

# SHOULD ENVIRONMENTAL MONETARY SANCTIONS BE TAX DEDUCTIBLE?

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Conventional wisdom assumes that environmental monetary sanctions should not be allowed as a deduction from income taxes. This Comment advances the counter-intuitive argument that under the present statutory framework, allowing some environmental monetary sanctions to be tax deductible is consistent with sound environmental policy and social values. Properly structuring sentences and settlements to be tax deductible and to keep the money local maximizes the resources that can be brought to bear in remediating the harm without diminishing the deterrent effect.

## INTRODUCTION

The basic public policy justification advanced for not allowing taxpayers to deduct environmental monetary sanctions from their income tax is that the government should not bear any part of the cost of reprehensible behavior, even if incurred in the normal course of a trade or business.<sup>1</sup> This is based, in part, upon the belief that allowing a deduction would enable the taxpayer to externalize the sanction and eviscerate the punitive scheme of the penalty.<sup>2</sup> If one accepts the premise that illegal, antisocial and other undesirable behavior can be deterred by monetary sanctions, then a deductible monetary sanction can have the same deterrent impact as a nondeductible fine or similar penalty, provided that the deductible monetary sanction is increased

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<sup>1</sup> See Jacob L. Todres, *Internal Revenue Code Section 162(f): An Analysis and Its Application to Restitution Payments and Environmental Fines*, 99 DICK. L. REV. 645, 650 (1995).

<sup>2</sup> See *id.*

to account for the value of the deduction.<sup>3</sup> For example, a \$650,000 nondeductible fine or similar penalty is economically equivalent to a \$1,000,000 deductible monetary sanction that reduces the taxpayer's income tax liability by \$350,000.<sup>4</sup> In each case, the after-tax cost to the taxpayer would be \$650,000. If payments of income tax and monetary sanctions are paid into the federal treasury, allowing a deduction would add a level of complexity without any benefit.<sup>5</sup>

While environmental statutes often provide for monetary sanctions in the form of fines and similar penalties to punish and deter violators,<sup>6</sup> these sanctions frequently do not remedy the local harm caused by the offense or eliminate (or reduce) the risk of future harm because the payments must be made to the federal government.<sup>7</sup> However, it is possible for judges and attorneys to keep the money local rather than allowing it to go into the federal treasury by carefully delineating the amount that is a fine, from that which is restitution or some other form of court imposed monetary sanction.<sup>8</sup> If the goal of the statute giving rise to the monetary sanction is to protect the environment, how should such structuring of sentences and settlements be regarded?<sup>9</sup>

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<sup>3</sup> Cf. John Y. Taggart, *Fines, Penalties, Bribes, and Damage Payments and Recoveries*, 25 TAX L. REV. 611, 615 (1970) (arguing that the deterrent effect is altered in proportion to the taxpayer's marginal tax bracket).

<sup>4</sup> Cf. Todres, *supra* note 1, at 651-52 (discussing the value of deductions in various tax brackets).

<sup>5</sup> See Taggart, *supra* note 3, at 615. If deductibility is permitted, the deterrent impact of a fine cannot be consistently maintained by raising the amount of the fine. See *id.* Since the alteration is in proportion to the taxpayer's tax bracket, this factor would have to be taken into account when raising the amount of the fine. See *id.*

<sup>6</sup> See ZYGMUNT J.B. PLATER ET AL., ENVIRONMENTAL LAW AND POLICY: NATURE, LAW, AND SOCIETY 869-70 (2d ed. 1998) (An Introduction to . . . Environmental Statutory Design).

<sup>7</sup> See Martin Harrell, *Organizational Environmental Crime and the Sentencing Reform Act of 1984: Combining Fines with Restitution, Remedial Orders, Community Service, and Probation to Benefit the Environment while Punishing the Guilty*, 6 VILL. ENVTL. L.J. 243, 247, 272-76 (1995) (discussing the requirement of payments to be paid to the federal treasury as a result of the following legislation: U.S. CONST. art. I, § 9, cl. 7; Miscellaneous Receipts Statute, Act of Mar. 3, 1849, ch. 11, 9 Stat. 398 (codified as amended at 31 U.S.C. § 3302(b) (1982)) (preventing federal agencies from spending money for their own causes by requiring it to be deposited in the Treasury for use as Congress directs); Anti-Deficiency Act, Act of Mar. 3, 1905, ch. 1484, § 4, 33 Stat. 1214 (codified as amended at 31 U.S.C. §§ 1341-1351 (1982)) (prohibiting government employees from spending money in excess of amounts available through Congressional appropriations or obligating the federal government to pay money prior to appropriation by Congress); 42 U.S.C. § 10601(b) (requiring most criminal fines to be deposited into a special account in the Department of Treasury known as the Victim Crime Fund to be used to pay for victim compensation and assistance programs)).

<sup>8</sup> See *id.* at 275.

<sup>9</sup> ZYGMUNT J.B. PLATER ET AL., ENVIRONMENTAL LAW AND POLICY: 1996-1997 CUMULA-

This Comment argues that under the present statutory framework, allowing some environmental monetary sanctions to be tax deductible is consistent with sound environmental and social values.<sup>10</sup> Carefully structuring sentences and settlements so that tax deductible payments fund local beneficial environmental projects maximizes the economic resources available to remediate the harms that gave rise to the environmental monetary sanctions.<sup>11</sup> Continuing with the above example, this Comment argues that it is better for the environment to allow a tax deductible \$1,000,000 monetary sanction paid to establish a beneficial environmental project (e.g. a Supplemental Environmental Project) to remediate the harm caused by the violation, than it is to pay \$650,000 into the federal treasury.

The key to bringing the maximum resources to bear against the environmental damage is to structure the sentence or settlement so that tax deductible monetary sanctions are kept local.<sup>12</sup> The current tax laws explicitly disallow a deduction "for any fine or similar penalty paid to a government for the violation of any law."<sup>13</sup> To determine the scope of this provision, it is helpful to use an analytical framework similar to that used by Congress when it enacted the law.<sup>14</sup> Accordingly, the question as to which environmental monetary sanctions should be tax deductible must be viewed both from the standpoint of tax policy and from the standpoint of environmental policy.<sup>15</sup>

Section I of this Comment reviews the current tax laws with respect to deducting fines and similar penalties to see which, if any, environmental monetary sanctions are tax deductible. The section parses the statutory language and examines the relevant Treasury Regulation and case law for the criteria to distinguish environmental monetary sanctions between deductible and nondeductible amounts. Section II examines whether monetary sanctions should be tax de-

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TIVE MANUAL FOR TEACHERS 76 (1996). "If prosecutors negotiating penalties wish to have penalty funds used for on-site remedies rather than merely pouring into the federal treasury, tax deductibility is a settlement incentive. Can such SEPs be made deductible? . . . Is such tax deductibility a good idea?" PLATER ET AL., *supra* note 6, at 895.

<sup>10</sup> This article focuses on whether or not I.R.C. § 162(f) is applicable to environmental monetary sanctions. It does not address whether deductible payments should be expensed immediately or must be capitalized.

<sup>11</sup> Cf. Harrell, *supra* note 7, at 275 (discussing structuring monetary sanctions).

<sup>12</sup> See *id.*

<sup>13</sup> See I.R.C. § 162(f) (1997).

<sup>14</sup> Cf. S. REP. NO. 91-552 (1969), reprinted in 1969 U.S.C.C.A.N. 2027, 2311 (enacting legislation dealing with the deductibility of antitrust damage payments in which the U.S. Senate stated that "[t]he question as to whether antitrust treble damage payments should be deductible must be viewed both from the standpoint of antitrust policy and from the standpoint of tax policy").

<sup>15</sup> See *id.*

ductible from an environmental perspective. The section first looks at the extent of penalties intended for criminal actions, as well as civil and administrative actions. The section then reviews case law to see how courts have treated these sanctions in environmental cases. Section III combines salient points of Sections I and II to show that in either a criminal or civil action, monetary sanctions can be structured so that some payments are tax deductible and stay local to help those most affected by the harm. Moreover, such structuring may also make it possible to obtain a tax deduction that can be factored into setting the sentence or settlement. For taxpayers with limited economic resources, this allows for larger assessments that can be used to remediate the harm and provide relief to the victims.

### I. TAX PERSPECTIVE

From the standpoint of tax policy, there has been a reluctance to disallow business expense deductions because of the notion that an income tax should only be imposed on business income after deducting all actual expenses.<sup>16</sup> During the Senate debate in 1913 on the bill that became the first modern income tax law, amendments were rejected that would have limited the deductions for losses to those incurred in a "legitimate" or "lawful" trade or business.<sup>17</sup> Senator Williams, who was in charge of the bill, stated on the floor of the Senate that:

[T]he object of this bill is to tax a man's net income; that is to say, what he has at the end of the year after deducting from his receipts his expenditures or losses. It is not to reform men's moral characters; that is not the object of the bill at all. The tax is not levied for the purpose of restraining people from betting on horse races or upon "futures," but the tax is framed for the purpose of making a man pay upon his net income, his actual profit during the year. The law does not care where he got it from, so far as the tax is concerned, although the law may very properly care in another way.<sup>18</sup>

The validity of this position is bolstered by the obvious difficulties confronting the Internal Revenue Service (IRS) when it is forced to undertake the disallowance of deductions for expenses of illegal or

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<sup>16</sup> See *id.*

<sup>17</sup> See *Commissioner v. Tellier*, 383 U.S. 687, 691 (1966).

<sup>18</sup> *Id.* at 691-92 (citation omitted). This 1966 case was the last I.R.C. section 162(a) public policy case to come before the United States Supreme Court and occurred before the 1969 amendment which added section 162(f). See *Todres*, *supra* note 1, at 661.

improper activities which other state or federal agencies have not sought to challenge.<sup>19</sup> The IRS is not equipped to serve as a junior Department of Justice or state attorney general.<sup>20</sup>

The U.S. Supreme Court has consistently held that "an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer."<sup>21</sup> Traditionally, taxpayers have attempted to claim deductions for fines and settlements under section 162(a) of the Internal Revenue Code (I.R.C.).<sup>22</sup> Section 162(a) states the general rule that "[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying out any trade or business."<sup>23</sup> In 1969, Congress amended section 162 to deny deductions for the following four types of expenditures:<sup>24</sup> first, fines or similar penalties paid to a government for the violation of any law;<sup>25</sup> second, a portion of treble damage payments under the antitrust laws following a related criminal conviction (or plea of equity or nolo contendere);<sup>26</sup> third, deductions for bribes paid to public officials (whether or not foreign officials);<sup>27</sup> fourth, and other unlawful bribes or "kick-

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<sup>19</sup> See Taggart, *supra* note 3, at 615.

<sup>20</sup> See *id.*

<sup>21</sup> *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992) (quoting *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593 (1943)).

<sup>22</sup> See Edward Schnee, *Some Fines and Penalties Can be Deducted*, 58 TAX'N FOR ACCT. 20, 20 (1997). Other sections of the Internal Revenue Code, that are used less frequently to claim an income tax deduction, include section 165, which authorizes deductions of certain losses, and section 170, which authorizes deduction of certain charitable contributions and gifts. See, e.g., *Stephens v. Commissioner*, 93 T.C. 108, 112 (1989) (concluding that at a minimum, the considerations involved in applying section 162(f) extend to determination of deductibility under section 165(c)(2)); Rev. Rul. 79-148, 1979-1 C.B. 93, 93-94 (holding contribution to charity in lieu of fine is not deductible under I.R.C. § 162(f) or § 170).

<sup>23</sup> I.R.C. § 162(a).

<sup>24</sup> See Tbdres, *supra* note 1, at 647-48.

<sup>25</sup> See I.R.C. § 162(f).

