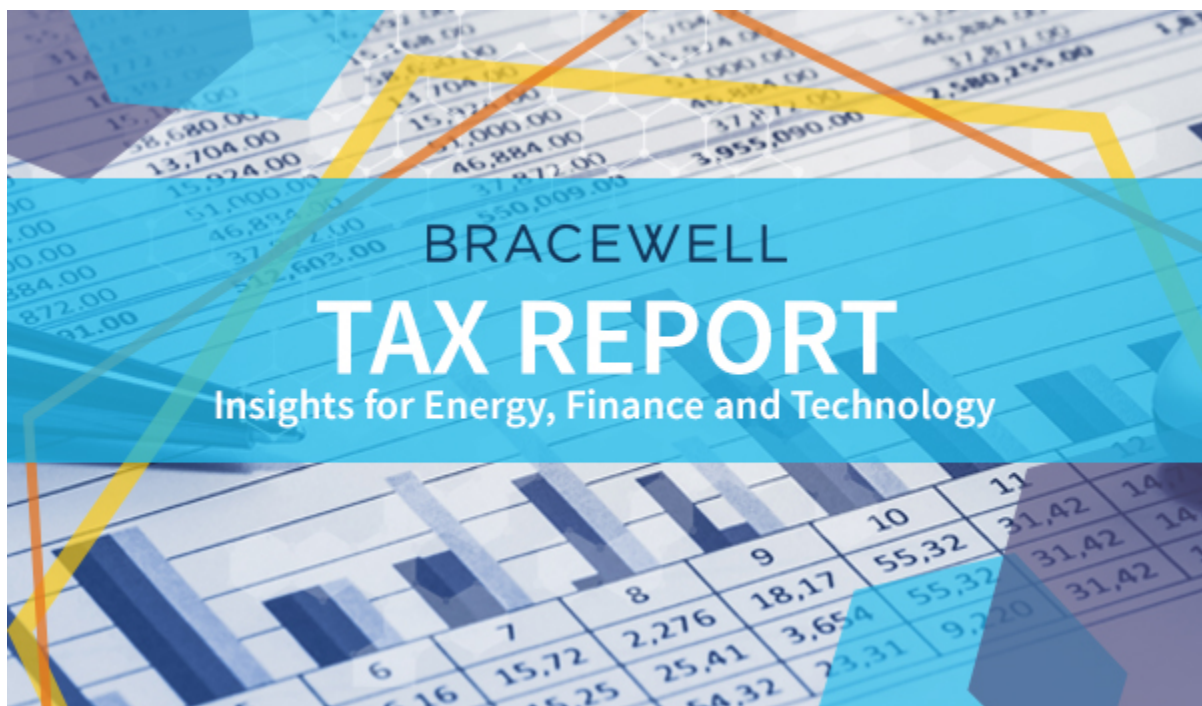


INSIGHTS

## New Requirements for Deducting Payments to Governmental Entities

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Section 162(f) of the Internal Revenue Code of 1986 (the Code), as amended by the Tax Cuts and Jobs Act (the TCJA), limits the federal income tax deductibility of certain payments made to a government or governmental entity, including certain non-governmental self-regulatory entities (a Governmental Entity), in connection with a violation of law or an investigation involving a potential violation of law, and imposes consistent reporting requirements with respect to such payments. Such changes to Code Section 162(f) are expected to impact the negotiation of settlements with respect to the characterization of payments made to Governmental Entities and taxpayers' efforts to minimize the after-tax cost of such payments.

### **Code Section 162(f) following the TCJA**

Prior to the enactment of the TCJA, Code Section 162(f) provided that only fines and penalties in connection with a violation of law were non-deductible for federal income tax purposes. New Code Section 162(f), however, expands the scope of non-deductible payments to all

payments made to, or at the direction of, a Governmental Entity in connection with a violation of law or an investigation involving a potential violation of law. There are two exceptions to the general rule. First, Code Section 162(f) does not limit the deductibility of payments that constitute restitution for damage or harm related to a violation or potential violation of law, including the cost of remediation of a property or site (the Restitution Exception). Second, the deductibility of payments made by a taxpayer to come into compliance with any law that was violated or otherwise was the subject of an investigation are not subject to limitation under new Code Section 162(f) (the Compliance Exception). Payments to reimburse a Governmental Entity for the cost of any investigation or litigation do not qualify for either exception and, therefore, are not deductible under Code Section 162(f).

