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Monetary Consequences of Environmental Regulations: Costs of Doing Business or Non-Deductible Penalties or Fines?

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MONETARY CONSEQUENCES OF ENVIRONMENTAL REGULATIONS: COSTS OF DOING BUSINESS OR NON-DEDUCTIBLE PENALTIES OR FINES?

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I. INTRODUCTION

The cost of doing business in the United States has increased significantly with the advent of environmental protection laws and regulations. Federal, state, and local governments are continually strengthening the laws and regulations that protect the environment.¹ For example, a Washington Post article from 2013 reported that in the prior year “[t]he federal government imposed an estimated \$216 billion in regulatory costs on the economy”² The article further noted that three-fourths of those costs were driven by two environmental rules that set new fuel economy standards for cars and trucks, and limited mercury emissions from power plants fueled by coal and oil.³ Environmental regulators and advocacy groups publicize numerous benefits of environmental regulations.⁴ Regardless, the cost-burden of compliance rests on the business community. For instance, the U.S. Environmental Protection Agency (“EPA”) has promulgated extensive rules for mitigating wetland impacts.⁵ These mitigation requirements result in significant costs to real estate developers. Yet, that is only a snapshot of the compliance side

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1. *See generally* Clean Water Act, 33 U.S.C. §§ 1251–1275 (2018) (codifying laws to prevent water pollution); Resource Conservation and Recovery Act, 42 U.S.C. §§ 6901–6908 (2018) (governing federal law relating to safe disposal of solid waste); Clean Air Act, 42 U.S.C. §§ 7401–7431 (2018) (controlling air quality); Comprehensive Environmental Response, Compensation, and Liability Act, 42 U.S.C. §§ 9601–9675 (2018) (regulating cleanup sites where hazardous material was spilled).

2. Jim Tankersley, *New Regulations Cost \$216B and 87 Million Hours of Paperwork. What Do They Reap?*, WASH. POST (Jan. 14, 2013), https://www.washingtonpost.com/news/wonk/wp/2013/01/14/report-new-regulations-cost-216-billion-and-87-million-hours-of-paperwork/?utm_term=.b1f6a31f0016.

3. *See id.*

4. *See id.* (noting government calculations that demonstrate “lives saved and improvements in public health”).

5. *See generally* 40 C.F.R. §§ 230.91–230.98 (2008) (detailing the EPA’s purpose and general duties).

of the equation.

Businesses not meeting the requirements of environmental laws and regulations are liable for damages to the impacted natural resources and are increasingly being assessed larger penalties and fines. The government seeking indemnification from the alleged violator for Natural Resource Damages (“NRD”) is one potential consequence of non-compliance.⁶ Several laws establish the authority of Natural Resource Trustees⁷ to negotiate with Potentially Responsible Parties (“PRP”) to obtain PRP-financed or PRP-conducted assessment and restoration of a natural resource injury, to sue PRPs for the costs of assessing and restoring the natural resource, or to conduct the assessment themselves and seek reimbursement from the PRPs.⁸

Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (“CERCLA”) is the leading federal law governing NRD compliance.⁹ CERCLA does not provide an express standard for measuring NRD but defines the term “damages” as “damages [payable in money] for injury or loss of natural resources”¹⁰ The regulations provide that the measure of damages is the cost of restoring injured resources to their baseline condition, compensation for the interim loss of injured resources pending recovery, and the reasonable cost of a damage assessment.¹¹ While not defining the measure of damages, CERCLA provides that “the measure of damages . . . shall not be limited by the sums which can be used to restore or

6. See 42 U.S.C. § 9613(g)(5) (“[A]n action under section 9607 of this title for recovery of such indemnification payment from a potentially responsible party may be brought at any time before the expiration of 3 years from the date on which such payment is made.”).

7. See *id.* § 9604(b)(2).

8. See 33 U.S.C. § 1268(a)(3)(L) (2018) (defining “responsible party” as “an individual or entity that may be liable under any Federal or State authority that is being used or may be used to facilitate the cleanup and protection of the Great Lakes”); 42 U.S.C. § 9622(c)(1) (describing conditions for when a potentially responsible party is liable); *id.* § 9601 (stating objective to provide redress for environmental claims); 33 U.S.C. § 1251 (attempting to restore and maintain the chemical, physical, and biological integrity of the nation’s waters); Oil Pollution Liability and Compensation Act, 33 U.S.C. § 2701 (2018) (providing redress for oil-related environmental claims).

9. 42 U.S.C. §§ 9601–9628.

10. *Id.* § 9601(6); see also *id.* § 9607(a) (defining covered persons, scope, recoverable costs and damages, interest rate; and comparable maturity date); *id.* § 9611(b)(2) (defining limitations on payment for natural resource claims and peripheral matters).

11. 43 C.F.R. § 11.15 (2018); see 15 C.F.R. § 990.52 (2018) (emphasizing that “trustees must quantify the degree, and spatial and temporal extent of such injuries relative to baseline”); 33 U.S.C. § 2706(d) (highlighting that the “measure of natural resource damages” includes “the cost of restoring . . . or acquiring the equivalent [resource], . . . the diminution in value,” and the reasonable cost of assessment).

replace such resources.”¹² Trustees may also recover the “reasonable costs” of assessing natural resource damages and any prejudgment interest.¹³ Thus, at a minimum, a trustee may seek to recover the costs of restoration, replacement, or acquiring the equivalent of the affected resource, the lost use and non-use values of the natural resource from the time of the injury until restoration, and the reasonable costs of assessing damages.¹⁴

In light of the current regulatory climate, this Article analyzes the federal income tax consequences to businesses for compliance, or non-compliance, with environmental regulation. A threshold question is whether the cost or expense of complying with environmental regulations or resolving alleged violations is considered a cost of doing business, restoration of damage, or a penalty or fine. To frame the analysis, it is helpful to begin by discussing the various categories of environmental regulatory costs that are commonly imputed on businesses.

