*Teresa Abney is an associate at Crowell & Moring LLP.*