Qualification under the Restitution Exception or the Compliance Exception also requires that the taxpayer and the Governmental Entity agree on the portion of any payment made by the taxpayer that qualifies for the Restitution Exception or the Compliance Exception as a term of the relevant settlement or similar agreement (the Identification Requirement). Former Code Section 162(f) did not include such a requirement and, consequently, settlement and similar agreements typically did not recite the tax treatment of payments made thereunder, other than stating that the taxpayer agreed not to seek a federal income tax deduction for fines or penalties paid. Accordingly, prior to the TCJA, taxpayers could unilaterally determine and report the character and deductibility of such payments, subject only to a future IRS audit on the issue.

Finally, new Code Section 6050X adds a reporting requirement for payments deductible under Code Section 162(f). Code Section 6050X provides that the Governmental Entity must file an information statement with the IRS specifying (1) the name of the Governmental Entity involved in resolving the dispute, (2) the amount of the entire payment to the Governmental Entity, and (3) the portion of such payment qualifying for the Restitution Exception or the Compliance Exception (the Reporting Requirement). The Reporting Requirement binds both the taxpayer and the Governmental Entity to a single position with respect to the nature and purpose of the payments made pursuant to a settlement agreement or order.

#### **Issues Arising In Connection with Environmental Investigations and Settlements**

In the context of environmental investigations and settlements, questions arise regarding the application and scope of the Restitution Exception and the Compliance Exception. Further guidance from the IRS or the Treasury Department is necessary to provide greater clarity to taxpayers and Governmental Entities in this area.

The Restitution Exception should permit a taxpayer to deduct the cost of remediation of a contaminated site associated with such taxpayer's violation of law. Such violations could include a hazardous spill or release by the taxpayer that caused the contamination. A taxpayer's ownership of property with historic contamination not caused by the taxpayer, however, generally does not constitute a violation of law, unless such contamination threatens human health or adjacent properties. Accordingly, the cost of remediation of historic contamination, not in violation of law, may not be deductible under the Restitution Exception, even if the remediation of such property is effected pursuant to clean up standards imposed by federal or state environmental regulators. Future guidance should clarify whether the cost of remediation of contaminated property to meet environmental standards, but not directly attributable to the taxpayer's violation of law, is deductible.

It also is unclear whether the Restitution Exception permits taxpayers to deduct the cost of mitigation credits purchased in connection with a settlement or order when a taxpayer's actions caused harm to an environmental resource, such as a wetland, stream or species habitat, and the affected resource cannot be fully restored. A Governmental Entity may require a taxpayer to purchase such credits from a mitigation bank as redress for such an impact. The proceeds from such credits are applied to restore and protect resources other than those directly harmed by the taxpayer. Although the proceeds of such credits are used for the restoration of environmental resources, it is unclear whether such costs are deductible under Code Section 162(f) because of the absence of a direct correlation between such costs and the specific environmental impact caused by the taxpayer. The use of mitigation multipliers raises a similar question. If the taxpayer harmed an environmental resource that is deemed to have a different function or value from the resource to be restored with the proceeds of the mitigation credits, the Governmental Entity may apply a multiplier to increase the number of credits the taxpayer is required to purchase as part of the settlement or order. Whether such additional cost should be deductible under Code Section 162(f) is unclear if the cost of such additional credits is punitive in nature.

Similar issues may arise with respect to the Compliance Exception. If a taxpayer incurs costs to come into compliance with an environmental administrative order or court order, such payments should qualify for the Compliance Exception. In a negotiated environmental settlement, however, a taxpayer may agree to incur additional costs and expenses to cause its ownership and operation of the assets to exceed the standard required under applicable law, often in exchange for a reduced fine or penalty. Future guidance may indicate that such additional costs are not subject to the Compliance Exception to the extent made by the taxpayer in lieu of fines or penalties.

#### **Looking ahead**

The changes to Code Section 162(f) and the addition of Code Section 6050X were effective as of December 22, 2017. Proposed regulations for new Code Section 162(f) and Code Section 6050X are on the IRS 2018-2019 Priority Guidance Plan, although no date has been provided for the anticipated issuance of such regulations. Until proposed regulations under Code Section 6050X are issued, the Identification Requirement will be deemed satisfied if the settlement agreement or order states the portion of the payments that are within the Restitution Exception or the Compliance Exception.