II. CATEGORIES OF ENVIRONMENTAL REGULATORY COSTS

A. Environmental Permits

There may be significant costs associated with preparing and submitting applications for environmental permits. This often includes the need to engage a variety of experts such as engineers, botanists, toxicologists, fish and wildlife experts, hydrologists, geologists, hydrogeologists, and wetlands experts. The permit application process may require responding to requests for additional information from the regulatory authority and engaging in a lengthy negotiation process that ultimately leads to the issuance or denial of a permit. For example, on the federal level, the National Pollutant Discharge Elimination System (“NPDES”),¹⁵ within the Clean Water Act (“CWA”), requires a permit prior to the discharge of pollutants from a point source into

12. 42 U.S.C. § 9607(f)(1); *see* *United States v. Alcan Aluminum Corp.*, 990 F.2d 711, 722 (2d Cir. 1993) (reasoning that a defendant may escape liability for money damages “if it either succeeds in proving” that its conduct “did not contribute to the release” and subsequent damages, or that it contributed “only a divisible portion of the harm” at most); *see also* *New York v. Lashins Arcade Co.*, 881 F. Supp. 101, 102–03 (S.D.N.Y. 1995) (explaining that the Act’s minutely limited liability is “essentially tortious in nature” because a defendant establishes a defense by proving, “by a preponderance of the evidence,” that a third party’s act or omission, other than an employee or agent, caused “the release or threat of release of a hazardous substance” and its subsequent damages).

13. 33 U.S.C. § 2706(d).

14. *Id.*

15. 33 U.S.C. § 1342(a) (2018).

waters of the United States.¹⁶ An NPDES permit imposes limits on the composition of the discharge, monitoring and reporting requirements, and other provisions to protect water quality and human health.¹⁷ According to the EPA, “the permit translates general requirements of the Clean Water Act into specific provisions tailored to the operations of each person discharging pollutants.”¹⁸ The EPA has implemented NPDES permitting through its regulatory program.¹⁹ The CWA also provides for delegation to the states.²⁰

If the agency denies the permit, the applicant may then challenge the denial in an administrative hearing and, subsequently, in an appellate court.²¹ Litigating a permit denial greatly increases the cost to the applicant.²² For instance, in Florida, an applicant who is denied a permit may file a petition for a formal administrative hearing.²³ Proceeding through the administrative process is usually required prior to seeking redress in court due to the Doctrine of Exhaustion of Administrative Remedies.²⁴ The U.S. Supreme Court has addressed this long-established judicial doctrine, stating that it assures that “no one is entitled to judicial relief for a supposed threat or injury

16. *See id.* § 1342(f) (stating that administrator shall establish categories of point sources).

17. *Id.* § 1342(o)(2)(4).

18. *NPDES Permit Basics*, U.S. EPA, <https://www.epa.gov/npdes/npdes-permit-basics> (last visited May 20, 2020) (defining an NPDES permit).

19. 40 C.F.R. § 122.1(a) (2018).

20. *See* 33 U.S.C. § 1342(b).

21. *See, e.g.*, FLA. STAT. ANN. § 120.68 (West 2019); *see also id.* § 120.569.

22. *See id.* § 120.569.

23. *See id.*

24. *See Fla. Dep’t of Agric. & Consumer Servs. v. City of Pompano Beach*, 792 So. 2d 539, 545 (Fla. Dist. Ct. App. 2001) (noting that the limited exceptions to the exhaustion doctrine include: (1) no adequate administrative remedy exists; (2) an agency is acting without authority and clearly in excess of its legislatively delegated powers; or (3) to invoke the power of the circuit court to decide constitutional issues). Additionally, it should be noted that certain statutes may provide an exception to the general rule. For instance, section 72.011(1)(a) of the Florida Statutes provides, in part: “A taxpayer may contest the legality of any assessment or denial of refund of tax, fee, surcharge, permit, interest, or penalty provided for under . . . [certain specified sections of the Florida Statutes] . . . by filing an action in circuit court; or, alternatively, the taxpayer may file a petition under the applicable provisions of [Ch.] 120.” FLA. STAT. § 72.011(1)(a) (2019); *see also JES Publ’g Corp. v. Fla. Dep’t of Revenue*, 730 So. 2d 854, 855 (Fla. Dist. Ct. App. 1999) (holding that JES had the option to file in circuit court or request an evidentiary hearing from the DOR to prove additional facts needed for its argument regarding a tax issue); FLA. STAT. ANN. §§120.569(1), 120.68; *id.* §373.114 (regarding appeals to the Florida Land and Water Adjudicatory Commission); FLA. R. APP. P. 9.110 (2019) (outlining the applicability of the rule to administrative actions, orders of review for a new trial, and appellate jurisdiction).

until the prescribed administrative remedy has been exhausted.”²⁵ The state of Texas has codified the concept.²⁶ Disappointed permit applicants often find the process exhausting.

B. Wetland Mitigation

If a real estate development plan displaces wetlands, mitigation becomes a part of the environmental permit negotiation process.²⁷ Mitigation may be accomplished by creating a new wetland from uplands, enhancing an existing wetland, or preserving an existing wetland through the use of instruments such as a conservation easement.²⁸ The mitigation may be accomplished offsite and could result in additional costs.²⁹ A regulatory agency may insist on a ratio of wetlands created, enhanced, or preserved to compensate for impacted wetlands;³⁰ such that it is cost-prohibitive, and the development may no longer be financially feasible. At a minimum, the process of obtaining approval of a mitigation plan can be costly and complicated.³¹

C. Enforcement

Whether intentionally or inadvertently, a real estate developer may start construction without a permit in violation of environmental laws or regulations. In this scenario, mitigation comes into the picture from the perspective of restoring damage to the environment. The negotiation process is similar to that of permitting, except that the regulatory agency may seek a higher ratio of created, enhanced, or preserved wetlands.³² Generally, when

25. *Myers v. Bethlehem Shipbuilding Corp.*, 303 U.S. 41, 50–52 (1938) (holding that the district court could not enjoin the NLRB from holding a hearing regarding a union complaint alleging unfair labor practices).

