This article was originally published in the April 2002 issue of the Real Estate Tax Digest. (c)2002 by Matthew Bender & Company, Inc. All rights reserved. Reprinted with permission of the publisher.

CONSIDER TAX TREATMENT OF ENVIRONMENTAL PAYMENTS

by Robert W. Wood

Introduction. Environmental law has exploded as a specialty field over the last fifteen years. The size of the potential liabilities to private parties, quasi-governmental bodies and governmental entities can be staggering. Perhaps as a consequence of the size of these potential payments, the tax treatment of the payments can be particularly important. Like many other payments, the payor of an environmental payment will virtually always want the payment to be deductible as an ordinary and necessary business expense. After all, the ordinary deduction makes the cost of the payment on an after-tax basis significantly less dear.

If ordinary business expense treatment is not available, the second best tax treatment would be capitalization. Recovering the cost of the payment over time is a decidedly weak second choice compared with the enormous benefits of an immediate deduction. Thus, most of the administrative law and case law in this area concerns the deduct vs. capitalize dichotomy.

There is a third type of payment made in the environmental field that is even less attractive from a tax viewpoint than capitalization. Payments to the government may be classified as fines or penalties and therefore may be nondeductible under Section 162(f). In contrast to the general rule that payments in a business context either by way of settlement or judgment will be deductible, the Internal Revenue Code states expressly that no deduction is allowed for "any fine or similar penalty paid to a government for the violation of any law." This provision denies a deduction for both criminal and civil penalties, as well as for sums paid in settlement of potential liability for a fine. It is the latter element of the provision that often causes great controversy, as it may or may not be clear that there is a likelihood of a fine being imposed.

Whether a fine or penalty may be imposed may in some cases depend upon the intent of the perpetrator. However, the denial of the deduction does not require that the violation of law have been intentional. Thus, no deduction will be permitted for the payment of a fine even if the violation is inadvertent or if the taxpayer must violate the law in order to operate profitably.

The significance of the rule that fines and penalties are nondeductible, and the considerable incentive that taxpayers have to avoid this rule, are well illustrated by the experience of Exxon with respect to its liability over the Exxon Valdez oil spill litigation. According to news reports, the U.S. government's $1.1 billion Alaska oil spill settlement with Exxon actually cost Exxon a maximum of $524 million when Exxon's tax deductions for the payments are taken into account. These findings were made by the Congressional Research Service, and announced by Representative Gerry E. Studds, Democrat from Massachusetts.

The study by the Congressional Research Service determined that more than half of the civil damages totaling $900 million could be deducted on Exxon's federal income tax returns. The study also indicated that because the civil penalties would be paid out over ten years, the real return to the government will be significantly eroded by inflation."Tax Deductions Will Help Exxon Slip Away From Much Of Its Oil Spill Liability Says CRS," Tax Analysts Highlights & Documents, March 21, 1991, p. 2853

One of the more important cases to define the line between nondeductible fines or penalties and deductible compensatory payments is Allied-Signal, Inc. v. Commissioner. In this case, the Third Circuit affirmed the Tax Court's denial of any deduction for an $8 million payment that Allied-Signal paid into a trust to eradicate a toxic chemical pesticide from the environment. The court found that the payment was made with the virtual guarantee that the district court would reduce the criminal fine by at least the amount previously levied against Allied-Signal. This issue is being discussed with increasing frequency by commentators.

In S. Clark Jenkins, et ux. v. Commissioner, the Tax Court held that a shareholder of a fertilizer manufacturer was entitled to deduct, through his S corporation, amounts he paid to two states as "penalties" for deficiencies in the fertilizer produced by his company. The IRS had disallowed the deduction (passed through from his S corporation). The IRS argued that the payments represented nondeductible penalties. The Tax Court, however, looked to the purpose of the state legislation, finding that it was to compensate the consumer, not to punish the manufacturer.

Indeed, the Tax Court noted that the "penalty" was calculated by determining the value of the deficient ingredient that the consumer paid for but never received, plus an additional amount that was to compensate for additional crop yield. In this case, the Tax Court found for the taxpayer because it was a remedial statute, not a punitive one. This case demonstrates that it is important to look beyond the language of the mere "fine or penalty" language and discover the purpose of the statute pursuant to which the fine or penalty is levied.