<sup>26</sup> See *id.* § 162(g). Congress's 1969 amendments to section 162 were most likely spurred by the IRS's ruling five years earlier. See Tbdres, *supra* note 1, at 647. Under section 4 of the Clayton Act, a person injured by an antitrust violation may sue for damages and recover three times the amount of economic loss established. See S. REP. NO. 91-552 (1969), *reprinted in* 1969 U.S.C.A.N. 2027, 2311. The 1964 Revenue Ruling 64-224 held that amounts paid or incurred in satisfaction of treble damage claims under that act were fully deductible as ordinary and necessary business expenses. See *id.* The Tax Reform Act of 1969 amended section 162 so that if a taxpayer is convicted in a criminal proceeding for the violation of Federal antitrust laws (or pled guilty or nolo contendere), then no deduction is to be allowed for two-thirds of any amount paid on any judgment for damages against the taxpayer or for settlement of any action brought under section 4 of the Clayton Antitrust Act. See *id.* at 2312.

<sup>27</sup> See I.R.C. § 162(c)(1). This amendment expanded code section 162(c) (and renumbered it

backs.”<sup>28</sup> The Senate Report for the Tax Reform Act of 1969 (Senate Report) noted that there was “no statutory provision setting forth a general ‘public policy’ basis for denying deductions which are ‘ordinary and necessary’ business deductions. Nevertheless, a number of business expenses ha[d] been disallowed on the ground that the allowance of these deductions would be contrary to Federal or State ‘public policy.’”<sup>29</sup> The Senate Report further noted:

There still remains . . . the question as to what is an ordinary and necessary business expense. The Supreme Court in the *Tank Truck Rental case*, for example, in holding that the payment of fines could not be considered as ordinary and necessary, stated: “A finding of ‘necessity’ cannot be made however, if allowance of the deduction would frustrate sharply defined national or State policies proscribing the particular types of conduct evidenced by some governmental declaration thereof.”

On the same grounds, it appears appropriate to deny deductions for bribes, illegal kickbacks, and the penalty portion of antitrust treble damage payments.<sup>30</sup>

Apparently-conflicting statements in the Senate Report have generated much litigation concerning the deductibility of payments, as well as the possible continuing validity of the pre-1969 “public policy” doctrine.<sup>31</sup> The Senate Report indicated that Congress intended the provision for the denial of deductions for payments in these situations

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162(c)(1) so as to deny a section 162(a) deduction for any illegal bribe or kickback given to an official or employee of any government. See Todres, *supra* note 1, at 648. The prior section 162(c) only applied to payments made to foreign government officials. See *id.*

<sup>28</sup> See I.R.C. § 162(c)(2). This amendment in its original form denied a section 162(a) deduction for any illegal bribe or kickback given to someone other than a government official or employee where the taxpayer had been convicted (or pled guilty or nolo contendere) in a criminal proceeding for making the payment. See Todres, *supra* note 1, at 648 & n.8. It was significantly changed by section 310(a) of the Revenue Act of 1971. See *id.*

<sup>29</sup> S. REP. NO. 91-552 at 2310. Prior to the 1969 amendments, the courts used two approaches to disallow deductions. See Todres, *supra* note 1, at 653-54. The first approach held that the expenses failed to qualify as ordinary and necessary business expenses under section 162(a). See *id.* at 654. This approach was problematic when courts wanted to disallow deductions for expenses that normally would qualify as ordinary and necessary expenses under the statute. See *id.* at 654. The second approach held that even if the expenses qualified as ordinary and necessary expenses under section 162(a), the deduction would be disallowed for reasons of public policy. See *id.* at 653. This approach required the court to overrule a statute that expressly allowed deductions of all ordinary and necessary business expenses. See *id.* Disparate and inconsistent outcomes resulted from the unchecked proliferation of “public policy” exceptions of obscure distinctions. See *id.* at 653-54.

<sup>30</sup> See S. REP. NO. 91-552 at 2311.

<sup>31</sup> See Schnee, *supra* note 22, at 21. For a more thorough discussion of public policy considerations and the pre-1969 “Public Policy” doctrine, see Todres, *supra* note 1, at 653-64.

to be all inclusive.<sup>32</sup> It specifically stated that “[p]ublic policy, in other circumstances, generally is not sufficiently clearly defined to justify the disallowance of deductions.”<sup>33</sup> Yet, when discussing the specific provision, the Senate Report also stated that “[t]his provision is to apply in any case in which the taxpayer is required to pay a fine because he is convicted of a crime (felony or misdemeanor) in a full criminal proceeding in an appropriate court. This represents a codification of the general court position in this respect.”<sup>34</sup>

Section 162(f) of the I.R.C. states in its entirety, “[n]o deduction shall be allowed under subsection (a) for any fine or similar penalty paid to a government for the violation of any law.”<sup>35</sup> The starting point for analyzing the statute is to examine each key statutory phrase.<sup>36</sup>

#### A. “. . . any Fine or Similar Penalty . . .”

The statutory language of section 162(f) does not define the scope of the phrase “any fine or similar penalty,” however, the language suggests that fines are a broader category than penalties.<sup>37</sup> While all fines are included within the section 162(f) disallowance, only those penalties which are “similar” to fines are included.<sup>38</sup> Courts give substantial weight to the Department of the Treasury’s regulations.<sup>39</sup> Although the Treasury Regulations expand on the wording used in the I.R.C., they do not supply a unique definition.<sup>40</sup> As a consequence,

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<sup>32</sup> See S. REP. NO. 91-552 at 2311.

<sup>33</sup> *Id.*

<sup>34</sup> See *id.* at 2311-12.

<sup>35</sup> I.R.C. § 162(f) (1997).

<sup>36</sup> See Todres, *supra* note 1, at 669.

<sup>37</sup> See *id.*

<sup>38</sup> See *id.*; see also *True v. United States*, 894 F.2d 1197, 1202 (10th Cir. 1990) (“A common sense reading indicates to us that the addition of the words ‘similar penalty’ reflects an intent to include more than just criminal fines, but not all penalties.”).

<sup>39</sup> See, e.g., *Cottage Sav. & Loan v. Commissioner*, 499 U.S. 554, 560-61 (1979) (“Because Congress has delegated to the Commissioner the power to promulgate ‘all needful rules and regulations for the enforcement of [the Internal Revenue Code],’ 26 U.S.C. § 7805(a), we must defer to his regulatory interpretations of the Code so long as they are reasonable, see *National Muffler Dealers Ass’n v. United States*, 440 U.S. 472, 477 (1979)”); *True*, 894 F.2d at 1202 (“The court’s role in reviewing Treasury Department regulations is very limited. . . . As a general rule, Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes. ‘In determining whether a particular regulation carries out the congressional mandate in a proper manner, [courts] look to see whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose.’”) (citation omitted) (quoting *National Muffler Dealers Ass’n.*, 440 U.S. at 477)).

<sup>40</sup> See Schnee, *supra* note 22, at 21. Treasury Regulation section 1.162-21(b)(1), states that a fine or similar penalty includes an amount—

there has been considerable litigation concerning the scope of section 162(f) and the regulation.<sup>41</sup>

### 1. Payments That Are Specifically Included in the Definition of a Fine or Similar Penalty

The first "fine or similar penalty" specifically included by the Treasury Regulations is an amount "paid pursuant to a conviction or a plea of guilty or a plea of *nolo contendere* for a crime (felony or misdemeanor) in a criminal proceeding."<sup>42</sup>

The second payment specifically included in a "fine or similar penalty" by the Treasury Regulations is an amount paid as a civil penalty imposed by federal, state, or local law.<sup>43</sup> Almost immediately after section 162(f) was enacted, the question arose as to what extent the enacting provision applied to civil penalties.<sup>44</sup> It is now generally accepted that civil penalties which are designed to punish or deter taxpayers are nondeductible, while civil penalties that are remedial or compensatory are deductible.<sup>45</sup> The distinction between punitive and remedial civil penalties is far from obvious.<sup>46</sup>

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(i) Paid pursuant to conviction or a plea of guilty or *nolo contendere* for a crime (felony or misdemeanor) in a criminal proceeding;

(ii) Paid as a civil penalty imposed by Federal, State, or local law . . . ;

(iii) Paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal); or

(iv) Forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty.

*Id.*; Treas. Reg. § 1.162-21(b)(1).

<sup>41</sup> See Schnee, *supra* note 22, at 21.

<sup>42</sup> See Treas. Reg. § 1.162-21(b)(1)(i).

<sup>43</sup> See *id.* at § 1.162-21(b)(1)(ii).

<sup>44</sup> See Taggart, *supra* note 3, at 646. In the course of amending section 162(c) in the Revenue Act of 1971, the Senate Finance Committee set forth its earlier intent with respect to section 162(f). See S. REP. NO. 92-437 (1971), *reprinted in* 1971 U.S.C.C.A.N. 1918, 1980. "In approving the provisions dealing with fines and similar penalties in 1969, it was the intention of the committee to disallow deductions for payments of sanctions which are imposed under civil statutes but which in general terms serve the same purpose as a fine exacted under a criminal statute . . ." *Id.* However, because post-enactment commentary is not necessarily controlling, the problem persists as to whether section 162(f) applies to civil penalties. See Todres, *supra* note 1, at 666.

<sup>45</sup> See Schnee, *supra* note 22, at 22; see, e.g., *Southern Pac. Transp. Co. v. Commissioner*, 75 T.C. 497, 652 (1980); *Middle Atl. Distrib., Inc. v. Commissioner*, 72 T.C. 1136, 1143 (1979). *But see* *Colt Indus., Inc. v. United States*, 880 F.2d 1311, 1313 (Fed. Cir. 1989) (holding Congress did not intend to distinguish between deductible and nondeductible civil penalties).

<sup>46</sup> See Schnee, *supra* note 22, at 22.



In the landmark case of *Southern Pacific Transportation Co. v. Commissioner*, the Tax Court distinguished between punitive versus remedial civil penalties.<sup>47</sup> The court analyzed the legislative history of section 162(f)'s "fine or similar penalty" phrase, stating:

Congress, by use of the word "similar," was not intending to distinguish between criminal and civil sanctions, but rather was intending to make a distinction between different types of civil penalties. If a civil penalty is imposed for purposes of enforcing the law and as punishment for the violation thereof, its purpose is the same as a fine exacted under a criminal statute and it is "similar" to a fine. However, if the civil penalty 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, it does not serve the same purpose as a criminal fine and is not "similar" to a fine within the meaning of section 162(f) . . . .<sup>48</sup>

The court rejected the taxpayer's argument that section 162(f) should only apply to penalties imposed on the commission of an act evidencing "reprehensible conduct" which normally accompanies the violation of a criminal law.<sup>49</sup> The court stated that "the appropriate consideration is not the type of conduct which gives rise to the violation resulting in the penal imposition but is the purpose which the statutory penalty is to serve."<sup>50</sup>

While most courts and the IRS have concluded that some civil fines are deductible,<sup>51</sup> despite variations in how to distinguish among various civil fines,<sup>52</sup> the conclusion is not unanimous.<sup>53</sup> In *Colt Industries v. United States*, the United States Court of Appeals for the Federal Circuit interpreted the same legislative history to conclude that all civil and criminal fines, with the exception of late filing charges or interest charges to encourage prompt compliance with filing or other requirements, are nondeductible.<sup>54</sup>

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<sup>47</sup> See *Southern Pacific*, 75 T.C. at 652; Todres, *supra* note 1, at 668 & nn.136-38.

<sup>48</sup> See *Southern Pacific*, 75 T.C. at 653.

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> See, e.g., *id.* at 652; *Middle Atlantic*, 72 T.C. at 1143; Gen. Couns. Mem. 39,596 (Sept. 26, 1986).

<sup>52</sup> Compare, e.g., *Southern Pacific*, 75 T.C. at 653, and *Middle Atlantic*, 72 T.C. at 1143 (distinguishing punitive from remedial), with *True v. United States*, 894 F.2d 1197, 1204 (10th Cir. 1990) (distinguishing retributive from compensatory or remedial).

<sup>53</sup> See Schnee, *supra* note 22, at 23.