26. *See* TEX. GOV'T CODE ANN. § 2001.171 (West 2019) (“A person who has exhausted all administrative remedies available within a state agency and who is aggrieved by a final decision in a contested case is entitled to judicial review under this chapter.”).

27. 40 C.F.R. §§ 230.91, 230.92 (2019).

28. *See id.* § 230.93(c)(2)(iv).

29. *See id.* § 230.93(b)(6).

30. *Id.*

31. *See* FLA. ADMIN. CODE ANN. R. 62–345.100(1) (2016) (detailing the requirements for mitigation proposals).

32. *Compare* 40 C.F.R. § 230.93 (stating compensatory mitigation may be performed using “methods of restoration, enhancement, establishment, and, in certain circumstances, preservation”), *with* FLA. STAT. ANN. §373.414(18) (West 2019) (requiring the establishment of a uniform mitigation assessment method “to determine the amount of mitigation needed to offset adverse impacts to wetlands and other surface waters and to award and deduct mitigation bank credits”).

it comes to violations of environmental laws, the greater the environmental harm and deviation from the regulatory requirements, the larger the penalty that may be assessed.³³

D. Natural Resource Damages

In cases involving NRD, the government is seeking indemnification from the alleged violator for damage to the natural resources.³⁴ Several U.S. federal environmental laws establish the authority of Natural Resource Trustees to negotiate with PRPs to obtain PRP-financed or PRP-conducted assessment and restoration of a natural resource injury, to sue PRPs for the costs of assessing and restoring the natural resource, or to conduct the assessment themselves and seek reimbursement from the PRPs.³⁵

E. Penalties and Fines

i. Consent Orders and Consent Decrees

When a respondent reaches an agreement with the regulatory agency to resolve an alleged violation, the settlement agreement is embodied in a Consent Order or a Consent Decree.³⁶ A Consent Order is an administrative order executed by both the enforcement agency and the respondent.³⁷ A Consent Decree is similar except that it is a judicial order approving the settlement.³⁸ For example, in August 2018, Southern California Gas Company agreed to a \$119.5 million settlement for the Aliso Canyon methane leak.³⁹ At that time, it was the biggest action that dealt with the

33. See Comprehensive Environmental Response, Compensation, and Liability Act, 42 U.S.C. § 9609(a)(3) (2018).

34. See *id.* § 9607 (“[L]iability shall be to the United States Government and to any State for natural resources within the State or belonging to, managed by, controlled by, or appertaining to such State”); 33 U.S.C. § 1321(f)(5) (2018) (“The President, or the authorized representative of any State, shall act on behalf of the public as trustee of the natural resources to recover for the costs of replacing or restoring such resources.”); Oil Pollution Liability and Compensation Act, 33 U.S.C. § 2702(a) (2018) (“[E]ach party responsible . . . is liable for the removal costs and damages specified . . . that result from such incident.”).

35. 42 U.S.C. § 9607(f)(1); 33 U.S.C. § 1321(f)(5); 33 U.S.C. § 2702(a).

36. See 40 C.F.R. § 209.19 (2019); FLA. ADMIN. CODE ANN. R. 40E-1.711(2).

37. See 40 C.F.R. § 209.19(b).

38. GOVERNMENT INSTITUTES, ENVIRONMENTAL LAW HANDBOOK 589 (Thomas F. P. Sullivan ed., 21st ed., 2011) (“The difference between the two forms of agreement is that a consent decree is filed with and signed by a federal court, while a consent order does not involve any judicial action.”).

39. See Tony Barboza, *SoCal Gas Agrees to \$119.5-Million Settlement for Aliso Canyon Methane Leak – Biggest in U.S. History*, L.A. TIMES (Aug. 8, 2018, 9:50 AM),

health effects and climate damage of the largest release of methane in U.S. history.⁴⁰

ii. Final Orders and Judgments

While a vast majority of enforcement cases are settled, some are litigated, resulting in a final order of an agency or a judgment of a court.⁴¹ These orders and judgments are imposed rather than mutually agreed upon.⁴² For example, on April 1, 2019, the North Carolina Department of Environmental Quality ordered Duke Energy Progress, LLC, to excavate all remaining coal ash impoundments in the state.⁴³ Cleanup costs are estimated to be in excess of \$10 billion.⁴⁴

iii. Fines

Criminal prosecution of an alleged environmental violation may result in the imposition of a fine.⁴⁵ The main difference between penalties and fines is that penalties are generally administrative or civil in nature, while fines typically result from criminal prosecutions.⁴⁶ In September 2018, “[a] pipeline company was convicted of nine criminal charges . . . for causing the worst California coastal spill in twenty-five years, a disaster that blackened

<https://www.latimes.com/local/lanow/la-me-aliso-canyon-settlement-20180808-story.html> (detailing an agreement between California officials and Southern California Gas Company resolving state agencies’ lawsuits against the utility company for releasing over 109,000 metric tons of methane at its Aliso Canyon, California facility).

40. *See id.* (describing the agreement’s terms, which include millions of dollars allocated to funding a long-term community health study and various environmental projects to offset the methane leak’s effect on global warming).

41. *See generally* FLA. STAT. ANN. § 120.69 (West 2019) (providing avenue for agency enforcement in court).