<u>Difference Between Fines and Late Fees</u>. Although Section 162(f) bars a deduction for any fine or similar penalty paid to a government for a violation of law, many payments have been ruled not to constitute fines for this purpose. Thus, a late filing fee, which is really designed to encourage prompt compliance with the law, has not been treated as a fine for this purpose.

<u>Compensatory Payments Distinguished From Fines</u>. Another exception from the scope of Section 162(f) and its denial of deductions for the payment of fines relates to so-called "compensatory" fines. Even a fine (as distinguished from a late fee), can be deducted if it is compensatory. The notion here is that if a fine is imposed only to compensate a governmental entity for harm it has suffered, as distinguished from a fine having a punitive motivation, a deduction will be allowed.

***Example*: A fine that is deductible as a reimbursement to the government for the amount of lost custom taxes has been held deductible. Similarly, a payment to the Clean Water Fund in order to avoid prosecution for water pollution was held deductible in S&B Restaurant, Inc. v. Commissioner.**

Even fines that may appear on the surface to be punitive may be held deductible as long as the requisite compensatory character of the payment can be proven. Thus, in Mason-Dixon Lines, Inc. v. U.S., statutory "liquidated damages" imposed for the violation of truck weight limitations were held to be deductible. The theory of the case is that the statutory liquidated damages compensated the state for damage to highways caused by the overweight vehicles. Liquidated damages imposed by contracts, even where denominated as "fines," have been viewed as compensatory on the same theory.

***Caution*: The line between compensatory fines and noncompensatory ones is sometimes difficult to discern. The regulations, for example, take the position that civil environmental fines that are imposed are nondeductible. Moreover, it may be difficult for the taxpayer to show that a fine is imposed with a compensatory motive. How high the stakes are, of course, depends upon the size of the fine that has been**

imposed and the degree to which it is likely to be recurrent.

In Talley Industries, Inc., et al v. Commissioner, a company and several of its executives were indicted for filing false claims for payment with the federal government. The Navy contracts which were in question allegedly resulted in a loss to the Navy of approximately $1.56 million. However, because of various potential liabilities, the settlement that was ultimately agreed to between the company and the Justice Department was $2.5 million. The company deducted this amount on its tax return, and the IRS asserted that essentially the settlement amounted to a fine or penalty that could not be deducted.

The Tax Court granted summary judgment for the taxpayer, holding that the settlement payment was not a fine or penalty, except for a very small amount ($1,885) that was explicitly for restitution. The Tax Court found that the government had never suggested that it was attempting to exact a civil penalty from the company. Noting that $2.5 million was less than double the alleged $1.56 million loss, the court inferred that the settlement was not intended to be penal or punitive, but rather to be compensatory. Unfortunately for the taxpayer, the Ninth Circuit then reversed and remanded the case, concluding that there was a material issue of fact and that the matter was not ripe for summary judgment.

In Allied-Signal, Inc. v. Commissioner, the Tax Court considered a deduction claimed by Allied-Signal for payments made pursuant to the resolution of a suit involving environmental violations. In addition to other payments, the company made an $8 million payment into a nonprofit environmental fund. The Tax Court determined that the entire payment to the endowment fund was nondeductible because the payment was made with the virtual guarantee that the sentencing judge would reduce the criminal fine to which the company was subject by at least that amount.

The Tax Court rejected the company's argument that the payment was not a fine or penalty because it did not serve to punish or deter, concluding that the payment served a law enforcement, not a compensatory purpose. The Third Circuit Court of Appeals affirmed the Tax Court in a widely watched decision. In the environmental area in particular, taxpayers should make every attempt to avoid "penalty: characterization and to emphasize the remedial effects or intent of the payments.Raby, "Two Wrongs Make a Right: The IRS View of Environmental Cleanup Costs," Tax Notes, May 24, 1993, p. 1091

***Note*: Occasionally, a payment that is entered into to settle a dispute between the taxpayer and environmental authorities can be structured as a remediation payment rather than as a penalty. Although this flexibility is not unlimited (and some statutes are quite clear that something is a "penalty" regardless of how one denominates it), there is more flexibility here than one might imagine. Tax advisors should be alert to attempt to position a payment as favorably as possible.**

In Hawronsky v. Commissioner, the Tax Court held that Section 162(f) prohibited a man from deducting treble damages he was required to pay when he breached a scholarship program contract. Finding that the payment was a civil penalty, the Tax Court concluded that Section 162(f) applies both to criminal fines and to certain civil penalties.