<sup>54</sup> See *Colt Indus., Inc. v. United States*, 880 F.2d 1311, 1313 (Fed. Cir. 1989). The court reasoned:

The third "fine or similar penalty" specifically included by the Treasury Regulations is an amount "paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal)."<sup>55</sup> While section 162(f) does not specifically address whether settlement or compromise payments are within its ambit, the statute's silence is meaningful.<sup>56</sup> When Congress enacted the Tax Reform Act of 1969, it explicitly required a conviction (or plea of guilty or nolo contendere) for sections 162(g) and 162(c)(2), but omitted such requirements for sections 162(f) and 162(c)(1).<sup>57</sup> The failure to state any such requirement for section 162(f) suggests that none was intended.<sup>58</sup> Courts have routinely held that settlement and compromise payments are within section 162(f), and that section 1.162-21(b)(1)(iii) of the regulations is valid.<sup>59</sup>

The determination of whether a settlement payment is a penalty under section 162(f) is made using the "origin of the liability" test.<sup>60</sup> For example, in *Middle Atlantic Distributors v. Commissioner*, the Tax Court, in determining whether the settlement payment was deductible or not, stated that "the character of the payment involved depends on the origin of the liability giving rise to it."<sup>61</sup> After noting that the statute under which the claim was made had dual purposes, the court based its decision on an inquiry into whether the claim was

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The [1971 Senate Finance] committee's comments were to clarify that civil penalties, as well as criminal, are within the ambit of section 162(f), not an effort to distinguish between deductible and nondeductible civil penalties. The committee emphasized that it "did not intend to liberalize the law in the case of fines or penalties." To the extent that it recognized an exception to the nondeductibility of civil penalties, the committee said only that the deduction of "late filing charges or interest charges" imposed to "encourage prompt compliance with filing or other requirements" is not barred.

*Id.* at 1313 (citations omitted) (quoting S. REP. No. 92-437 (1971), *reprinted in* 1971 U.S.C.C.A.N. 1825, 1918).

<sup>55</sup> See Treas. Reg. § 1.162-21(b)(1)(iii).

<sup>56</sup> See *Todres*, *supra* note 1, at 699.

<sup>57</sup> Compare I.R.C. § 162(g) (1969) and § 162(c)(2) (1969) (statutes having explicit requirement that there be a conviction or plea of guilty or nolo contendere), with § 162(f) (1969) and § 162(c)(1) (1969) (statutes not having such requirement).

<sup>58</sup> See *Todres*, *supra* note 1, at 699 (citing Taggart, *supra* note 3, at 647-48).

<sup>59</sup> See, e.g., *Colt Industries*, 880 F.2d at 1314; *Adolf Meller Co. v. United States*, 600 F.2d 1360, 1364 (Ct. Cl. 1979).

<sup>60</sup> See, e.g., *Middle Atl. Distrib., Inc. v. Commissioner*, 72 T.C. 1136, 1144-45 (1979). The U.S. Supreme Court set forth the "origin and character of the claim" test in *United States v. Gilmore*. See 372 U.S. 39, 49 (1963). The Court held that "the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was . . . deductible or not." *Id.*

<sup>61</sup> See *Middle Atlantic*, 72 T.C. at 1144-45.

made in respect to the statute's compensatory purposes or for the purpose of punishing culpable behavior.<sup>62</sup> The court concluded that at all times during the settlement negotiations, the United States was only seeking reimbursement for lost revenue, without the intent to punish or deter, and thus the payment was deductible.<sup>63</sup>

It should be noted that in *Middle Atlantic*, the court gave effect to the parties' characterization of the payment only after it had determined that the governing statute had a dual purpose.<sup>64</sup> This does not necessarily mean that the parties' characterization of a penalty as deductible will be given effect by the court when there is a single purpose statute to the contrary.<sup>65</sup> However, in instances where the settlement agreement characterizes a civil penalty as nondeductible, presumably such characterization will be given effect.<sup>66</sup>

In General Counsel Memorandum 39,596, the IRS used a two-part analysis to discuss the deductibility of payments made in a settlement agreement for violations of the Anti-dumping Act of 1921.<sup>67</sup> The first prong of the analysis examined the punitive or remedial character of the statute.<sup>68</sup> The second prong of the analysis examined the effect of the settlement agreement on whether the payment should be viewed as a fine or similar penalty.<sup>69</sup> The IRS explained that although this agreement, by its terms, was not binding on the Department of the Treasury, it provided further evidence of the remedial rather than punitive nature of the settlement.<sup>70</sup> After examining the facts and circumstances, the IRS concluded that the settlement payments were deductible by reasoning that not only is the settlement payment not a fine or similar penalty in its own right because of the underlying

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<sup>62</sup> See *id.*

<sup>63</sup> See *id.* at 1145.

<sup>64</sup> See Todres, *supra* note 1, at 676.

<sup>65</sup> See *id.*

<sup>66</sup> See *id.* at 676 n.194.

<sup>67</sup> See Gen. Couns. Mem. 39,596 (Sept. 26, 1986).

<sup>68</sup> See *id.* The IRS stated:

We interpret . . . the term "remedial" . . . to include those monetary exactions in which there is a compensatory or computational nexus between the amount of the exaction and the harm or injury done to the exacting government . . . or to third parties that the government is attempting to protect. We do not . . . include[] within the scope of the term "remedial" those penal or punitive exactions enacted to enforce the law even though such exactions may be aggregated in a fund to mitigate the harm or injury caused by the proscribed action or conduct.

*Id.* (interpreting *Middle Atlantic*).

<sup>69</sup> See *id.*

<sup>70</sup> See *id.*

remedial nature, but it is further precluded from being a nondeductible fine or similar penalty by the express language of the settlement agreement.<sup>71</sup>

In Revenue Ruling 79-148, the IRS suggested that once a payment is determined to be a fine or similar penalty under the normal requirements, any settlement in lieu of such amount will automatically remain within section 162(f).<sup>72</sup> In the underlying case, the taxpayer pled no contest and was convicted for unlawfully selling products to a foreign country in violation of federal law.<sup>73</sup> Before any fine was imposed, the taxpayer offered to make a contribution to a charitable organization equal to the maximum fine that could be imposed.<sup>74</sup> At sentencing, the court suspended the taxpayer's sentence, placed him on probation, and directed him to pay the charitable contribution.<sup>75</sup> The IRS relied on Regulation section 1.162-21(b)(1)(iii) to conclude that the charitable payment was nondeductible under section 162(f).<sup>76</sup> The IRS reasoned that the taxpayer's payment to the charitable organization was in lieu of having to pay a fine to the federal government.<sup>77</sup>

Dicta in *S & B Restaurant v. Commissioner* questioned whether the institution of a legal proceeding prior to reaching a settlement was a necessary precondition to the application of section 162(f).<sup>78</sup> Although there is no specific requirement of a legal proceeding in section 162(f), the Tax Court noted that there is some indication that Congress may have intended such a requirement.<sup>79</sup> However, the court

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<sup>71</sup> See *id.*

<sup>72</sup> See Rev. Rul. 79-148, 1979-1 C.B. 93, 93-94. The weight to be accorded Revenue Rulings is unclear. Compare *Davis v. United States*, 495 U.S. 472, 484 (1990) ("Although the Service's interpretative rulings do not have the force and effect of regulations . . . we give an agency's interpretations and practices considerable weight where they involve the contemporaneous construction of a statute and where they have been in long use.") (citations omitted), with *Johnson City Med. Ctr. v. United States*, 999 F.2d 973, 976 (6th Cir. 1993) ("a revenue ruling is entitled to some deference unless 'it conflicts with the statute it supposedly interprets or with that statute's legislative history or if it is otherwise unreasonable'" (citations omitted), and *Stubbs, Overbeck & Assoc., Inc. v. United States*, 445 F.2d 1142, 1146-47 (5th Cir. 1971) ("A ruling is merely the opinion of a lawyer in the agency and must be accepted as such. It may be helpful in interpreting a statute, but it is not binding on . . . the courts. It does not have the effect of a regulation or a Treasury Decision.") (citations omitted).

<sup>73</sup> See Rev. Rul. 79-148, 1979-1 C.B. at 93.

<sup>74</sup> See *id.*

<sup>75</sup> See *id.*

<sup>76</sup> See *id.* at 94.

<sup>77</sup> See *id.*

<sup>78</sup> See *S & B Restaurant, Inc. v. Commissioner*, 73 T.C. 1226, 1234 (1980).

<sup>79</sup> See *id.* (citing S. REP. NO. 91-552, 274 (1969), 1969-3 C.B. 423, 597; H. CONF. REP. NO. 91-782, 331-332 (1969), 1969-3 C.B. 644, 676-77 (in connection with section 902 of the Tax

also noted that requiring the institution of legal proceedings before settlement is reached, as a precondition to denying the tax deduction, could present a serious problem by encouraging taxpayers "to pay early and get the deduction."<sup>80</sup>

The last payment specifically included in a fine or similar penalty by the Treasury Regulation is an amount "forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty."<sup>81</sup>

## 2. Payments That Are Specifically Excluded from the Definition of a Fine or Similar Penalty

Treasury Regulation section 1.162-21(b)(2) excludes certain payments from the definition of a fine or similar penalty.<sup>82</sup> "The amount of a fine or penalty does not include legal fees and related expenses paid or incurred in the defense of a prosecution or civil action arising from a violation of the law imposing the fine or civil penalty . . . ."<sup>83</sup> More importantly, the Treasury Regulation also excludes "[c]ompensatory damages . . . paid to a government."<sup>84</sup> It is not clear how strictly the courts enforce the "paid to a government" component under this exclusion.<sup>85</sup>

## 3. Restitution

### a. *Criminal Actions*

While it is clear that a criminal fine is not deductible, courts are split as to whether restitution payments are deductible under section 169(f).<sup>86</sup> The deciding factor appears to be whether the payment is classified as a fine (nondeductible), or as a compensatory payment

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Reform Act of 1969, 83 Stat. 710); S. REP. NO. 92-437, 72-74 (1971), 1972-1 C.B. 559, 559-600 (in connection with section 310 of the Revenue Act of 1971, 85 Stat. 525)).

<sup>80</sup> See *id.*

<sup>81</sup> See Treas. Reg. § 1.162-21(b)(1)(iv).

<sup>82</sup> See *id.* § 1.162-21(b)(2).

<sup>83</sup> *Id.*

<sup>84</sup> *Id.*

<sup>85</sup> Cf. *infra* Section I.B (discussing "paid to a government" requirement of I.R.C. § 162(f)).

<sup>86</sup> Compare *Waldman v. Commissioner*, 88 T.C. 1384, 1386, 1389 (1987), *aff'd*, 850 F.2d 611 (9th Cir. 1988), and *Stephens v. Commissioner*, 93 T.C. 108, 113 (1989) (holding that restitution paid to victims, made to obtain a stay of sentencing, is a nondeductible fine or similar penalty), with *Stephens v. Commissioner*, 905 F.2d 667, 674 (2d Cir. 1990), *rev'g* 93 T.C. 108 (1989), and *Spitz v. United States*, 432 F. Supp. 148, 149-50 (E.D. Wis. 1977) (holding that restitution paid to a

(deductible).<sup>87</sup> In *Waldman v. Commissioner*, the taxpayer's entire prison sentence was stayed on the condition that he pay specified amounts of restitution to his victims.<sup>88</sup> The Tax Court disallowed the deduction because the "payments . . . were . . . in satisfaction of . . . criminal liability to the state."<sup>89</sup> The court reasoned that "had [the taxpayer] pled not guilty, and had he been subsequently acquitted, the court could not have ordered payment of restitution."<sup>90</sup> The court noted that since restitution was not a substitute for a civil action to recover damages, it can not be considered compensatory.<sup>91</sup> The court held that the restitution payments met the definition of a "fine or similar penalty" because they were paid pursuant to his plea of guilty, and under the state penal code, restitution was a deterrent to future criminality imposed for the purpose of enforcing the law.<sup>92</sup>

In *Stephens v. Commissioner*, the court also held that restitution payments were nondeductible.<sup>93</sup> The taxpayer was convicted on several counts of embezzlement and was sentenced to several concurrent prison terms and substantial fines.<sup>94</sup> The sentencing judge suspended one of the prison terms and substituted probation on the condition that the taxpayer make restitution.<sup>95</sup> The Tax Court stated:

It is equally clear that the restitution payment involved herein was made as the result of a criminal conviction and that it was ordered in lieu of an additional prison term and as a condition of probation. That the payment had the effect of reimbursing [the victim] for all or part of its loss and, therefore, had a civil aspect, does not detract from this overriding fact.<sup>96</sup>

Yet on appeal, *Stephens* was reversed by the United States Court of Appeals for the Second Circuit, which held that the restitution payment was not a fine or similar penalty under section 162(f) because

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victim, even though required to avoid incarceration, is not a fine or similar penalty, but rather is deductible because it is compensatory).