42. *See id.*

43. *See* Press Release, N.C. Dep’t of Envtl. Quality, DEQ Orders Duke Energy to Excavate Coal Ash at Six Remaining Sites (Apr. 1, 2019), <https://deq.nc.gov/news/press-releases/2019/04/01/deq-orders-duke-energy-excavate-coal-ash-six-remaining-sites> (determining that North Carolina environmental law requires coal company to excavate coal ash at all six sites in the state and dispose of it in a lined landfill).

44. *See* Bruce Henderson, *NC Orders Duke Energy to Dig Up Millions of Tons of Coal Ash at Six Power Plants*, THE CHARLOTTE OBSERVER (Apr. 1, 2019, 9:17 PM), <https://www.charlotteobserver.com/news/politics-government/article228681894.html> (reporting that the excavation agreement could add an extra four to five billion dollars to previously estimated cleanup costs of almost six billion).

45. *See, e.g.*, FLA. STAT. ANN. § 403.161(3)–(6).

46. *See id.* § 403.161(6) (imposing both “civil penalties and criminal fines” for noncompliance).

popular beaches for miles, killed wildlife and hurt tourism and fishing.”⁴⁷ The jury found the pipeline company “guilty of a felony count of failing to properly maintain its pipeline and eight misdemeanor charges, including killing marine mammals and protected sea birds.”⁴⁸ The company estimated that it spent at least \$335 million in response costs and will likely face additional large penalties and fines.⁴⁹ In the British Petroleum (“BP”) Deepwater Horizon Oil Spill, BP is estimated to pay up to \$8.8 billion in natural resource damages.⁵⁰

III. ORDINARY AND NECESSARY EXPENSES

Section 162 of the Internal Revenue Code allows businesses to deduct “ordinary and necessary” business expenses.⁵¹ However, § 162(f) does not allow the deduction of “any amount paid or incurred (whether by suit, agreement, or otherwise) 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.”⁵² Additionally, the Tax Cuts and Jobs Act of 2017 (“TCJA”), contains provisions that may change the litigation and settlement calculus for companies facing environmental enforcement actions.⁵³ These provisions also apply to certain non-governmental regulatory entities (“NGRE”) that shall be treated as governmental entities for purposes of § 162.⁵⁴ In order for these provisions to apply, such entities must exercise “self-regulatory powers (including imposing sanctions) as part of performing

47. Associated Press, *Pipeline Company Found Guilty in California’s Worst Coastal Oil Spill in 25 Years*, N.Y. POST (Sept. 8, 2018, 12:00 PM), <https://nypost.com/2018/09/08/pipeline-company-found-guilty-in-californias-worst-coastal-oil-spill-in-25-years/>.

48. *Id.*

49. *Id.*

50. *Natural Resource Damage Assessment*, ENVTL. LAW INST., <http://eli-ocean.org/gulf/nrda/> (last visited Feb. 18, 2020).

51. I.R.C. § 162(a) (2018).

52. *Id.* § 162(f)(1).

53. Tax Cuts and Jobs Act (TCJA), Pub. L. No. 115–97, 131 Stat. 2054 (2017). The new additions to the tax code will have a significant impact on litigation since any environmental enforcement action related settlement agreement will now have to identify any payment as either restitution or remediation in order to receive tax favorable treatment. This change will force litigators to negotiate agreements with an eye towards the tax consequences of any agreement. It will also require litigators to raise defenses geared toward the characterization of any action addressing an environmental violation in terms of remediation and restitution.

54. I.R.C. § 162(f)(5).

an essential governmental function.”⁵⁵

A. Fines or Penalties

In order to better understand the interplay between “ordinary and necessary” expenses under § 162(a) and “fines or penalties” under § 162(f), we must examine the actual wording of the statute. 26 U.S.C. § 162 provides, in relevant part, as follows:

(a) In General. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business

(f) Fines, Penalties, and Other Amounts

(1) In General. Except as provided in the following paragraphs of this subsection, no deduction otherwise allowable shall be allowed under this chapter for any amount paid or incurred (whether by suit, agreement, or otherwise) 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 law.

(2) Exception for amounts constituting restitution or paid to come into compliance with law.

(A) In General. Paragraph (1) shall not apply to any amount that—

(i) The taxpayer establishes —

(I) constitutes restitution (including remediation of property) for damage or harm which was or may be caused by the violation of any law or the potential violation of any law, or

(II) is paid to come into compliance with any law which was violated or otherwise involved in the investigation or inquiry described in paragraph (1)

(ii) is identified as restitution or as an amount paid to come into compliance with such law, as the case may be, in the court order or settlement agreement, and . . .

(B) Limitation. Subparagraph (A) shall not apply to any amount paid or incurred as reimbursement to the government or entity for the costs of any investigation or litigation.

i. Revisions to the Exception

The main changes brought about by TCJA pertain to the exceptions to the non-deductibility of fines, penalties, and other amounts under § 162(f), which will now require express identification of a payment as remediation

55. *Id.* § 162(f)(5)(B).

or restitution,⁵⁶ and clear establishment of the payment as remediation or restitution.⁵⁷ TCJA also created 26 U.S.C. § 6050X, which requires information reporting to the Internal Revenue Service (“IRS”) by the affected governmental entity with respect to fines, penalties, and other amounts.