The deductibility of payments in restitution has been raised in a number of cases. For example, in Jess Kraft, et ux. v. U.S., the Sixth Circuit held that payments of restitution to Blue Cross/Blue Shield arising out of a criminal action for fraud were nondeductible. Although the restitution was paid to a private party and not to the government, the court held the payments nondeductible. The cases dealing with restitution payments have become more common. Although traditionally such

restitution payments have been analogized by the IRS to penalties, a number of courts have disagreed and found restitution payments to be deductible.

Deduct vs. Capitalize. Not surprisingly, the IRS view is that many clean-up costs are not deductible but must rather be capitalized. Regulation §1.162-4 allows businesses to deduct repair costs, yet the IRS views such remediation as going beyond "repair." Technical Advice Memorandum 9541005 concluded that a company could not deduct any professional fees associated with an environmental clean-up.

In Technical Advice Memorandum 9541005, the taxpayer was a subsidiary that owned polluted land. The subsidiary had acquired the land, used it as an industrial waste disposal site, and then contributed it to a county that conveyed it back to the subsidiary after the county discovered contamination. Professional fees were paid to engineering firms for studies and investigations, to lawyers for drafting contracts and a consent order, and to various consultants. No actual remediation expenses were yet incurred.Lipton, "IRS Reverses Environmental TAM," 4 M&A Tax Report 9 (April 1996), p. 1

Then, in a published ruling, the IRS ruled that contingent environmental liabilities that had not been deducted or capitalized, and that were assumed by a newly formed subsidiary in a Section 351 exchange, could be deducted as ordinary and necessary business expenses under Section 162 or capitalized under Section 263. The ruling holds that such liabilities are not liabilities for purposes of Sections 357(c)(1) and 358(d).

Finally, the IRS has issued proposed regulations concerning trusts formed to handle waste clean-up costs. The proposed regulations, PS-54-94, were issued under Section 7701 dealing with the proper classification of such trusts. After issuing proposed regulations concerning trusts formed to deal with clean-up costs, a short time later the IRS finalized such regulations.

Effect of Indemnity. Environmental cleanup costs can be enormous, and the deductibility versus capitalization issue can be equally significant. Field Service Advice 9942025 gives some hope that environmental cleanup costs may still be in the deductible category. The question was whether a corporation could deduct certain environmental cleanup costs even though those costs were subject to indemnification under an agreement to sell the corporation's stock. The indemnity agreement (and the stock sale agreement) were made in a prior year. The IRS nevertheless ruled that the corporation could deduct the costs.

A target corporation formed a subsidiary to facilitate the sale of assets in a refining, marketing and transportation business. The environmental damage that saddled the target's assets was vast and difficult to assess, so the parent corporation and the target's buyer agreed to make the transfer free and clear of both present and future liabilities. There were numerous later transfers of the target's stock through stock purchase agreements, as well as various other inter-corporate transactions that included transfers of liability under the initial indemnity agreement connected with the sale of the target's assets.

After a few years, the target began to incur environmental cleanup costs on some of its properties. It was fully responsible under the law regardless of whether it could seek indemnification. The target eventually sought indemnification under the stock purchase agreements and brought a lawsuit against two other companies. Under a settlement agreement, the target received a current lump sum payment, a specified amount to be received over three future years, and an agreement to share certain future environmental cleanup costs.

The target did not include any of the indemnity payments it received in gross income, but rather treated them all as capital contributions. The target asserted that these payments related back to the initial stock purchase, and merely reduced the basis of the target's stock. The target also deducted all environmental cleanup costs incurred during the years in question, including those for which it received indemnity payments. The company claimed that the environmental cleanup costs were paid out of capital contributions.

The issue was whether the clean-up costs should be disallowed as deductions because they related back to the stock and were capitalized, or because they were subject to the indemnity provisions and were reimbursed. The IRS assumed that the costs would have been deductible and not capitalized under Revenue Ruling 94-38, 1994-1 CB35. The IRS ruled that the costs should not be disallowed as deductions either because they related back to the sale of its stock or because they were subject to reimbursement.

