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Environmental Alert

IRS Clarifies the Deductibility of Settlement and Court Ordered Payments

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On January 19, 2021, the Internal Revenue Service (IRS) published a second amendment to § 162(f) of the Internal Revenue Code clarifying when a taxpayer may deduct certain amounts paid to, or at the direction of, a government or governmental entity in relation to a violation of law.

Historically, settlement agreements entered between private parties and a governmental agency, such as the Environmental Protection Agency (EPA), have included a provision that prohibits the defendant from deducting any fines or penalties paid under the agreement when calculating their federal income taxes. The first amendment to § 162(f), which was published in 2017 and generally applies to orders and agreements entered between December 22, 2017 and January 18, 2021, opened the door to deductibility but lacked clarity in the details and process for claiming the deductions. The new rule, however, provides important direction as to what expenses are potentially deductible by outlining novel requirements for what a taxpayer must do to qualify for a deduction, including deductions for environmental restitution, remediation and compliance. In publishing the changes to § 162(f), the IRS simultaneously published an amendment to § 6050X requiring increased governmental reporting obligations related to the deductions.

SECTION 162(F) – BACKGROUND ON DEDUCTIBILITY

Section 162(f) of the Internal Revenue Code provides that a taxpayer may not deduct amounts paid to, or at the direction of, a government entity for a violation of any law or the investigation into the potential violation of any law. This means that, generally, monies paid pursuant to a court order or settlement agreement with a government entity are not deductible. However, the 2017 Tax Cuts and Jobs Act (TCJA) amended § 162(f) to allow deductions for payments for restitution, remediation, or those paid to come into compliance with a law. Yet, in the years following the amendment to § 162(f), taxpayers were left with several questions about what was and was not deductible.

The January 19, 2021 amendment clarifies that deductions may be available for, among other things: settlement agreements, orders, administrative adjudications, decisions issued by government officials, and any legal actions or hearings that impose a liability on the taxpayer. The new rule outlines enhanced requirements and greater definitional guidance on what qualifies as “restitution,” “remediation,” and “coming into compliance with a law,” particularly when it comes to environmental matters.

RESTITUTION, REMEDIATION, AND COMING INTO COMPLIANCE WITH A LAW UNDER § 162(F)

The new amendment to § 162(f) defines amounts paid or incurred for “restitution” or “remediation” as those that restore in whole or in part, the person, government, governmental entity, or property harmed by the violation. The final rule also expressly includes harm, injury, or damage to the environment, wildlife, or natural resources.

This second amendment specifies that an amount is paid or incurred for restitution or remediation of the environment, wildlife, or natural resources if it is paid or incurred for the purpose of conserving soil, air, or water

resources, protecting or restoring the environment or an ecosystem, improving forests, or providing a habitat for fish, wildlife, or plants. The amount paid or incurred must also be significantly connected to the harm that the taxpayer has caused or is alleged to have caused.

Restitution and remediation do not include amounts paid to a governmental account for general enforcement efforts or other discretionary purposes. Rather, to be deductible, the monies paid to a government or government entity must be paid into a separate fund or account and be used exclusively for the restitution or remediation of the environment, wildlife, or natural resources.

Amounts paid or incurred to "come into compliance with a law" include performance of services, taking corrective action, and providing property. Corrective action can include updates and modifications to equipment, such as air pollution control equipment, wastewater treatment equipment, and the installation or enhancement of monitoring equipment.

The rule specifies that, regardless of how the order or agreement identifies them, amounts paid or incurred to reimburse the government for investigation or litigation costs or those paid at the payor's election in lieu of a fine or penalty are not deductible.

IDENTIFICATION AND ESTABLISHMENT REQUIREMENTS UNDER § 162(F)

Importantly, to qualify for a deduction, § 162(f) establishes "identification" and "establishment" requirements. The rule specifies that meeting the identification requirement is not sufficient to meet the establishment requirement, and vice versa. Rather, each requirement must be independently satisfied.