Prior to the enactment of TCJA, violators of environmental laws and regulations sought to characterize or structure any payments made to the government as remediation or restitution and deduct such payments as a business expense under § 162(a).⁵⁸ The issue would usually arise after the violator made the required tax payment, took the deduction under § 162(a), and then the IRS challenged the deduction and sought the deficiency from the taxpayer. In these cases, the IRS would insist that these deductions were fines or penalties and therefore not allowed under § 162(f). The taxpayer would argue that the payment was remediation or restitution and, as such, qualified under the § 162(f) exception. The argument becomes more convoluted if the person or entity made a voluntary contribution to a third party, usually an environmental non-governmental organization, such as the Sierra Club, and then sought a reduction of the penalty or fine in direct proportion to the contribution made, also taking a deduction for the contribution under § 162(a).⁵⁹

Prior to the enactment of TCJA, civil payments, although labeled “penalties,” remained deductible if imposed as a remedial measure to compensate another party⁶⁰ or if imposed to encourage prompt compliance with a requirement of the law.⁶¹ When faced with the question of whether a particular type of payment was for remediation or restitution, which could

56. *Id.* § 162(f)(2)(A)(ii).

57. *Id.* § 162(f)(2)(A)(i).

58. See *Allied-Signal, Inc. v. Comm’r*, 63 T.C.M. (CCH) 2672, 2680 (1992) (showing that the company deducted payments for environmental law violations as a necessary business expense under section 162(a)).

59. See *S & B Rest., Inc. v. Comm’r*, 73 T.C. 1226, 1233 (1980) (finding that the deductions were valid under section 162(a) because the payments were not in response to a violation or fine but an agreement to control the “quality and quantity of sewage discharges”); see also *Allied-Signal, Inc.*, 63 T.C.M. at 2681 (arguing that payments to a third-party endowment were voluntary and thus not a fine or penalty “serv[ing] to punish or deter the payer”).

60. *Huff v. Comm’r*, 80 T.C. 804, 821–22 (1983) (quoting *S. Pac. Transp. Co. v. Comm’r*, 75 T.C. 497, 652 (1980)) (illustrating that section 162(f), prior to the enactment of the TCJA, “does not preclude deductions for civil penalties which is imposed to encourage prompt compliance with a requirement of the law, or as a remedial measure to compensate another party for expenses incurred as a result of the violation”).

61. *Jenkins v. Comm’r*, 72 T.C.M. (CCH) 1470 (1996) (quoting *Huff*, 80 T.C. at 821–22).

be deductible under § 162(a), or whether the payment was a fine or penalty, and thus not deductible under § 162(f), courts had to engage in an often tedious case-by-case analysis of the facts to make that determination.

However, in light of the amendments to § 162(f), this tedious analysis may now be a moot point since, under the TCJA, a taxpayer must: (i) establish that the payment was for remediation or restitution; and (ii) must expressly and clearly identify the payment as such.⁶² Although there are no reported cases analyzing this issue, it would appear that any payment labeled a penalty in a court order or settlement agreement would not qualify for a deduction even if it was imposed as a remedial measure to compensate another party.

There are instances, however, where a payment may be both a penalty and restitution.⁶³ In these cases, the courts try to determine which purpose the payment was designed to serve.⁶⁴ However, once again, with the enactment of the amendments to § 162(f), this analysis should be a moot point going forward. The taxpayer (an alleged violator) now must clearly establish that the payment is not a penalty or a fine. If the payment is both, then § 162(f)(2)(A)(ii) requires the judgment or settlement agreement to identify the portion of the payment that is a penalty or a fine.⁶⁵ Additionally, under § 6050X, the government official involved in a suit or agreement must file a return setting forth: (i) the amount required to be paid as a result of the suit or agreement;⁶⁶ (ii) the amount required to be paid as a result of the suit or agreement which constitutes restitution or remediation of property;⁶⁷ and (iii) any amount required to be paid as a result of the suit or agreement for the purpose of coming into compliance with any law that was violated or involved in the investigation or inquiry.⁶⁸ The return must be filed at the time that the agreement is entered.⁶⁹ The appropriate official must provide the taxpayer with this information at the same time the official provides the

62. I.R.C. § 162(f)(2)(A)(i)–(ii).

63. *Waldman v. Comm’r*, 88 T.C. 1384, 1387 (1987) (requiring payment of restitution pursuant to taxpayer’s guilty plea, constituting a fine or similar penalty).

64. *Id.* (quoting *S & B Rest., Inc.*, 73 T.C. at 1232) (“Where a payment ultimately serves each of these purposes, i.e. law enforcement (nondeductible) and compensation (deductible), our task is to determine which purpose the payment was designed to serve.”).

65. I.R.C. § 162(f)(2)(A)(ii) (requiring a court order or settlement agreement to identify the amount for restitution or to be paid for a business to be in compliance with the law).

66. *Id.* § 6050X(a)(1)(A).

67. *Id.* § 6050X(a)(1)(B).

68. *Id.* § 6050X(a)(1)(C).

69. *Id.* § 6050X(a)(3).

IRS with the information required by § 6050X(a).⁷⁰ This should eliminate most, if not all, disputes as to whether a particular payment made to the government is deductible.⁷¹ The courts can look not only to the actual language in a particular judgment or court order for guidance, but also at the information return filed by the government in relation to that order or settlement.

B. Attorney General Memorandums

It is likely that the amendment to § 162(f) and the enactment of § 6050X are intended to help with public perception. In the past, many believed that allowing tax deductions for those that caused environmental damage was a subsidy for wrongdoing.⁷² This was particularly true when the wrongdoer “donated” to a third party (usually an environmental non-governmental organization) in exchange for a reduction in a penalty or imposed fine.⁷³ The wrongdoer would then deduct this “donation” as a necessary business expense under § 162(a). The changes effected by TCJA work well with a growing sentiment that settlement payments to third parties should not be used to circumvent the non-deductibility provisions of § 162(f) and that allowing the practice negatively impacts the impartial rule of law.⁷⁴

In fact, prior to the enactment of TCJA, in a memorandum dated June 5, 2017, directed to all Component Heads and United States Attorneys (“2017 Memorandum”), the Attorney General referred unfavorably to certain previous settlement agreements involving the Department of Justice (“DOJ”), which included “payments to various non-governmental, third-

70. *Id.* § 6050X(c) (“[T]he term ‘appropriate official’ means the officer or employee having control of the suit, investigation, or inquiry or the person appropriately designated for purposes of this section.”).