The IRS supported its conclusion with Arrowsmith v. Commissioner, 344 U.S. 6 (1952). In Arrowsmith, two former shareholders of a liquidated company were required (as transferees of the assets) to pay a judgment against the corporation several years after the liquidation. While the gain from the liquidation was a capital gain to the shareholders, they deducted the payment of the judgment as an ordinary loss. The court disagreed, finding the loss to be capital because it would have been capital had it been made in the same year as the liquidation.

After Arrowsmith, subsequent indemnity payments required to be made pursuant to a stock transfer have been found to result in an adjustment to the sales price of the stock to a buyer. Accordingly, Field Service Advice 9942025 concludes that the target should capitalize the indemnity payments and adjust its stock price, and recognize net income or capital gain. See Freedom Newspaper v. Commissioner, TC Memo 1977-429 (1977). Arrowsmith, said the IRS, held that the costs could not be disallowed as current deductions because they related back to the sale of the target's stock.

Case law also supported deductibility. In VCA Corp. v. U.S., 215 Ct. Cl. 939, 566 F.2d 1192 (Ct. Cl. 1977), the taxpayer deducted an expense that was (at least in part) indemnified under a merger agreement. In Revenue Ruling 83-73, 1983-1 C.B. 84, the IRS followed VCA, holding that indemnified expenses arising out of a merger were deductible. Revenue Ruling 83-73 also determined that indemnity payments should be treated as if they were contributions to the capital of the transferor corporation, made by its shareholders immediately before the merger.

The IRS concluded that the court's holding in VCA (and its own ruling in Revenue Ruling 83-73) were inconsistent with disallowing the deductibility of the environmental remediation costs that were at issue. The cleanup costs could not be disallowed on the grounds that they were subject to reimbursement. Instead, the IRS ruled that the indemnity payment should be treated as a contribution to the capital of the target just before its sale of stock. Revenue Ruling 83-73 stands directly contrary to the notion that it is impermissible for the taxpayer to deduct indemnified expenses.

<u>Revenue Procedure 98-17</u>. Revenue Procedure 98-17, 1998-5 I.R.B. 21, provides procedures for requesting written guidance on the tax treatment of environmental clean-up costs incurred in a continuing project. Under this revenue procedure, a taxpayer may request a ruling covering all tax years during which clean-up costs are incurred. The ruling can even cover years for which a return has already been filed, or is under examination, or even before an Appeals Officer.

Revenue Procedure 98-17 defines an environmental cost as any cost associated with the assessment, mitigation, removal or remediation of environmental hazards, whether latent or imminent, on the taxpayer's property or on the property of another. Revenue Procedure 98-17 was effective for ruling requests made during the two-year period from February 2, 1998 to February 2, 2000. (For the full text of Rev. Proc. 98-17, see Tax Notes Doc. No. 98-2969.)

Revenue Procedure 98-17 lists a number of items that are explicitly to be covered by the Revenue Procedure. The types of environmental clean-up projects covered, which might span several tax years, include projects to study, remediate and monitor soil and groundwater at a former manufacturing site; remove and replace asbestos in manufacturing equipment located at several of the taxpayer's operating plants; or remove underground storage tanks, treat contaminated soil and groundwater, and remove asbestos from a retail facility where the taxpayer intends to be in operation. See Rev. Proc. 98-17, 1998-5 I.R.B. 21, §§3.02, 3.03.

Other Guidance. We have barely scratched the surface of authorities dealing with the tax treatment of environmental payments. The Service has issued a variety of guidance. For example:

- **Regarding asbestos removal, see Letter Ruling 9541005, revoked by IRS Document 96-2070.**
- **Regarding PCB clean-up, see Technical Advice Memorandum 9315004.**
- **Regarding soil remediation and groundwater, see Revenue Ruling 94-38.**

Conclusion. Environmental payments, whether clean-up expenses, lawsuit settlements, or fines, are almost never paid without some degree of pain. Nevertheless, a properly structured payment — and there often is at least some room for structuring — can help the payor's tax position, and thus help ameliorate the sting of the payment. Practitioners should be alert for such opportunities.

***Consider Tax Treatment of Environmental Payments*, Vol. 20, No. 4, The Real Estate Tax Digest (April 2002), p. 3.**