The "identification" requirement requires the taxpayer to provide a court order or agreement that identifies a payment by stating the nature of, or purpose for, each payment that the taxpayer is obligated to pay, and the amount of each payment. The requirement is met if an order or agreement specifically states the amount of the payment and that the payment constitutes restitution, remediation, or an amount to be paid to come into compliance with a law. The final rule also provides circumstances in which the identification requirement may still be met despite payment amounts not being fully identified or where other forms of the words "remediate" or "comply with a law" are used. In those limited circumstances, it is important that the order or agreement specifically describe the damage done, harm suffered or manner of noncompliance with a law, as well as what the taxpayer must do to provide restitution, remediation, or to come into compliance with a law.

To meet the "establishment" requirement, the taxpayer must substantiate with documentary evidence: (1) the taxpayer's legal obligation to pay the amount identified as restitution, remediation or to come into compliance with the law; (2) the amount paid; (3) the date the amount was paid or incurred; and (4) that based on the origin of the liability and the nature and purpose of the amount paid or incurred, the amount was for restitution, remediation, or to come into compliance with a law. Such evidence may include receipts, the legal provisions relating to the violation of the law, government documents relating to the inquiry, and correspondence between the taxpayer and the government.

It is prudent that taxpayers involved in legal proceedings with the government or a governmental entity include identification and establishment language in their settlement agreements and draft orders. If they fail to do so, they may forfeit their ability to claim a deduction for those payments.

SECTION 162(F) AND CERCLA

The new rule clarifies that § 162(f) generally will not apply to cleanup requirements and reimbursements required to be paid or incurred under the Comprehensive Environmental Response, Compensation, and Liability Act

(CERCLA), as they may apply without any finding of a violation of law. This is not to say that payments made for CERCLA cleanups or reimbursements are not deductible, but only that this is a question not subject to § 162(f) and thus not impacted by the new regulations. However, § 162(f) and the final regulations apply to penalties required to be paid or incurred by reason of a violation of specific CERCLA provisions (i.e., CERCLA release reporting requirements).

CHANGES TO GOVERNMENTAL REPORTING UNDER § 6050X

Section 6050X of the Internal Revenue Code imposes a reporting requirement on government officials, such as the Environmental Protection Agency, involved in settlements where § 162(f) applies. Section 6050X(a)(1) previously required officials to file an information return if the total amount of all court orders and settlement agreements for the violation, investigation, or inquiry amounted to $600 or more.

The new rule, however, increases the threshold reporting amount to $50,000 and creates more stringent reporting requirements. The rule requires that information returns provide the aggregate amount required to be paid, the separate amounts to be paid as restitution, remediation or come into compliance with a law, the taxpayer's tax identification number, and any other additional information required by the information return. The official must also file a Form 1098-F and Form 1096, and must do so on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which the order or agreement became binding. Finally, the official must provide a written statement, including the information reported to the IRS, to each taxpayer for which an information return was filed.

The new rule clarifies that the reporting requirements apply to federal, state, and local government entities and are for tax administration purposes only. As such, the reporting requirements imposed by § 6050X, including the Form 1098-F, may not be used to demonstrate that the taxpayer has met the identification or establishment requirements.

EFFECTIVE DATES

Changes to § 162(f) apply to taxable years beginning on or after January 19, 2021. However, the rule does not apply to amounts paid or incurred pursuant to an order or agreement that became binding before January 19, 2021.

Unlike the proposed rule, which provided a "material change" provision under which orders and agreements entered before December 22, 2017 would become subject to the § 162(f) amendments if they were materially changed, the final rule does not apply to any pre-December 22, 2017 order or agreement, even if materially modified. However, the new rule notes that a material change to an order or agreement will generally result in a new order or agreement that is subject to § 162(f). Amounts paid or incurred pursuant to an order or agreement that became binding between December 22, 2017 and January 18, 2021 may still be deductible under the first amendment to § 162(f), however the new January 19, 2021 amendment will not apply.

Changes to § 6050X apply to orders and agreements that become binding on or after January 1, 2022.

The final rule can be found here.

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This Environmental Alert is intended to keep readers current on developments in the law. It is not intended to be legal advice. If you have any questions, please contact Jessica Rosenblatt at 412.566.1911 or jrosenblatt@eckertseamans.com, Scott Dismukes at 412.566.1998 or sdismukes@eckertseamans.com, or any other attorney at Eckert Seamans with whom you have been working.