71. *See id.* § 162(f)(2), (5) (stating that non-governmental regulatory entities that “exercise self-regulating powers (including imposing sanctions) in connection with a qualified board or exchange” or “as part of performing an essential governmental function” will be treated as governmental agencies for the purposes of section 162(f)).

72. *See* *Tank Truck Rentals v. Comm’r*, 356 U.S. 30, 34–35 (1958) (denying a deduction that would “thwart” state policy by “encourag[ing] continued violations” and “increasing the odds in favor of noncompliance”).

73. *See, e.g.*, *S & B Rest., Inc. v. Comm’r*, 73 T.C. 1226, 1232 (1980) (holding that a company’s monthly payments to the Pennsylvania Clean Water Fund in lieu of prosecution for discharging sewage waste into an underground waterway are deductible because the payments further the Clean Streams Law policy).

74. *See* Memorandum from Jeffrey H. Wood, Acting Assistant Attorney Gen., to ENRD Section Chiefs and Deputy Section Chiefs (Mar. 12, 2018) [hereinafter Mar. 12 Memorandum], <https://www.justice.gov/enrd/page/file/1043731/download> (quoting Attorney General Jeff Sessions) (“No greater good can be done for the overall health and well-being of our Republic, than preserving and strengthening the impartial rule of law.”).

party organizations as a condition of settlement with the United States.”⁷⁵ The Attorney General took issue with the fact that the third-party organizations that were beneficiaries of the settlement agreements were neither victims nor parties to the lawsuits.⁷⁶ The 2017 Memorandum indicated that the DOJ would no longer engage in this practice.⁷⁷ The 2017 Memorandum went on to indicate that, effective immediately, DOJ attorneys could not enter into any agreement on behalf of the United States in settlement of federal claims or charges, including agreements settling civil litigation, accepting plea agreements, or deferring or declining prosecution in a criminal matter, that directed or provided for a payment or loan to any non-governmental person or entity that was not a party to the dispute.⁷⁸ However, the 2017 Memorandum did provide for three limited exceptions: (i) 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”; (ii) “payments for legal or other professional services rendered in connection with the case”; and (iii) “payments expressly authorized by statute, including restitution and forfeiture.”⁷⁹

On January 9, 2018, just after the implementation of TCJA, the acting Assistant Attorney General circulated a memorandum to Section Chiefs and Deputy Assistant Attorneys at ENRD (“ENRD Memorandum”).⁸⁰ The purpose of the ENRD Memorandum was to provide guidance concerning the application of the 2017 Memorandum, in particular as it pertained to environmental cases. The ENRD Memorandum made it clear that the Assistant Attorney General (“AAG”) must approve any provision that contains a payment to a third party under the limited exceptions set forth in the 2017 Memorandum before it becomes a part of an ENRD agreement or decree.⁸¹ The ENRD Memorandum expressly prohibited any third-party payment that could serve as an offset or otherwise allow any reduction in the civil or criminal monetary penalties.⁸²

75. Memorandum from Attorney Gen. Jeff Sessions to All Component Heads and U.S. Attorneys (June 5, 2017) [hereinafter June 5 Memorandum], <https://www.justice.gov/opa/press-release/file/971826/download>.

76. *Id.*

77. *Id.*

78. *Id.*

79. *Id.*

80. Memorandum from Jeffrey H. Wood, Acting Assistant Attorney Gen., to ENRD Deputy Assistant Attorneys Gen. and Section Chiefs (Jan. 9, 2018) [hereinafter ENRD Memorandum], <https://www.justice.gov/enrd/page/file/1043726/download>.

81. *Id.* at 1.

82. *Id.* at 2.

The ENRD Memorandum clarified one of the limited exceptions regarding payment to third parties listed in the 2017 Memorandum that allowed payments to third parties that “directly remed[y] the harm that is sought to be redressed” in the action, “including, for example, harm to the environment.”⁸³ The ENRD Memorandum suggests that in limited circumstances, studies of the environmental harm caused by the violations that are the subject matter of the underlying litigation may be included in a plan intended to remedy the environmental harm, even if the study is performed by a non-governmental third-party.⁸⁴ The ENRD Memorandum further provides that a third-party payment provision must include “specific requirements to ensure that the payment will directly remedy the harm that is sought to be redressed.”⁸⁵ The ENRD Memorandum goes on to provide examples of acceptable third-party payments.⁸⁶

The March 12, 2018, memorandum from the acting Assistant Attorney General to the Section Chiefs and Deputy Section Chiefs of the ENRD (“Priority Memorandum”) should be of interest to all environmental law practitioners.⁸⁷ The Priority Memorandum sets forth the ENRD’s enforcement principles and priorities.⁸⁸ Of interest is the first enforcement priority to which ENRD should give “particular attention and dedication of resources within the Division.”⁸⁹ That first priority is a focus on protecting clean water, clean air, and clean land.⁹⁰ The Priority Memorandum directs ENRD to “prioritize enforcement actions that provide concrete environmental benefits for clean water, clean air, and clean land.”⁹¹ Cases under this designation arise mainly under CERCLA, the Oil Pollution Act, the Resource Conservation and Recovery Act, the Clean Air Act, the Clean Water Act, and the Safe Drinking Water Act.⁹² The Priority Memorandum further provides that where referring agencies (such as the EPA) prioritize

83. *Id.* (quoting June 5 Memorandum, *supra* note 75).