<sup>87</sup> See *Stephens*, 905 F.2d at 672-73.

<sup>88</sup> See *Waldman*, 88 T.C. at 1387. On appeal, the Ninth Circuit affirmed the lower court's decision "substantially for the reasons stated by the Tax Court." See *Waldman v. Commissioner*, 850 F.2d 611, 611 (9th Cir. 1988).

<sup>89</sup> See *Waldman*, 88 T.C. at 1389.

<sup>90</sup> *Id.* at 1387.

<sup>91</sup> See *id.*

<sup>92</sup> *Id.* at 1387-88.

<sup>93</sup> See *Stephens v. Commissioner*, 93 T.C. 108, 113 (1989).

<sup>94</sup> See *id.* at 109.

<sup>95</sup> See *id.*

<sup>96</sup> *Id.* at 113 (citation omitted).

it was primarily a remedial measure to compensate another party and was paid to an individual, rather than the government.<sup>97</sup> The Second Circuit, in allowing the deduction, expressly declined to decide if either condition alone would be sufficient to make the payment of restitution outside the scope of section 162(f).<sup>98</sup> It distinguished *Waldman*, noting that the defendant's entire sentence was suspended on the condition that he make restitution, and thus the purpose of the Waldman's payment was equally compensatory and punitive in nature.<sup>99</sup> By contrast, the court noted that only one of Stephens' several concurrent prison terms was suspended and conditioned on restitution for the primary, not "incidental", purpose of reimbursing the victim.<sup>100</sup> In *Stephens*, the defendant's sentence consisted of incarceration, fines, and an order to make restitution, supporting the inference that the restitution payment was compensatory in nature and not in the nature of a fine or penalty.<sup>101</sup> The restitution payments were imposed in addition to the fine, not in lieu thereof.<sup>102</sup>

As demonstrated in *Stephens*, it is possible for the monetary sanctions imposed by the sentencing court to consist of both nondeductible and deductible components.<sup>103</sup> In *Stephens*, the Sixth Circuit observed that:

Stephens' situation resembles that of the petitioners in *Mason and Dixon Lines, Inc. v. United States*, whose fine for trucking violations were punitive and not deductible, but whose liquidated damages payments were compensatory and therefore deductible. While the fines Stephens paid as part of his punishment are obviously not deductible, we find that the restitution payment, which is compensatory in nature, is deductible.<sup>104</sup>

#### b. Civil and Administrative Actions

To determine the deductibility of restitution payments in civil actions, the payments must be classified as either "fines or similar pen-

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<sup>97</sup> *Stephens v. Commissioner*, 905 F.2d 667, 672-74 (2d Cir. 1990).

<sup>98</sup> *See id.* at 672. The court stated, "Two considerations drawn from section 162(f) and the cases construing that provision combine to support our conclusion in this case. Whether either consideration alone would suffice is a matter we need not decide." *Id.*

<sup>99</sup> *See id.* at 673.

<sup>100</sup> *See id.*

<sup>101</sup> *See id.*

<sup>102</sup> *See Stephens*, 905 F.2d at 674.

<sup>103</sup> *See id.* at 673.

<sup>104</sup> *Id.* (citations omitted).

alties" or "compensatory damages paid to the government."<sup>105</sup> Fines or similar penalties must be further analyzed to determine if they are punitive or remedial.<sup>106</sup> The tax treatment of the payment depends on the origin of the liability rather than the use to which the payment is put.<sup>107</sup>

In *Bailey v. Commissioner*, the Sixth Circuit upheld the Tax Court's use of section 162(f) to disallow the taxpayer's deduction for restitution payments.<sup>108</sup> The district court judge at sentencing imposed a fine and then allowed it to be applied as restitution in a settlement of a multi-district class action that was pending against the taxpayer's corporation and officers.<sup>109</sup> The court's order authorizing the transfer expressly stated that "the ultimate disposition of these funds in no way shall alter their status as civil penalties."<sup>110</sup> The Sixth Circuit affirmed the Tax Court, reasoning that under the circumstances, the civil penalty was a fine imposed for purposes of enforcing the law and as punishment for a violation thereof.<sup>111</sup> The court rejected the taxpayer's argument that the payment was not a penalty paid to a government, but rather constituted restitution paid to private litigants.<sup>112</sup> The court stated:

The fact that the . . . district court, upon Bailey's application, permitted him to apply the . . . civil penalty toward the settlement of his potential liabilities in the multidistrict class action does not change the status of the payment as a civil penalty. The characterization of a payment for purposes of § 162(f) turns on the origin of the liability giving rise to it.<sup>113</sup>

#### B. ". . . Paid to a Government . . ."

The next key statutory phrase in section 162(f) requires that the fine or similar penalty be "paid to a government."<sup>114</sup> Treasury Regulation section 1.162-21(a) states:

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<sup>105</sup> See I.R.C. § 162(f) (1997); Treas. Reg. §§ 1.162-21(b)(1)(ii) and (b)(2).

<sup>106</sup> See *supra* Section I.A.1.(ii).

<sup>107</sup> See *supra* note 60 and accompanying text.

<sup>108</sup> See *Bailey v. Commissioner*, 756 F.2d 44, 47 (6th Cir. 1985).

<sup>109</sup> See *id.* at 46.

<sup>110</sup> See *id.*

<sup>111</sup> See *id.* at 47.

<sup>112</sup> See *id.* at 46-47.

<sup>113</sup> *Bailey*, 756 F.2d at 47 (citations omitted).

<sup>114</sup> See I.R.C. § 162(f) (1997).



*In general.* No deduction shall be allowed under section 162(a) for any fine or similar penalty paid to—

(1) The government of the United States, a State, a territory or possession of the United States, the District of Columbia, or the Commonwealth of Puerto Rico;

(2) The government of a foreign country; or

(3) A political subdivision of, or corporation or other entity serving as an agency or instrumentality of, any of the above.<sup>115</sup>

Technically, this requirement seems relatively straightforward and noncontroversial.<sup>116</sup> In reality, the cases and revenue rulings either ignore the “paid to a government” requirement or piggyback this requirement onto the “fine or similar penalty” requirement.<sup>117</sup> Although this approach gives the courts greater flexibility in fashioning alternative remedies which they deem nondeductible under section 162(f), it ignores the literal requirements of that section which imposes both the “fine or similar penalty” requirement and the “paid to a government” requirement.<sup>118</sup>

Some courts treat certain payments to a nongovernment recipient as “paid to a government.”<sup>119</sup> In *Waldman v. Commissioner*, the Tax Court held that the taxpayer’s restitution payments to his victims as a condition of staying the execution of his prison sentence met the “paid to a government” requirement.<sup>120</sup> The court reasoned:

The State . . . exercised complete control over the ultimate disposition of petitioner’s payments. The court ordered petitioner to pay specified amounts of restitution to specified victims and informed him that “If the court and the victims are not satisfied that things are going along as they should be, we will not hold a probation violation hearing; I will simply dissolve the stay of execution and you will be committed to State Prison.” We do not believe that a Government must actually “pocket” the fine or penalty to satisfy the “paid to a government” requirement of section 162(f). Petitioner’s “fine or penalty” was “paid to a government” and is not deductible.<sup>121</sup>

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<sup>115</sup> See Treas. Reg. § 1.162-21(a).

<sup>116</sup> See *Todres*, *supra* note 1, at 705.

<sup>117</sup> See *id.* at 713.

<sup>118</sup> See *id.* at 708.

<sup>119</sup> See, e.g., *Waldman v. Commissioner*, 88 T.C. 1384, 1389 (1987), *aff’d*, 850 F.2d 611 (9th Cir. 1988); *Allied-Signal, Inc. v. Commissioner*, 63 T.C.M. (CCH) 2672 (1992), *aff’d without opinion*, 54 F.3d 767 (3d Cir. 1995). *But see* *Stephens v. Commissioner*, 905 F.2d 667, 672-74 (2d Cir. 1990).

<sup>120</sup> See *Waldman*, 88 T.C. at 1387, 1389.

<sup>121</sup> *Id.* at 1389.

Other courts, and at times the IRS, basically ignore the "paid to a government" requirement.<sup>122</sup> In *Bailey v. Commissioner*, the taxpayer argued that section 162(f) was not applicable because the payment was made to private litigants rather than "paid to a government."<sup>123</sup> The Sixth Circuit ignored the taxpayer's argument, holding that the origin of the liability was in punishment for violating the Federal Trade Commission Act and the payment's character as a nondeductible fine remained unchanged even though it was received by victims.<sup>124</sup> In a subsequent case, the Sixth Circuit held that a restitution payment made to a private, nongovernmental entity, was nondeductible under section 162(f), and cited *Bailey* without discussing the "paid to a government" requirement.<sup>125</sup>

Similarly, the IRS in Revenue Ruling 74-148 concluded that a court directed payment to a charitable organization instead of a government was a nondeductible fine under section 162(f).<sup>126</sup> The IRS looked to the origin of the liability and held that an amount paid to someone other than the government can still be a nondeductible fine under section 162(f).<sup>127</sup>

On the other hand, certain payments to the government may be treated as paid to a nongovernment recipient.<sup>128</sup> In *Spitz v. United States*, the taxpayer was ordered to pay restitution to his victim as a condition of probation.<sup>129</sup> In holding that the restitution payment was deductible because it constituted neither a fine nor a penalty, the court concluded that "although the payment was funneled through the State Department of Public Welfare, it was paid to [the victim], not 'to a government' within the meaning of [section] 162(f)."<sup>130</sup>

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<sup>122</sup> See Todres, *supra* note 1, at 706.

<sup>123</sup> See *Bailey v. Commissioner*, 756 F.2d 44, 46 (6th Cir. 1985).

<sup>124</sup> See *id.* at 46-47.

<sup>125</sup> See *Kraft v. United States*, 991 F.2d 292, 298-99 (6th Cir. 1993).

<sup>126</sup> See Rev. Rul. 79-148, 1979-1 C.B. 93, 93-94.

<sup>127</sup> Gen. Couns. Mem. 39,465 (Aug. 19, 1985).

<sup>128</sup> See Schnee, *supra* note 22, at 21.

<sup>129</sup> 432 F. Supp. 148, 149 (E.D. Wis. 1977).

<sup>130</sup> See *id.* at 149-50. The court in *Waldman* critically pointed out that the court in *Spitz*: "(a) never explained how the State court, in a criminal proceeding, could determine Spitz's liability to his victim; (b) never focused on the fact that the restitution was ordered as a condition of probation; and (c) never focused on Supreme Court of Wisconsin precedent that restitution is part of the rehabilitative process in that it forces a defendant to live up to his financial responsibilities." See Todres, *supra* note 1, at 689 (discussing how the court in *Waldman* criticized the opinion in *Spitz*).

C. "... For the Violation of Any Law."

The final requirement under the statutory language of section 162(f) is that the fine or similar penalty paid to a government be "for the violation of any law."<sup>131</sup> The legislative history of this requirement is silent and no case law exists which interprets this statutory phrase.<sup>132</sup> However, the regulations make clear that the law violated need not be a federal law, but could be a state or local law.<sup>133</sup>

## II. ENVIRONMENTAL PERSPECTIVE

From the standpoint of environmental policy, the basic issues in determining whether monetary sanctions should be tax deductible are the extent of the penalties intended by the underlying environmental statute, and whether the impact of the penalties should be reduced by permitting them to reduce taxes which otherwise would have been paid.<sup>134</sup>

### A. Extent of Penalties Intended

#### 1. Criminal Actions

In the federal system, the Attorney General has plenary authority to investigate and prosecute criminal violations of the nation's environmental laws and to settle such cases.<sup>135</sup> Congress enacted the Sentencing Reform Act<sup>136</sup> in 1984 for the primary purposes of decreasing

<sup>131</sup> See I.R.C. § 162(f) (1997).

