IRS Requests Comments on Form 1098-F – Should Defendants in Environmental Enforcement Actions Care?

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For many years, the Internal Revenue Code (Code) has denied a deduction for fines or penalties paid to a government for the violation of any law. The Tax Cuts and Jobs Act of 2017 (TCJA) amended the Code to further limit deductions for payments made to a government. Now, effective for amounts paid or incurred on or after December 22, 2017, no deduction is allowed (with certain exceptions) for amounts paid in relation to the violation of a law or investigation into the potential violation of a law, if a government (or similar entity) is a complainant or investigator with respect to the violation or potential violation. TCJA also imposes new information reporting requirements on a government (or similar entity). (Similar entities are governmental entities and certain nongovernmental entities that exercise self-regulatory powers.)

The Internal Revenue Service (IRS) developed Form 1098-F to report the required information, but postponed the requirement to file Form 1098-F until further notice. In connection with the development of proposed regulations for these new rules, **the IRS is requesting comments from the public and effected governments and governmental entities** by October 29, 2019 (details can be found here) on any and all issues related to Form 1098-F.

Background

Before enactment of TCJA, Code section 162(f) denied a deduction for fines or penalties paid to a government for violations to law. While section 162(f) continues to disallow a deduction for fines and penalties, TCJA amended Code section 162(f) to further limit deductions by providing that ". . . no deduction otherwise allowable shall be allowed . . . 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 any violation of law or the investigation or inquiry by such government or entity into the potential violation of law." The amendment does not apply to amounts paid or incurred under any binding order or agreement entered into before December 22, 2017. In the case of an order or agreement requiring court approval, however, this exception does not apply unless the approval was obtained before December 22, 2017.

What Expenses are Deductible

New Code section 162(f) does not deny a deduction for all payments made to a government or governmental entity; there are exceptions. **A deduction is not denied** for a payment in the case of restitution (other than restitution for failure to pay tax, see below) or to come into compliance with any law **if *both* the "establishment requirement" and the "identification requirement" are met**.

1. The establishment requirement is met if the taxpayer establishes –

> *a. the payment is restitution (which term includes the remediation of property) for damage or harm that was or may be caused by the violation of any law or the potential violation of any law, or*
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> *b. the payment is made to come into compliance with any law that was violated or otherwise involved in the investigation or inquiry by a government or other entity into the potential violation of any law.*

2. The identification requirement is met if the payment is identified as restitution, or as an amount paid to come into compliance with the law discussed in (1) above, in the court order or settlement agreement.

Thus, the exception for restitution applies to payments that: (1) the taxpayer establishes are either restitution (including remediation of property) or amounts required to come into compliance with any law that was violated or involved in the investigation or inquiry; and (2) are identified in the court order or settlement agreement as restitution, remediation, or amounts required to come into compliance. **Identification of the payment as restitution in the court order or settlement agreement alone is not sufficient.** The taxpayer must also meet the establishment requirement.

The term "restitution" is not defined, but an amount generally 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. Code section 162(f) specifically provides, however, that the exception for restitution does not apply to amounts paid or incurred as reimbursement to the government (or similar entity) for investigation or litigation expenses.

In the case of restitution for failure to pay any federal tax, a deduction is not denied in situations in which the restitution is imposed in the same manner as if the restitution were the tax, provided such tax would have been allowed as a deduction if it had been timely paid. Thus, for any amount of restitution for failure to pay any tax that is assessed under the Code, **the restitution is deductible only to the extent it would have been allowed as a deduction if it had been timely paid**.

Difficulties are sure to arise in obtaining specific information related to the amount of restitution or cost to come into compliance. This is especially true for settlement agreements requiring specific performance where the actual cost has yet to be incurred. Indeed, EPA has urged the IRS to shift the burden to the company or allow the agencies to identify the specific provisions in the agreement that describe the performance meant to constitute restitution or compliance, such as remediation of a property or installation of a pollution-control technology. More often than not, it is virtually impossible for EPA to know and verify the precise amount that a company will spend to remediate a property or install pollution control technology to achieve compliance as this occurs well after the case concludes. What happens in the event that EPA reports an estimated amount less

than what the company actually spent? Settlement agreements should require EPA to amend any information returns in the event the payment exceeds the estimated amount.