84. *Id.*

85. *Id.* at 3 (“A provision stating in general terms that monies that will fund habitat improvements by a particular third-party organization do not contain sufficient specificity to ensure that the standard is met.”).

86. *See id.* at 3–5 (listing that “an appropriate third-party payment would:” (1) “directly remedy harm to affected bodies of water”; (2) “support cleanup of pollution from the body of water”; and (3) be a “lawful payment that directly remedies the same kind of harm” in cases involving stationary source pollution).

87. *See* Mar. 12 Memorandum, *supra* note 74.

88. *Id.*

89. *Id.* at 9.

90. *Id.* at 9–10.

91. *Id.* at 9.

92. *See id.*

these types of violations, ENRD will likewise seek to pursue them.⁹³ As such, in the near future we are likely to see more civil lawsuits and criminal prosecutions under these Acts. This makes understanding the amendments to § 162(f) even more critical and time-sensitive.

C. Transitional Guidelines

To better understand the amendments to § 162(f) and the enactment of § 6050X, it is important to understand how they are to be implemented. In the April 9, 2018, Internal Revenue Bulletin, the IRS provided transitional guidance under §§ 162(f) and 6050X with respect to certain fines and penalties.⁹⁴ As of this writing, the Department of the Treasury and the IRS are yet to publish proposed regulations regarding these sections of the Internal Revenue Code. Thus, the transitional guidelines remain the only source for direction.

The most important factor under the transitional guidelines is that reporting under § 6050X will not be required until the date specified in the proposed regulations and in no case earlier than the date of publication of the proposed regulations.⁹⁵ Reporting will not be required with respect to amounts to be paid under a binding court order or agreement entered into before the date specified in the proposed regulations.⁹⁶ As of the date of this writing, the proposed regulations are yet to be published, and there are no reporting requirements under § 6050X in the meantime.⁹⁷ However, a careful practitioner should be on the lookout for the date of publication of the proposed regulations. Although it is the government official that must file the return, the taxpayer must be provided with a copy of the return at the same time it is filed with the IRS.⁹⁸

On the other hand, the requirements of § 162(f) must be complied with immediately. The identification requirement found in § 162(f)(2)(A)(ii) applies to any amount paid or incurred after December 22, 2017, unless the amounts were paid or incurred under a binding order or agreement that was entered into before that date.⁹⁹ Until proposed regulations under § 162(f) are

93. *Id.* at 10.

94. *See* Rev. Proc. 2018-23, 2018-15 I.R.B. 474 [hereinafter I.R.S. Bulletin] (providing transitional guidance under sections 162(f) and 6050X to help with new regulations).

95. *See id.* at 476.

96. *Id.*

97. *See id.*; 2018-2019 Priority Guidance Plan, INTERNAL REVENUE SERVICE (Nov. 8, 2018), https://www.irs.gov/pub/irs-utl/2018-2019_pgp_initial.pdf.

98. *General Instructions for Certain Information Returns (2019)*, INTERNAL REVENUE SERVICE, <https://www.irs.gov/instructions/i1099gi> (last visited Feb. 12, 2020).

99. I.R.S. Bulletin, *supra* note 94, at 475.

issued, the identification requirement in § 162(f)(2)(A)(ii) is satisfied for a specific amount if the settlement agreement or court order specifically states that the amount is for restitution, remediation, or for coming into compliance with the law.¹⁰⁰ Satisfying the identification requirement of § 162(f)(2)(A)(ii) does not automatically satisfy the establishment requirement of § 162(f)(2)(A)(i).¹⁰¹ This aspect will require additional guidance, including clarifying what would satisfy the establishment requirement, which is not addressed by the transitional guidance. The proposed regulations will amend and add sections to the Income Tax Regulations as it pertains to §§ 162(f) and 6050X. The regulations should provide additional assistance in determining how a taxpayer establishes that a payment is for remediation or restitution and thus may be deductible under § 162(a).¹⁰²

Even though the transitional guidelines do not provide any direction as to how a taxpayer must establish that a payment is for remediation or restitution, there is no reason to believe that the standard will be any different than in the past. Prior to the enactment of TCJA, a taxpayer that settled an environmental action by making a payment to the government was required to prove that the payment that it sought to deduct as an ordinary business expense under § 162(a) was for remediation or allowable restitution. The main question that the courts have asked when faced with a restitution payment is whether the payment was punitive.¹⁰³ If it was, the deduction could be barred; if it was not, then the court must ask whether the payment is an otherwise ordinary and necessary expense of the taxpayer's business.¹⁰⁴ This is necessarily a factual determination that can only be made on a case-by-case basis. Presumably, the establishment requirement of § 162(f)(2)(A)(i) will require a similar analysis.

IV. CONCLUSION AND PRACTICAL IMPLICATIONS

From a practical perspective, it is imperative that an alleged violator seek immediate counsel. To the extent possible, the alleged violator, whether in a civil or criminal proceeding, should attempt to reach a settlement agreement with the governmental entity pursuing the violation. In so doing,

100. *Id.* at 476.

101. *Id.* at 475.

102. *See id.* at 475–76.

103. *Cavaretta v. Comm'r, T.C.M. (RIA) 2010–004 10 (2010)* (analyzing the question of whether restitution payments were deductible and explaining that if the payments were punitive, “the deduction may be barred”).