<sup>132</sup> See Todres, *supra* note 1, at 709.

<sup>133</sup> See *id.* at 709 n.410 (citing Treas. Reg. § 1.162-21(b)(1)(i) (referring to a conviction, plea of guilty or nolo contendere in a criminal proceeding, without limiting it in any way); § 1.162-21(b)(1)(ii) (referring specifically to a civil penalty imposed by federal, state or local law); § 1.162-21(c) exs. (6), (7) and (8) (discussing violations of a state maximum vehicle weight law, state environmental and local housing code, respectively)).

<sup>134</sup> Cf. S. REP. NO. 91-552 (1969), reprinted in 1969 U.S.C.C.A.N. 2027, 2311 (enacting legislation dealing with the deductibility of antitrust damage payments in which the U.S. Senate stated that "[f]rom the standpoint of antitrust policy, the basic issues are the extent of the penalties intended and whether their impact should be reduced by permitting them to reduce taxes which otherwise would have to be paid").

<sup>135</sup> See Harrell, *supra* note 7, at 279 & 279 n.195 (citing inter alia 28 U.S.C. §§ 516, 519 (reserving litigation to the Department of Justice); *United States v. Morgan*, 222 U.S. 274, 282 (1911) (prosecuting attorney has authority to enforce criminal laws which is not diminished without a "clear and unambiguous expression of legislative will")).

<sup>136</sup> Sentencing Reform Act of 1984, Pub. L. No. 98-473, 98 Stat. 1987 (codified at 28 U.S.C. §§ 991-998 (1994 & Supp. I 1995); 18 U.S.C. §§ 3551-3673 (1994)); see Ilene H. Nagel & Winthrop

unwarranted sentencing disparity, increasing sentencing uniformity and certainty, and for some select offenses to increase sentence severity.<sup>137</sup> The Sentencing Reform Act provides that sentences must be responsive to the goals of: just punishment for the offense, deterrence, incapacitation, and rehabilitation.<sup>138</sup> This commitment to multiple goals represents a substantial shift in sentencing from the prior overwhelming emphasis on rehabilitation to the current emphasis on just punishment and deterrence.<sup>139</sup> The Sentencing Reform Act created the U.S. Sentencing Commission (Commission) to promulgate guidelines and policy statements for federal district court judges to use in determining the type and duration of sentences to be imposed on offenders of federal crimes.<sup>140</sup> The U.S. Sentencing Guidelines Manual (Guidelines) promulgated by the Commission is applicable to sentencing convicted individuals, as well as corporate and other organizational defendants.<sup>141</sup>

#### a. *Sentencing Individuals*

For convicted individuals, the Guidelines took effect on November 1, 1987, and apply to all offenses committed on or after that date.<sup>142</sup> The Guidelines require the court to order restitution for most offenses unless full restitution has already been made or "the court determines that the complication and prolongation of the sentencing process resulting from the fashioning of an order of restitution . . . outweighs the need to provide restitution to any victims."<sup>143</sup>

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M. Swenson, *The Federal Sentencing Guidelines for Corporations: Their Development, Theoretical Underpinnings, and Some Thoughts about their Future*, 71 WASH. U. L.Q. 205, 206 n.6 (1993). Ilene H. Nagel is a member of the U.S. Sentencing Commission (Commission) and also co-chaired an advisory group of outside experts to consider issues relevant to the development of environmental sanctions for convicted organizations. *See id.* at 205, 254-55. Winthrop M. Swenson is Deputy General Counsel and Legislative Counsel of the Commission. *See id.* at 205. The views expressed do not necessarily represent those of the Commission. *See id.*

<sup>137</sup> *See* Nagel & Swenson, *supra* note 136, at 205-06.

<sup>138</sup> *See id.* at 207.

<sup>139</sup> *See id.*

<sup>140</sup> *See* 28 U.S.C. §§ 991(a), 994(a). The Commission is a full-time, bipartisan, independent agency in the judicial branch created to develop and implement a consistent, just and rational sentencing policy. *See* Nagel & Swenson, *supra* note 136, at 206-07.

<sup>141</sup> U. S. SENTENCING GUIDELINES MANUAL (1995) [hereinafter *U.S.S.G.*]. The Commission has the authority to submit amendments to Congress each year, between the beginning of a regular congressional session and May 1. *See* 28 U.S.C. § 994(p). Such amendments automatically take effect 180 days after submission unless a law is enacted to the contrary. *See id.*

<sup>142</sup> *See U.S.S.G.*, *supra* note 141, at 10 (historical note).

<sup>143</sup> *See id.* § 5E1.1 commentary at 287-88 (quoting 18 U.S.C. § 3663(d)). "The court shall—

The Guidelines also require that "[t]he court shall impose a fine in all cases, except where the defendant establishes that he is unable to pay and is not likely to become able to pay any fine."<sup>144</sup> A table of fines specifies the minimum and maximum amounts for each offense, but the limitation on the maximum fine does not apply if the defendant is convicted under a statute authorizing a fine for each day of the violation.<sup>145</sup> Environmental statutes frequently carry per diem fine provisions.<sup>146</sup> In such cases, "the court may impose a fine up to the maximum authorized by the statute."<sup>147</sup> The Guidelines list factors that the court must consider in determining the amount of the fine,<sup>148</sup> and state "[t]he amount of the fine should always be sufficient to ensure that the fine, taken together with other sanctions imposed, is punitive."<sup>149</sup> If the defendant is ordered to make restitution and to pay a fine, the court is to order that any money paid by the defendant shall first be applied to satisfy the order of restitution.<sup>150</sup>

In addition to monetary sanctions, the court has nonmonetary sanctions that it can use to address environmental crimes.<sup>151</sup> The Guidelines left the courts with a significant amount of discretion in setting prison sentences for environmental criminals.<sup>152</sup> Furthermore, the Comprehensive Crime Control Act of 1984 makes probation a sentence in and of itself.<sup>153</sup> Probation may be used as an alternative to incarceration provided that the terms and conditions of probation can be fashioned so as to meet fully the statutory purposes of sentencing.<sup>154</sup> If the court imposes an order of restitution or a fine, the Guidelines recommend that the court impose a condition on probation and

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(1) enter a restitution order if such order is authorized under 18 U.S.C. §§ 3663-3664; or (2) if a restitution order would be authorized under 18 U.S.C. §§ 3663-3664, except for the fact that the offense of conviction is not an offense set forth in Title 18, United States Code, or 49 U.S.C. § 46312, § 46502, or § 46504, impose a term of probation or supervised release with a condition requiring restitution." *Id.* § 5E1.1(a).

<sup>144</sup> *Id.* § 5E1.2(a).

<sup>145</sup> *See id.* § 5E1.2(c)(3)-(4).

<sup>146</sup> *See* Gary S. Lincenberg, *Sentencing Environmental Crimes*, 29 AM. CRIM. L. REV. 1235, 1253-54 (1992) (citing Resource Conservation and Recovery Act (RCRA) § 3008(d), 42 U.S.C. § 6928(d) (1988); Clean Water Act (CWA) § 309, 33 U.S.C. § 1319(c)(1) (1988)).

<sup>147</sup> *See U.S.S.G., supra* note 141, § 5E1.2(c)(4).

<sup>148</sup> *See id.* § 5E1.2(d).

<sup>149</sup> *Id.* § 5E1.2(e).

<sup>150</sup> *See id.* § 5E1.1(c).

<sup>151</sup> *See id.* § 5F.

<sup>152</sup> *See* Lincenberg, *supra* note 146, at 1238-39 (discussing the development and application of the Guidelines to environmental crimes).

<sup>153</sup> *See* 18 U.S.C. § 3561 (1994); *U.S.S.G., supra* note 141, § 5B introductory commentary at 274.

<sup>154</sup> *See U.S.S.G., supra* note 141, § 5B1.1 introductory commentary at 274. The statutory

supervised release which requires the defendant to make payment or adhere to a court order installment schedule for payment.<sup>155</sup>

b. *Sentencing Corporations and Other Organizations*

Convicted corporations and other organizational defendants are sentenced under Chapter 8 of the Guidelines, which became effective November 1, 1991.<sup>156</sup> Throughout history, the sentencing of corporations has proven to be problematic because there is "no soul to damn: no body to kick."<sup>157</sup> While the centerpiece of the Guidelines for sentencing these defendants is the fine range,<sup>158</sup> environmental offenses are specifically excluded from the fine provisions.<sup>159</sup> For environmental offenses, the sentencing judge must determine the appropriate fine by applying pre-Guidelines general sentencing principles.<sup>160</sup>

The over-arching reason why the Commission elected to postpone coverage of environmental offenses from the Guidelines is based on agreement by the commissioners that these might be sufficiently different to warrant special treatment.<sup>161</sup> Four principal considerations led to the Commission's decision to defer coverage.<sup>162</sup>

The first [consideration] was the potential difficulty in many environmental cases of defining and computing loss—a key measure of offense seriousness under the existing corporate Guidelines.

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purposes of sentencing include promoting respect for law, providing just punishment for the offense, achieving general deterrence, and protecting the public from further crimes by the defendant. *See id.*

<sup>155</sup> *See id.* § 5B1.4(b)(15), (16).

<sup>156</sup> *See id.* § 8A1.1-E1.3. "Organization" means "a person other than an individual." 18 U.S.C. § 18. "The term includes corporations, partnerships, associations, joint-stock companies, unions, trusts, pension funds, unincorporated organizations, governments and political subdivisions thereof, and non-profit organizations." *U.S.S.G.*, *supra* note 141, commentary at 338.

<sup>157</sup> *See* John C. Coffee, Jr., "No Soul to Damn: No Body to Kick": *An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386, 386 (1981). The complete quote, attributed to Edward, First Baron Thurlow 1730–1806 is: "Did you ever expect a corporation to have a conscience, when it has no soul to be damned, and no body to be kicked?" *Id.* One version reports that he then added in a stage whisper, "[a]nd by God, it ought to have both." *Id.* at n.1 (quoting H.L. MENCKEN, A NEW DICTIONARY OF QUOTATIONS ON HISTORICAL PRINCIPLES FROM ANCIENT TO MODERN SOURCES, 223 (1942)).

<sup>158</sup> *See* Nagel & Swenson, *supra* note 136, at 210.

<sup>159</sup> *See U.S.S.G.*, *supra* note 141, § 8C2.1 commentary at 346.

<sup>160</sup> *See* Lincenberg, *supra* note 146, at 1257; *see also U.S.S.G.*, *supra* note 141, § 8C2.1 commentary at 346 (directly referring to *U.S.S.G.*, *supra* note 141, § 8C2.10 which then refers to 18 U.S.C. §§ 3353, 3572).

<sup>161</sup> *See* Nagel & Swenson, *supra* note 136, at 256. The Justice Department shared this view, and accepted the Commission's consensus to defer coverage. *See id.*

<sup>162</sup> *See id.*

Loss in environmental cases can be especially difficult to determine . . . .

. . . .

A second reason why environmental offenses were considered to be somewhat different from other offenses relates to the legal question of scienter. Under various environmental statutes, unlike most other areas of criminal law, a defendant corporation can be convicted on a showing of negligence, or in some cases without any showing of specific or general intent. . . .

The third reason . . . is that, arguably, more than other kinds of offenses, environmental violations are subject to overlapping enforcement schemes and collateral sanctions. State and local enforcement of environmental violations, for example, can be more co-extensive with federal enforcement efforts than is the case with other frequently committed organizational offenses . . . .