The new rules place a greater burden on the taxpayer in establishing that payments to resolve a violation or alleged violation of law are deductible. This is because a taxpayer can no longer on its own qualify for a deduction on the basis that the deduction is not a fine or penalty. Moreover, it is not sufficient to demonstrate that the payment is restitution or made to comply with the law. Now, **the relevant court order or settlement agreement must specifically identify the payments as being restitution** or as amounts paid to come into compliance in order for them to be deductible. If the court does not identify a payment in its order or the parties do not identify the payment in their settlement agreement, the payment will not be deductible. Language such as "…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 [e.g. Updated, modified or state of-the-art pollution controls] is restitution or required to come into compliance with the law" will help preserve a company's right to claim deductions.

In settlements with the government, any expenses associated with remediation of hazardous substances under the Resource Conservation and Recovery Act (RCRA) should continue to be deductible as expenses associated with "restitution." However, taxpayers must be aware that expenses paid pursuant to the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) do not necessarily involve a "violation of any law or a potential violation of the law" as CERCLA is a remedial statute. If there is no violation of law or potential violation of law, remediation payments made pursuant to CERCLA arguably would not be subject to the Section 162(f) limitation. Nevertheless, because CERCLA potentially could involve a violation of law, taxpayers should ensure that they satisfy the establishment and identification requirements when it comes CERCLA settlement agreements. Injunctive relief expenses should continue to be deductible as expenses incurred for coming "into compliance." As was the case before TCJA, expenses associated with civil penalties, criminal penalties, and stipulated penalties are not deductible. Similarly, expenses associated with Supplemental Environmental Projects (SEPs) are not deductible to the extent they are used to offset civil penalties. While it is easy to assume that expenses of SEPs used above and beyond the offset of a civil penalty are deductible, **the government has aggressively started the curtailing of SEPs** as reflected in the August 21, 2019, newly released Department of Justice Memorandum captioned "Using Supplemental Environmental Projects ('SEPs') in Settlements with State and Local Governments."

It is important to note that Code section 162(f) specifically provides that the provisions denying a deduction for payments to any government or governmental entity **do not apply** to any amount paid or incurred by reason of any order of a court in a suit in which no government or governmental entity is a party.

Reporting Requirements

In addition to amending Code section 162(f), TCJA added new Code section 6050X. Under Code section 6050X, the appropriate official of any government or governmental entity that is involved in suits or agreements with respect to a violation of law generally must report to the IRS:

1. the amount required to be paid as a result of the suit or agreement for which no deduction is allowed under Code section 162(f)(1);
1. any amount required to be paid as a result of a suit or agreement that constitutes restitution or remediation of property; and
2. 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.

No reporting is required, however, if the aggregate amount required to be paid or incurred to or at the direction of the government is less than $600 (or such other amount as may be specified by the IRS).

In IRS Notice 2018-23, the IRS suspended the reporting requirements under Code section 6050X until a date specified in proposed regulations that the IRS intends to publish. Therefore, entities required to report do not need to file a Form 1098-F until further notice. For the latest information, visit Information Return Reporting for Federal Agencies.

Takeaway for Environmental Defendants

Environmental defendants (or potential defendants) are being given the opportunity to comment on all issues related to Form 1098-F through October 29, 2019 (click here for details). There is uncertainty in how the new provisions apply to environmental settlements. Confirmation that expenses associated with remediation of hazardous substances under CERCLA and RCRA are deductible would be helpful, as well as clarification on the treatment of expenses associated with SEPs. Examples that contrast expenses that are deductible with those that are not (establishment requirement), as well as sample language that satisfies the identification requirement would be helpful.

Until further guidance is issued, environmental defendants should require as much clarity as possible in court orders and settlement agreements with respect to the identification of the purpose for which a payment is being made to a government or governmental entity. If possible, the language should specifically reference that the payment is being made for “restitution” or to “come into compliance with the law” within the meaning of Code section 162(f).

For more information about this alert, please contact one of the authors or any member of McGlinchey Stafford’s Corporate, Tax Law, or Environmental teams.

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