104. *See id.* at 13 (recognizing that payments made pursuant to the settlement of a third-party claim can be tax-deductible).

it is imperative from a tax perspective to negotiate the characterization of payments as remediation or restitution that is not punitive in nature. However, such characterization must not be illusory, but actual in nature. For example, it is not enough to merely characterize a particular payment as being for remediation or restitution. The payment must be inextricably tied to actual remediation or restitution efforts. In this regard, substance prevails over form.¹⁰⁵

To the extent payments are made to third party non-governmental entities, it becomes even more important for the alleged violator to be able to demonstrate a specific reason or benefit for paying the third party for any remediation or restitution efforts. For example, mitigation or restoration of destroyed wetlands may be accomplished by purchasing the right to record conservation easements in mitigation banks. Governmental entities generally do not want the responsibility of maintaining conservation areas. Instead, conservation easements are often granted to non-governmental organizations willing to take on the responsibility.¹⁰⁶ Additionally, in light of recent ENRC policy disfavoring payments to third parties by alleged violators, the party in alleged violation of environmental laws must obtain an ENRC AAG approval prior to entering into any settlement agreement requiring such payment, if it intends to claim a deduction under § 162(a) for such payment.¹⁰⁷

105. See *Gregory v. Helvering*, 293 U.S. 465, 468, 470 (1935) (holding that although certain transactions pursuant to a corporate reorganization are not taxable under the Revenue Act of 1928, when a holistic view of a company's reorganization plainly reveals that its efforts were for the sole purpose of avoiding tax liability, the substantive actions of the company determine which tax provisions apply).

106. See, e.g., FLA. STAT. ANN. § 704.06(3) (West 2019) (“Conservation easements may be acquired by any governmental body or agency or by a charitable corporation or trust whose purposes include protecting natural, scenic, or open space values of real property, assuring its availability for agricultural, forest, recreational, or open space use, protecting natural resources, maintaining or enhancing air or water quality, or preserving sites or properties of historical, architectural, archaeological, or cultural significance.”); *Wetlands Protection: Partnering with Land Trusts*, U.S. EPA (2003), <https://nepis.epa.gov/Exec/ZyNET.exe/100048AH.TXT?ZyActionD=ZyDocument&Client=EPA&Index=2000+Thru+2005&Docs=&Query=&Time=&EndTime=&SearchMethod=1&TocRestrict=n&Toc=&TocEntry=&QField=&QFieldYear=&QFieldMonth=&QFieldDay=&IntQFieldOp=0&ExtQFieldOp=0&XmlQuery=&File=D%3A%5Czyfiles%5CIndex%20Data%5C00thru05%5CTxt%5C00000007%5C100048AH.txt&User=ANONYMOUS&Password=anonymous&SortMethod=h%7C-&MaximumDocuments=1&FuzzyDegree=0&ImageQuality=r75g8/r75g8/x150y150g16/i425&Display=hpfr&DefSeekPage=x&SearchBack=ZyActionL&Back=ZyActionS&BackDesc=Results%20page&MaximumPages=1&ZyEntry=1&SeekPage=x&ZyPURL> (last visited Feb. 18, 2020) (explaining that land trusts can employ “more flexible and creative” conservation techniques than public agencies).

107. See ENRD Memorandum, *supra* note 80.

Once a settlement is reached, the alleged violator must ensure that the written settlement agreement expressly and unequivocally identifies any remediation or restitution payment as such. To the extent that the governmental agency imposes penalties or fines, in addition to remediation or restitution, the payment must be broken down by category, so that there is no question as to what portion of the payment is for remediation or restitution, as opposed to a penalty or fine. As it pertains to restitution, the agreement should clearly express that the restitution is not punitive in nature. The clearer the agreement, the more likely it is that the alleged violator will be able to comply with § 162(f) and deduct all or part of the payment as an ordinary and necessary business expense under § 162(a).

To the extent that an agreement cannot be reached and the case proceeds to trial, the substance of any court order or final judgment takes on added significance. Courts have held that the critical difference between a fine or similar penalty is whether the payment is voluntary.¹⁰⁸ By its very nature, any court-ordered payment is not voluntary. “At the very least, a ‘voluntary’ payment must be one made without expectation of a *quid pro quo* from the court.”¹⁰⁹ Thus, any pro-rata reduction in a fine or penalty as a result of remediation or restitution would likely not be voluntary. However, to the extent that the judge orders remediation, restitution, or requires a payment that is remedial in nature, such payment should be expressly and clearly identified as such in the order. Any such payments should be itemized or set apart from the portion of the payment that is a penalty, a fine, or is meant to punish or deter certain conduct. If the judge is not explicit in itemizing the payment in the ruling, the alleged violator must seek clarification and ask the court to separate any required payment into its compensatory and punitive components.¹¹⁰

Until the Treasury Department and the IRS issue regulations to clarify and provide further guidance pertaining to §§ 162(f) and 6050X, practitioners should continue to abide by the IRS transitional guidelines. If an entity is

108. See *Allied-Signal, Inc. v. Comm’r*, 63 T.C.M. (CCH) 2672, 2681–82 (1992) (recognizing that a restitution payment made with a “virtual guarantee” that the associated criminal fine would be commensurately reduced is not voluntary and therefore may not be deducted as a legal or professional expense on a federal income tax return).

109. *Id.* at 2681 (holding a contribution to an environmental endowment fund that is made with the clear expectation of a reduced criminal fine is not voluntary).

110. See, e.g., VA. CODE ANN. § 8.01–576.11 (2019) (stating that “upon request of all parties and consistent with law and public policy, the court shall incorporate” the terms of a settlement agreement into the final decree of the case). Many judges, particularly in civil proceedings, will allow the parties to submit an agreed upon order, or if an agreement cannot be reached, submit competing orders. If such is the case, then the alleged violator should be careful to clearly identify and itemize each portion of the required payment.

entering into a settlement agreement with the government for the alleged violation of environmental laws or regulations, it should pay particular attention to strict compliance with § 162(f)'s establishment and identification requirements. Failure to do so will preclude the alleged violator from being able to deduct any payments made pursuant to the settlement agreement.