The fourth principal reason . . . is because opinion is so divided as to how to balance concerns for the environment with concerns for corporate effectiveness. . . . In the environmental context, these positions appear to be felt passionately, each believing in the moral virtue of their position.<sup>163</sup>

Even though the fine provisions do not apply to environmental offenses, the provisions on restitution and probation continue to apply.<sup>164</sup> A sentencing court's structuring of restitution, remedial conditions, community service, and probation must have some nexus to the offense.<sup>165</sup>

The Guidelines state that as a general principle, the court should require that the organization take all appropriate steps to provide compensation to victims and otherwise remedy the harm caused or threatened by the offense.<sup>166</sup> A restitution order or an order of probation requiring restitution can be used to compensate identifiable victims of the offense.<sup>167</sup> The court may also impose an order of notice to victims so that notice is given to yet unidentified victims of the offense.<sup>168</sup>

Direct monetary sanctions are generally preferable to indirect monetary sanctions, except where the convicted organization possesses knowledge, facilities, or skills that uniquely qualify it to repair the damage caused by the offense.<sup>169</sup> In such cases, community service

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<sup>163</sup> *Id.* at 256–58 (citations omitted).

<sup>164</sup> See *U.S.S.G.*, *supra* note 141, § 8A1.1 commentary at 338.

<sup>165</sup> See Lincenberg, *supra* note 146, at 1259 & 1259 n.142.

<sup>166</sup> See *U.S.S.G.*, *supra* note 141, § 8B introductory commentary at 343.

<sup>167</sup> See *id.*

<sup>168</sup> See *id.*

<sup>169</sup> See *id.* § 8B1.3 commentary at 344. Since community service can be performed by an

directed at repairing the damage may provide an efficient means of remedying the harm.<sup>170</sup> A remedial order or an order of probation requiring community service can be used to reduce or eliminate the harm or threatened harm which would otherwise not be remedied.<sup>171</sup> Moreover, a remedial order requiring corrective action by the organization may be necessary to prevent future injury from the instant offense, e.g., a cleanup order for an environmental violation.<sup>172</sup> Yet, a court order may be unnecessary where a governmental regulatory agency, e.g., the Environmental Protection Agency (EPA), has authority to order remedial measures.<sup>173</sup> If a remedial order is entered by the court, it should be coordinated with any administrative or civil actions taken by the appropriate governmental regulatory agency.<sup>174</sup>

An organization convicted of a crime must be sentenced to a term of probation if the sentence imposed on the organization does not include a fine.<sup>175</sup> The Guidelines also specify other instances of when a court "shall" impose probation, e.g., if necessary to secure payment of a monetary penalty or restitution, enforce a remedial order, ensure completion of community service, or ensure that the changes are made within the organization to reduce the likelihood of future criminal conduct.<sup>176</sup> However, such conditions must fulfill statutory requirements that they: (1) are reasonably related to the nature and circumstances of the offense or the history and characteristics of the organization; and (2) involve only such deprivations of liberty or property as are necessary to effect the purposes of sentencing.<sup>177</sup>

The Commission has worked persistently to draft comprehensive guidelines for organizational defendants convicted of environmental offenses.<sup>178</sup> In 1991, the Commission assembled an advisory group, comprised of two commissioners and sixteen lawyers from the public and private sectors, to further study and make recommendations as to appropriate methods for calculating organizational fines for environmental offenses.<sup>179</sup> In November, 1993, this Advisory Working Group

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organization only by employing its resources or paying its employees or others to do so, it is an indirect monetary sanction. *See id.*

<sup>170</sup> *See id.*

<sup>171</sup> *See U.S.S.G., supra* note 141, § 8B introductory commentary at 343.

<sup>172</sup> *See id.* § 8B1.2 commentary at 344.

<sup>173</sup> *See id.*

<sup>174</sup> *See id.*

<sup>175</sup> *See id.* § 8D1.1 commentary at 368; 18 U.S.C. § 3551(c) (1994).

<sup>176</sup> *See U.S.S.G., supra* note 141, § 8D1.1(1), (6).

<sup>177</sup> *See id.* § 8D1.3(c); 18 U.S.C. § 3563(b).

<sup>178</sup> *See Harrell, supra* note 7, at 266.

<sup>179</sup> *See Douglas A. Berman, Editor's Observations*, 8 FED. SENTENCING R. 204, 204 (1996).



on Environmental Sanctions submitted to the Commission a proposed fine-setting guideline for these offenses.<sup>180</sup> The proposal, drafted as Chapter 9, was written as an additional chapter for the U.S. Sentencing Guidelines Manual.<sup>181</sup> The Commission has yet to formally act on the proposal, though it has indicated that Chapter 9 remains a priority.<sup>182</sup>

## 2. Civil and Administrative Actions

The federal environmental statutes generally contemplate that the EPA Administrator, rather than the Attorney General, should commence civil or administrative actions.<sup>183</sup> Remedies sought in civil and administrative cases are usually selected and approved by the Agency.<sup>184</sup> If EPA decides to seek civil judicial relief, the Department of Justice represents it in federal court.<sup>185</sup> Additionally, EPA has administrative enforcement authority totally independent of the Department of Justice.<sup>186</sup>

When violations are found pursuant to a citizen suit, federal courts have the authority to impose civil penalties, to order parties to come into compliance, and to order injunctive relief.<sup>187</sup> At least one commentator has called for an expansion in the court's use of judicial equitable discretion, including the use of monetary sanctions to fund Supple-

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<sup>180</sup> See *id.*

<sup>181</sup> See *id.* The full text of the proposal is on Lexis. See *Draft Corporate Sentencing Guidelines for Environmental Violations Nov. 16, 1993*, [24 Current Developments] ENV'T REP. (BNA) 1378 (Nov. 26, 1993), available in LEXIS, BNA Library, ER file. Discussion of a dissent filed by two members of the Advisory Group urging the Commission to reject the draft can also be found on Lexis. See *Enforcement: Dissent Filed by Advisory Group Members Urges Sentencing Commission to Reject Draft*, [24 Current Developments] ENV'T REP. (BNA) 1594 (Jan. 7, 1994), available in LEXIS, BNA Library, ER file.

<sup>182</sup> See Berman, *supra* note 179, at 204.

<sup>183</sup> See Harrell, *supra* note 7, at 280 n.199 (citing Clean Water Act (CWA) § 309, 33 U.S.C. § 1319(a), (g) (1988); Resource Conservation and Recovery Act (RCRA) § 3008(a), 42 U.S.C. § 6928(a) (1988)).

<sup>184</sup> See Harrell, *supra* note 7, at 279 (citing CWA § 309(g), 33 U.S.C. § 1319(g)).

<sup>185</sup> See *id.* at 279 & n.196 (citing CWA § 506, 33 U.S.C. § 1366 ("Administrator shall request the Attorney General to appear and represent the United States in any civil or criminal action instituted under this chapter")).

<sup>186</sup> See *id.* at 279.

<sup>187</sup> See Quan B. Nghiem, Comment, *Using Equitable Discretion to Impose Supplemental Environmental Projects Under the Clean Water Act*, 24 B.C. ENVTL. AFF. L. REV. 561, 561 (1997). EPA defines SEPs as "environmentally beneficial projects which a violator agrees to undertake in settlement of an enforcement action, but which the violator is not otherwise legally required to perform. See EPA, OFFICE OF ENFORCEMENT AND COMPLIANCE ASSURANCE, EPA CIVIL PENALTY POLICIES (May 8, 1995), available in LEXIS, Environ Library, Penlty file, 1995 CPP LEXIS 7 [hereinafter 1995 EPA CIVIL PENALTY POLICIES].

mental Environment Projects (SEPs), to remedy harms caused by the violation of environmental laws.<sup>188</sup> As authority, this commentator cites *Weinberger v. Romero-Barcelo*, in which the U.S. Supreme Court stated that “[u]nless a statute in so many words, or by a necessary and inescapable inference, restricts the court’s jurisdiction in equity, the full scope of that jurisdiction is to be recognized and applied.”<sup>189</sup>

The federal environmental statutes set forth various factors which EPA or a court must consider in determining an appropriate penalty.<sup>190</sup> In administrative litigation, the penalty sought by EPA is based upon the Agency’s applicable penalty policy and the specific facts of the case.<sup>191</sup> If EPA does not have an applicable penalty policy for the relevant statute, the penalty sought by EPA is based on the statutory factors governing penalty assessment, case law interpreting such factors, and the facts of the particular case.<sup>192</sup>

In settling all civil and administrative actions, EPA requires alleged violators to promptly cease the violations and, to the extent possible, remediate any harm caused by the violations.<sup>193</sup> EPA also seeks substantial monetary penalties to deter future violations by the same violator or other members of the regulated community, and to create a national level playing field by ensuring that the violators do not obtain an unfair economic advantage over their competitors who made the necessary expenditures to comply in a timely manner.<sup>194</sup> In the settlement context, when EPA establishes a penalty, it considers such factors as the economic benefit associated with the violations, the gravity or seriousness of the violation, and the prior history of violations.<sup>195</sup> EPA also considers evidence of a violator’s commitment and ability to perform a SEP in establishing a settlement penalty.<sup>196</sup>

EPA encourages the use of SEPs.<sup>197</sup> While penalties play an important role in environmental protection by deterring violations and creating a level playing field, a SEP can play an additional role in

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<sup>188</sup> See Nghiem, *supra* note 187, at 563.

<sup>189</sup> See *id.* at 581–82 (quoting *Weinberger v. Romero-Barcelo*, 456 U.S. 305 (1982)).

<sup>190</sup> See EPA, OFFICE OF ENFORCEMENT AND COMPLIANCE ASSURANCE, EPA CIVIL PENALTY POLICIES (Dec. 15, 1996), available in LEXIS, Envirn Library, Penlty file, 1996 CPP LEXIS 1 [hereinafter 1996 EPA CIVIL PENALTY POLICIES].

<sup>191</sup> See *id.*

<sup>192</sup> See *id.*

<sup>193</sup> See 1995 EPA CIVIL PENALTY POLICIES, *supra* note 187, at 4.

<sup>194</sup> See *id.* at 4–5.

<sup>195</sup> See *id.* at 5.

<sup>196</sup> See *id.*

<sup>197</sup> See *id.* at 6.

securing significant environmental or public health protection and improvements.<sup>198</sup> Although SEPs may not be appropriate in settlement of all cases, they are an important part of EPA's enforcement program.<sup>199</sup> In exercising its enforcement discretion to determine whether a settlement is appropriate, EPA's calculation of the final penalty in a settlement which includes a SEP is a five-step process.<sup>200</sup> First, the Agency penalty policies are used to calculate the minimum amount that would be necessary to settle the same case without a SEP.<sup>201</sup> The minimum amount necessary to settle the case without a SEP is calculated as the economic benefit of noncompliance plus the gravity component of the penalty.<sup>202</sup> The gravity component is all of the penalty other than the identifiable economic benefit amount, after gravity has been adjusted by all other factors in the penalty policy (e.g., audits, good faith, litigation considerations), except for the SEP.<sup>203</sup> Second, the Agency calculates the minimum penalty amount with a SEP, as the greater of the economic benefit of noncompliance plus ten percent of the gravity component, or twenty-five percent of the gravity component only.<sup>204</sup> Third, the Agency calculates the SEP cost.<sup>205</sup> The net after-tax cost of the SEP, hereinafter called the "SEP COST," is the maximum amount that EPA may take into consideration in determining an appropriate penalty mitigation for performance of a SEP.<sup>206</sup> Although EPA does not offer tax advice on whether the violator may deduct SEP expenditures from its income taxes, it does consider whether or not the violator will deduct the SEP in calculating the net SEP cost to the defendant to determine whether it will accept the proposed settlement.<sup>207</sup> Fourth, the Agency calcu-

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<sup>198</sup> See Final EPA Supplemental Projects Policy Issued, 63 Fed. Reg. 24,796, 24,797 (1998). A full copy of this policy is set forth in the Federal Register and also may be found at EPA's web site at <http://www.epa.gov/oeca/sep>. See *id.*

<sup>199</sup> See *id.*

<sup>200</sup> See *id.* at 24,801. The Final EPA Supplemental Environmental Projects Policy specifically states that the settlement penalty calculation methodology is not intended for use at a hearing or in a trial. See *id.* at 24,797.

<sup>201</sup> See *id.* at 24,801.

<sup>202</sup> See *id.*

<sup>203</sup> See 63 Fed. Reg. at 24,801.

<sup>204</sup> See *id.*

<sup>205</sup> See *id.*

<sup>206</sup> See *id.* Generally, EPA will only accept SEPs that have a negative cash flow to the defendant. See *id.* at 24,802.

<sup>207</sup> See *id.* at 24,802. If a defendant/respondent states that it will not deduct the cost of a SEP from its income taxes and is willing to commit to this in the settlement document and provide the agency with certification upon the completion of the SEP that it has not deducted the SEP expenditures, the SEP cost is calculated without reduction for taxes. See *id.* If a business is not

lates the SEP Mitigation Amount, which is the percentage of the SEP COST (calculated pursuant to step three) that may be applied as mitigation against the amount EPA would settle for but for the SEP.<sup>208</sup> This percentage is set by EPA, based upon an evaluation of whether and how effectively a SEP achieves specific factors established under the policy.<sup>209</sup> Fifth, the minimum final settlement penalty allowable based on the performance of the SEP is the greater of the minimum penalty amount with a SEP (step two), or the settlement amount without a SEP (step one) less the SEP Mitigation Amount (step four).<sup>210</sup>

### B. Case Law Considering Tax Deductibility

The second issue from the standpoint of environmental policy is whether the impact of amounts expended due to environmental violations should be reduced by permitting them to reduce taxes which otherwise would have been paid.<sup>211</sup> To date, there have been only four cases that discuss the deductibility of environmental monetary sanctions:<sup>212</sup> *Allied-Signal, Inc. v. Commissioner*,<sup>213</sup> *True v. United States*;<sup>214</sup> *Colt Industries, Inc. v. United States*,<sup>215</sup> and; *S & B Restaurant, Inc. v. Commissioner*.<sup>216</sup>

In *Allied-Signal, Inc. v. Commissioner*, the taxpayer pled nolo contendere to 940 counts of permit violations for discharging manu-

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willing to make this commitment, the business's marginal tax rate is used to calculate the after-tax SEP cost. *See id.*

<sup>208</sup> *See* 63 Fed. Reg. at 24,802.

<sup>209</sup> *See id.* The percent of penalty mitigation is within EPA's discretion; there is no presumption as to the correct percent of mitigation. *See id.* As a general guideline, the final mitigation percentage considered acceptable by EPA will not exceed 80% of the SEP cost. *See id.* at 24,802. However, for small businesses, government agencies or entities, non-profit organizations, or where the SEP develops and implements pollution prevention techniques and practices, this percentage may be set as high as 100%. *See id.* Should the defendant fail to satisfactorily complete a SEP, EPA Supplemental Environmental Projects Policy requires settlement documents to include stipulated penalty provisions. *See id.* at 24,803.

<sup>210</sup> *See id.* at 24,802.

<sup>211</sup> *Cf.* S. REP. NO. 91-552 (1969), *reprinted in* 1969 U.S.C.C.A.N. 2027, 2311 (enacting legislation dealing with the deductibility of antitrust damage payments in which the U.S. Senate stated that "[f]rom the standpoint of antitrust policy, the basic issues are the extent of the penalties intended and whether their impact should be reduced by permitting them to reduce taxes which otherwise would have to be paid").

<sup>212</sup> *See* Todres, *supra* note 1, at 716-17.

<sup>213</sup> 63 T.C.M. (CCH) 2672 (1992), *aff'd without opinion*, 54 F.3d 767 (3d Cir. 1995).

<sup>214</sup> 894 F.2d 1197 (10th Cir. 1990).

<sup>215</sup> 880 F.2d 1311 (Fed. Cir. 1989).

<sup>216</sup> 73 T.C. 1226 (1980).

facturing wastes into local waterways.<sup>217</sup> On October 5, 1976, Allied was sentenced to pay the maximum criminal fine on all counts, a total fine of \$13,240,000.<sup>218</sup> At sentencing, the judge wanted to punish the company and deter other corporate polluters.<sup>219</sup> He also reiterated his wish that the fines could be used to benefit directly the people of Virginia who were hurt by the company's actions, but he was "satisfied . . . that this cannot be done under the law."<sup>220</sup> The judge ordered the fine paid in ninety days, but indicated that he would entertain a motion to reduce the fine at the end of ninety days.<sup>221</sup> He further stated that the ninety-day period was not a probationary period and that he could not and would not require the company to take any actions as a condition of probation.<sup>222</sup>

The taxpayer's lawyers were concerned that the creation of a non-profit, tax-exempt foundation or trust to remedy the environmental harm could subject the company to a shareholder suit for waste of corporate assets.<sup>223</sup> However, they felt that if the company was able to deduct the voluntary payments from taxes and received a reduction in fine equal, for example, to seventy-five percent of the amount paid, then the defense to any such suit would be that the payments resulted in a net after tax benefit to the Company.<sup>224</sup> Although the

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<sup>217</sup> See *Allied-Signal*, 63 T.C.M. (CCH) at 2676. Each of the 940 counts represented a single day's discharge; 628 counts were for THEIC and TAIC (both are biologically inactive chemicals used in commercial wire manufacturing), 225 counts for Kepone (a highly toxic chemical pesticide), and 87 counts for TAIC and Kepone. See *id.* at 2673, 2675.

<sup>218</sup> See *id.* at 2677. The fine was \$2,500 per count for counts 1-456 and \$25,000 per count for counts 457-940. See *id.*

<sup>219</sup> See *id.* The judge stated:

I hope after this sentence, that every corporate official, every corporate employee that has any reason to think that pollution is going on, will think, "If I don't do something about it now, I am apt to be out of a job tomorrow." I want the officials to be concerned when they see it.

*Id.*

<sup>220</sup> See *id.*

<sup>221</sup> See *id.* The judge further stated:

Now, so there be no misunderstanding, this is not a suggestion that the Court will reduce the fines. I intend to and will consider what actions, if any, have been voluntarily taken by the defendant corporation to alleviate the horrendous effects that have occurred.

In no event, do I want any actions done under any compulsion whatsoever. Any action it would take should be taken voluntarily. In no event would a reduction, if there is a reduction, be in an amount equal to whatever they may voluntarily expend. I am not, however, closing my mind to consideration of an appropriate adjustment.

*Id.*

<sup>222</sup> See *Allied-Signal*, 63 T.C.M. (CCH) at 2677.

<sup>223</sup> See *id.*

<sup>224</sup> See *id.*

taxpayer never received any binding assurances during the ninety-day period, as a result of numerous contacts with the judge during that period, the taxpayer was virtually certain that any "voluntary" payments would be recognized at the hearing on the motion to reduce the fine.<sup>225</sup> The taxpayer decided to establish an endowment fund for the broad purpose of alleviating the effects of the violations on the environment and the lives of affected persons and generally to improve and enhance the quality of the environment in Virginia.<sup>226</sup>

The local U.S. Attorney, acting on behalf of the Department of Justice, first learned of the endowment and the company's proposal for the contribution of \$8 million to the fund at the hearing on the motion to reduce the fine.<sup>227</sup> The U.S. Attorney opposed the motion to reduce the fine on the ground that the taxpayer would probably try to claim a tax deduction for the payment to the endowment and thus effectively further reduce the fine and lessen its intended penal and deterrent purpose.<sup>228</sup> The court modified the sentence, reducing the fine to \$5 million by suspending some of the fines and putting the company on probation.<sup>229</sup> No part of the fine was actually paid to the court or contributed to the endowment until the day after the sentence was modified.<sup>230</sup>

The taxpayer's attempt to claim the \$8 million transferred to the endowment as a deduction under section 162(a) was denied by the Tax Court under section 162(f).<sup>231</sup> The court reasoned that the payment

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<sup>225</sup> See *id.* at 2677-80, 2682.

<sup>226</sup> See *id.* at 2680. The Virginia Environmental Endowment Fund was created as a section 501(c)(4) organization. See *id.* Corporate payments to a section 501(c)(4) organization would be claimed under section 162(a) as an ordinary and necessary business expense, and is not subject to the limitations on deductibility applicable to organizations created under section 501(c)(3) in which payments are claimed under section 170. See *id.*; compare I.R.C. § 162(a) (allowing payments from a corporation to a § 501(c)(4) charity to be deducted in full in the current year), with I.R.C. § 170(b)(2), (d)(2) (limiting payments from a corporation to a § 501(c)(4) charity to 10% of corporation's taxable income for the current and succeeding five years, with any unused deduction expiring after five years).

<sup>227</sup> See *Allied-Signal*, 63 T.C.M. (CCH) at 2680.

<sup>228</sup> See *id.*

<sup>229</sup> See *id.* The fines for counts 741-940 remained at \$25,000 per count, and the fines for counts 1-740 were eliminated with the taxpayer put on probation instead. See *id.*

<sup>230</sup> See *id.*; see also Morton Mintz & Daniel Klaidman, *Creative Settlement or Improper Deal*, LEGAL TIMES, May 11, 1992, at 1 (discussing questionable aspects of the settlement process, including: ex parte meetings between taxpayer's attorneys and judge, one of whom was a former law clerk and associate at judge's law firm; judge reserving right to appoint chairman of the endowment fund; judge appointing the U.S. Attorney who opposed the motion to reduce the fine as the chairman of the endowment fund; et cetera).

<sup>231</sup> See *Allied-Signal*, 63 T.C.M. (CCH) at 2683.

was not voluntary because it was made with the expectation of a quid pro quo reduction in the amount of the fine.<sup>232</sup> The court found that although the judge indicated that the fine had a dual purpose, based on the facts and circumstances, the purpose of the payment was punitive and if there were any compensatory or remedial purposes, they were minimal.<sup>233</sup> The court also stated, "[w]e do not believe that a Government must actually 'pocket' the fine or penalty to satisfy the 'paid to a government' requirement of section 162(f)."<sup>234</sup>

In *True v. United States*, the district court held that a civil penalty under section 311(b)(6) of the Federal Water Pollution Control Act, was deductible because the Act employed a strict liability standard as an essentially compensatory scheme to shift the cost of pollution from the public to the polluter.<sup>235</sup> The district court was also persuaded in part by the fact that the penalty was used to finance the cost of cleaning up oil spills when costs were not otherwise recoverable.<sup>236</sup> On appeal, the Tenth Circuit reversed the district court, holding that the legislative history of section 162(f) indicated that Congress intended that some strict liability penalties are nondeductible.<sup>237</sup> The court examined the statute and found that section 311(b)(6) served a deterrent and retributive function similar to a fine.<sup>238</sup> Moreover, since a wholly independent provision in the statute authorizing the government to recoup cleanup costs appeared to be the primary compensatory or remedial mechanism, the penalty section of section 311(b)(6) must serve as an additional sanction to deter and punish.<sup>239</sup> The court held that the civil penalty was punitive and thus nondeductible even though it conceded that "employment of the proceeds . . . to administer the Act and to finance cleanup costs actually does serve a remedial purpose."<sup>240</sup>

In *Colt Industries, Inc. v. United States*, EPA recommended that the Department of Justice institute a civil action against the taxpayer's subsidiary for violation of the Clean Air Act and the Clean

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<sup>232</sup> See *id.* at 2681. The quid pro quo aspect would also present difficulties had the taxpayer structured the payment as a charitable contribution to a section 501(c)(3) organization. See generally I.R.C. § 170 (1997).

<sup>233</sup> See *Allied-Signal*, 63 T.C.M. (CCH) at 2682.

<sup>234</sup> *Id.* at 2683 (quoting *Waldman v. Commissioner*, 88 T.C. 1384, 1389 (1987)).

<sup>235</sup> 803 F. Supp. 1370, 1374 (D. Wyo. 1985), *rev'd*, 894 F.2d 1197 (10th Cir. 1990).

<sup>236</sup> See *id.*

<sup>237</sup> See *True*, 894 F.2d at 1205.

<sup>238</sup> See *id.*

<sup>239</sup> See *id.* at 1205-06.

<sup>240</sup> See *id.* at 1205.

Water Act.<sup>241</sup> A settlement was reached whereby the subsidiary paid \$1.6 million to the Pennsylvania Clean Air and Clean Water Fund in satisfaction of the civil penalties.<sup>242</sup> The Claims Court denied the deduction, holding that the penalties assessed under the statutes constituted a "fine or similar penalty paid to a government for the violation of any law" for which a deduction was barred by section 162(f).<sup>243</sup> On appeal, the Federal Circuit affirmed the Claims Court, but had a very unusual reasoning.<sup>244</sup> In addition to interpreting the 1971 U.S. Senate Finance Committee Report differently from other courts, the Federal Circuit held that its role was only to determine the validity of the regulations.<sup>245</sup> The court stated:

[A]ccording to Colt, the court would have to "determine the purpose or purposes served by the specific civil penalty payment at issue in order to ascertain whether the payment is barred from deduction." But that is not our office; "Congress has delegated to the Commissioner, not to the courts, the task of prescribing 'all needful rules and regulations for the enforcement' of the Internal Revenue Code. . . . In this area of limitless factual variations, 'it is the province of Congress and the Commissioner, not the courts, to make the appropriate adjustments.'"

As is apparent, neither the statute nor the regulations prescribe a "purpose" inquiry. It is therefore beyond our mandate to embark on one to make our own assessment of the deductibility of a particular penalty. "The role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner."<sup>246</sup>

The final environmental case is *S & B Restaurant, Inc. v. Commissioner*.<sup>247</sup> The taxpayer, which was discharging raw sewage from its motel and restaurant business into an underground waterway, entered into an agreement with the Commonwealth of Pennsylvania under its Clean Streams Law.<sup>248</sup> The restaurant agreed to make monthly payments to the Clean Water Fund until a central municipal

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<sup>241</sup> 880 F.2d 1311, 1312 (Fed. Cir. 1989).

<sup>242</sup> See *id.* at 1313.

<sup>243</sup> See *id.* at 1312.

<sup>244</sup> See Todres, *supra* note 1, at 680.

<sup>245</sup> See *Colt Indus.*, 880 F.2d at 1314.

<sup>246</sup> *Id.* at 1314 (quoting *Commissioner v. Stidger*, 386 U.S. 287, 296 (1967); *United States v. Correll*, 389 U.S. 299, 307 (1967)).

<sup>247</sup> 73 T.C. 1226 (1980).

<sup>248</sup> See *id.*



sewer system became available and the restaurant connected to, and discharged its waste into, that system.<sup>249</sup> The Tax Court noted that the Clean Streams Law had punitive aspects (provided for criminal and civil penalties), but also was in furtherance of the policy to discourage separate treatment facilities and develop a comprehensive program of regional control and management of the treatment of sewage disposal.<sup>250</sup> Since the statute had a dual purpose, the court had to determine which purpose the payments in question were designed to serve.<sup>251</sup> The court concluded that the payments were in furtherance of the purpose of the statute to control pollution through consolidated, rather than individual, facilities.<sup>252</sup> The court held that the payments were made by the taxpayer in consideration of being allowed to continue to discharge its sewage waste, rather than as a fine or similar penalty imposed by the law or "settlement of the taxpayer's actual or potential liability for a fine or penalty."<sup>253</sup> The court recognized that the settlement agreement provided that the taxpayer would not be prosecuted for the violations, but viewed this as merely incidental to the main purpose of the agreement which was to ensure that the taxpayer would join the municipal disposal system.<sup>254</sup> Moreover, the court noted that the agreement not to prosecute was conditioned upon the continuation of the quality and quantity of the sewage discharges not exceeding those contemplated by the agreement.<sup>255</sup>

### III. STRUCTURING ENVIRONMENTAL MONETARY SANCTIONS

In trying to structure environmental monetary sanctions, one is struck by how disparate the bodies of tax law and environmental law

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<sup>249</sup> See *id.*

<sup>250</sup> See *id.* at 1232-33.

<sup>251</sup> See *id.* at 1232.

<sup>252</sup> See *S & B Restaurant*, 73 T.C. at 1232.

<sup>253</sup> See *id.* The court rested its conclusion on several grounds: 1) the taxpayer was obligated to connect into the municipal sewer, when it became available, and since the payments were to continue only until such time, the indefiniteness of the total amount made it distinguishable in some degree from a fine or penalty which is usually fixed in amount; 2) the special assistant attorney general fixed the payment based upon his belief of what the charges would have been had the municipal facility been available; 3) the State would have attempted to block any attempt by the taxpayer to construct its own sewage treatment facilities; and 4) the special assistant attorney general was led to believe that no practical environmental harm would be caused by the continued discharge of sewage waste, and regardless of whether this was technically correct, his understanding of the underlying basis for the agreement gave direction to its objective and thereby to the purpose of the payment. See *id.* at 1232-33.

<sup>254</sup> See *id.* at 1233.

<sup>255</sup> See *id.*

are from each other. Although the body of tax law is much maligned for its volume and complexity, the I.R.C. is a framework that provides structure to this area. By comparison, not only is the body of environmental laws and regulations more voluminous and arguably more complex,<sup>256</sup> it lacks any comparable framework.

### A. Structuring Monetary Sanctions to Maintain Tax Deductibility

From the tax perspective, which environmental monetary sanctions are deductible is straight-forward, at least in theory.<sup>257</sup> Criminal fines clearly are not deductible.<sup>258</sup> On the other hand, compensatory payments clearly are deductible.<sup>259</sup> If the statute giving rise to the claim has multiple purposes, the court must determine which purpose will govern.<sup>260</sup> If a monetary sanction is comprised of two or more components, the tax treatment of each component of the monetary sanction must be determined separately.<sup>261</sup> Generally, civil penalties imposed for purposes of enforcing the law and as punishment for the violation thereof are nondeductible payments under section 162(f), while civil penalties 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, fall outside the scope of the deduction prohibition in section 162(f).<sup>262</sup>

The origin of the liability test is used to determine the deductibility of a payment when an actual or potential claim against the taxpayer has been settled.<sup>263</sup> In each case, any payments made retain the characterization of the underlying claim, rather than the use to which the payments are put.<sup>264</sup> To the extent that a payment is made before charges are brought (i.e., demonstrating that the business is a good

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<sup>256</sup> See PLATER ET AL., *supra* note 6, at 72. "[T]he federal and state environmental agency structures and their regulations and guidelines, like the EPA Penalty Policy, have proliferated since the early 1970s into a quantum of public law that is now far more complex and voluminous than the Internal Revenue Code and its rules." *Id.*

<sup>257</sup> See Todres, *supra* note 1, at 716.

<sup>258</sup> See Treas. Reg. § 1.162-21(b)(1)(i).

<sup>259</sup> See *id.* § 1.162-21(b)(2).

<sup>260</sup> See *Middle Atl. Distrib., Inc. v. Commissioner*, 72 T.C. 1136, 1144-45 (1979).

<sup>261</sup> See *Stephens v. Commissioner*, 905 F.2d 667, 673 (2d Cir. 1990).

<sup>262</sup> See *Bailey v. Commissioner*, 756 F.2d 44, 46-47 (6th Cir. 1985) (citing *Southern Pac. Transp. Co. v. Commissioner*, 75 T.C. 497, 646-54 (1980); *accord Huff v. Commissioner*, 80 T.C. 804, 824 (1983); *Middle Atlantic*, 72 T.C. at 1136).

<sup>263</sup> See Todres, *supra* note 1, at 702-03.

<sup>264</sup> See *id.* at 703-04.

citizen), it may be possible to argue that the payment was voluntary and therefore deductible.<sup>265</sup> Payments made after formal charges are brought are nondeductible under section 162(f) if they are made with the expectation of quid pro quo or in settlement of an actual or potential liability.<sup>266</sup> From a policy standpoint, one may wonder what would and should occur if a taxpayer did in fact make a truly voluntary payment that the judge later expressly took into account by imposing a fine lower than might otherwise have been imposed.<sup>267</sup> Even though a portion of the monetary sanction may be nondeductible, courts can preserve the deductibility of amounts paid as restitution, or to remedy harms, by carefully delineating the amount that is a fine from that which is restitution or some other monetary sanction.<sup>268</sup>

### *B. Structuring Environmental Sentences and Settlements to Remedy Local Harms*

From an environmental perspective, there appears to be some latitude in structuring environmental sentences and settlements. Notwithstanding certain institutional difficulties and societal costs, in an appropriate case, imposing and implementing environmentally beneficial projects is often better public policy than a sentence which merely requires paying a fine to the federal government.<sup>269</sup>

It appears possible to structure sentences and settlements that allow the money to stay local to provide restitution to the victim and remediate the environment for those most affected by the damage caused by the violation. In criminal actions, the Guidelines state that as a general principle, the court should require that the defendant take all appropriate steps to provide compensation to victims and otherwise remedy the harm caused or threatened by the offense.<sup>270</sup> The Sentencing Reform Act and the organizational sentencing guidelines clearly authorize courts to impose conditions of probation in order to "repair" or "remedy" the harm caused by the offense or eliminate or reduce the future risk of harm.<sup>271</sup> In civil actions, the court

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<sup>265</sup> See Schnee, *supra* note 22, at 21.

<sup>266</sup> See *id.*

<sup>267</sup> See Todres, *supra* note 1, at 679-80.

<sup>268</sup> See Harrell, *supra* note 7, at 275.

<sup>269</sup> See *id.* at 247.

<sup>270</sup> See U.S.S.G., *supra* note 141, at § 8B introductory commentary at 343.

<sup>271</sup> See Harrell, *supra* note 7, at 271.

arguably can use its equitable discretion to order remedies, unless precluded by the underlying statute.<sup>272</sup> Environmentally beneficial projects which a defendant agrees to undertake, but is not otherwise legally obligated to perform, whether in a criminal or civil action, can obtain environmental and public health protection and improvements which otherwise might not be achieved.<sup>273</sup> A government official who has the authority to settle an enforcement case also has the authority to approve a SEP.<sup>274</sup> EPA settlement policy, in addition to imposing monetary sanctions to punish and deter violators, recognizes that SEPs play an important remedial role.<sup>275</sup> Although EPA does not offer tax advice on whether the violator may deduct SEP expenditures from its income taxes, if the violator decides to take the deduction, EPA will increase the amount that must be expended on the SEP to calculate what is an acceptable settlement.<sup>276</sup> While the parties' characterization of the settlement is not necessarily determinative, the courts and the IRS do consider the terms of the settlement agreement in considering whether that component of the monetary sanction is tax deductible.<sup>277</sup>

### CONCLUSION

Section 162(f) is an effective provision that has accomplished its framers' intent.<sup>278</sup> The provision seems to be flexible—some would argue, perhaps too flexible.<sup>279</sup> In certain instances, it is possible for judges and attorneys to keep some money local by carefully delineating the amount which is a fine, from that which is restitution or some other form of monetary sanction.<sup>280</sup> Such structuring may also make it possible to obtain a tax deduction that can be factored into setting the sentence or settlement. For taxpayers with limited economic resources, a socially desirable trade-off can be achieved. Monetary

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<sup>272</sup> See Nghiem, *supra* note 187, at 581–84 (arguing *Weinberger v. Romero-Barcelo*, 465 U.S. 305 (1982), authorizes expansion of judicial equitable discretion in civil actions to remedy environmental harms).

<sup>273</sup> See 1995 EPA CIVIL PENALTY POLICIES, *supra* note 187, at 1, 4.

<sup>274</sup> See *id.* at 38. Subject to few exceptions, no special approvals are required for the government official to approve a SEP. See *id.*

<sup>275</sup> See *id.* at 6.

<sup>276</sup> See *id.* at 31.

<sup>277</sup> See *supra* note 60–77 and accompanying text.

<sup>278</sup> See *Todres*, *supra* note 1, at 717.

<sup>279</sup> See *id.*

<sup>280</sup> See *Harrell*, *supra* note 7, at 275.

sanctions can be structured so that less money is paid to the federal government, and more money kept local to remediate the harm and provide relief to the victims.