UNITED STATES ENVIRONMENTAL PROTECTION AGENCY
WASHINGTON, D.C. 20460

DEC 21 2007

OFFICE OF
ENFORCEMENT AND
COMPLIANCE ASSURANCE

MEMORANDUM

SUBJECT: Advisory Memorandum on Internal Revenue Service Directive Regarding the Deductibility of Supplemental Environmental Projects

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Assistant Administrator

TO: Regional Counsel, Regions II-VII, IX-X
Enforcement Division Directors, Regions I-X
Office Directors, OECA

Recently, the Internal Revenue Service (IRS) issued a Tier I Technical Directive (Directive) regarding the deductibility of costs associated with Supplemental Environmental Projects (SEPs). The Directive, entitled "Tier I Issue: Government Settlements Directive #1" requires IRS auditors and field examiners to audit settlements that contain SEPs and other types of environmentally beneficial projects (including state projects) that cost $1 million or more. IRS examiners have discretion under the Directive to audit settlements with SEPs costing less than $1 million.[1]

The Directive and accompanying IRS guidelines indicate that a taxpayer may not deduct the portion of the costs incurred for the performance of a SEP that is an amount analogous to a non-deductible penalty or include such amount in the basis of assets or property it depreciates. For settlements that are subject to audit under the Directive, the IRS has requested EPA's assistance in obtaining the amounts by which the penalties were mitigated in consideration of the defendant/respondent's agreement to perform a SEP, for concluded cases beginning in FY 2004 and going forward.

This memorandum provides advice to enforcement staff on how to proceed in administrative settlements with respect to the above Directive. The Special Litigation and Projects Division (SLPD), within the Office of Civil Enforcement (OCE), will be primarily responsible for responding on behalf of EPA to formal written requests from the IRS for information on administrative settlements. Enforcement staff should refer

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[1] The Directive can be found at http://www.irs.gov/businesses/article/0,,id=171034,00.html. EPA may not provide tax advice; however, defendants/respondents should be referred to this site whenever settlement discussions include a potential SEP. *See also* http://www.irs.gov/businesses/article/0,,id=174273,00.html.

any inquiries about penalty mitigation amounts in past cases to SLPD. Inquiries regarding judicial cases should be referred to SLPD, which will refer them to the Department of Justice's Environment and Natural Resources Division (DOJ-ENRD). This memorandum also provides recommendations regarding continued use of the PROJECT Model in light of the Directive.

Concluded Cases with SEPs Beginning FY2004

For concluded cases, EPA will, upon request, provide the IRS with the penalty mitigation amount in administrative cases where that amount is certain and documented in the case file. Where no mitigation amount is certain and documented, EPA will inform the IRS that EPA does not possess a mitigation amount for that particular case.

In order to provide consistent responses to the IRS, SLPD will work with EPA enforcement staff to obtain case specific information and to coordinate responses to the IRS. The National SEP Coordinators, Beth Cavalier and Melissa Raack in OCE, will act as primary contacts on this issue.

Future Settlements that Include SEPs

The IRS has indicated to EPA that it will not seek the penalty mitigation amount from the Agency if the violator agrees to include language in the settlement stating that it will not deduct or depreciate SEP expenditures. Accordingly, subject to the exception noted below, all future settlements, both judicial and administrative, should include the following language reflecting the respondent/defendant's commitment not to deduct or capitalize the cost of implementing the SEP.

> "For federal income tax purposes, (Defendant/Respondent) agrees that it will neither capitalize into inventory or basis nor deduct any costs or expenditures incurred in performing the SEP."

This approach was developed in close coordination with DOJ-ENRD to ensure that we are proceeding in a similar fashion with respect to imposing this requirement in future settlements. As you were advised in October 2007,[2] case teams should include this language in all settlements (other than those with governmental units, non-profit corporations, or other entities not subject to taxation) concluded on or after December 1, 2007. We recognize that settlements may be in varying stages of negotiation. Accordingly, please use every effort to include this language in settlement agreements, taking into consideration the particular circumstances of a case. Should you have any concerns that this language may negatively impact a settlement because it is too late in negotiations to include it, please contact Melissa Raack or Beth Cavalier.

There may be limited instances when enforcement staff believes that the above

[2] In an email dated October 23, 2007, Susan O'Keefe, Acting Director of SLPD, advised Regional and HQ enforcement managers to include this language in administrative settlements concluded on or after December 1, 2007.

approach is not appropriate. These cases may include settlements where a violator agrees to conduct a SEP whose cost is both substantial and appreciably greater than the amount of penalty mitigation the violator is receiving. In such instances, case teams should consult the National SEP Coordinators in advance to ensure consistent application of this advisory.

Continued Use of the PROJECT Model

EPA's 1998 SEP Policy requires the use of the PROJECT Model to calculate the after-tax net present value of SEPs. The model was developed prior to receiving information from the IRS about the deductibility of SEP costs, on the premise that most violators would seek to deduct SEP costs for tax purposes. Accordingly, the PROJECT Model included an assumption of deductibility for certain SEP costs in its default parameters. By doing this, the model attempted to ensure that a violator did not receive a credit for a SEP based on project costs that would in fact be reduced as a result of deducting the expenditures from taxable income, thereby reducing the violator's tax liability.

Given the Directive, it is no longer appropriate to retain a default presumption in the PROJECT Model to account for the deductibility of SEP costs. For this reason, OECA will soon modify the PROJECT Model to reflect the assumption that SEP costs are not deductible and remove inputs regarding tax implications. Because the PROJECT Model does provide useful information about the net present value of SEP expenditures (*i.e.*, the actual "out-of pocket" expenses), OECA recommends that the model be used in the following circumstances:

1 To assess the project's appropriateness as a SEP, where there is a possibility that the proposed project may be profitable to the violator;[3] and

2. To calculate the time-value of money gained by the violator in cases in which the estimated expenditures for a SEP will exceed $1 million, or implementation is expected to take longer than 12 months. (If a proposed SEP is estimated to cost less than $1 million or will be implemented over a short period, running the costs through PROJECT will not yield a significantly different number from the proposed unadjusted costs. However, if the SEP will take more than a year to complete, or if the proposed costs exceed $1 million, then the PROJECT number may differ significantly from the proposed costs.)[4]

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[3] *See Guidance for Determining Whether a Project is Profitable and When to Accept Profitable Projects as Supplemental Environmental Projects, and How to Value Such Projects*, John Peter Suarez, Assistant Administrator, OECA, (Dec. 15, 2003).

[4] For example, if it takes one year from the date of settlement to complete a $100,000 SEP, that delay would yield a benefit to the violator of approximately $6,000 (assuming 6% annual return). If the SEP is costly, then even relatively short gaps can yield significant savings to the violator. Assuming 6% return, a two month gap between the settlement date and the completion date of a $10 million project could yield a $100,000 benefit to a violator.

Finally, for purposes of reporting enforcement results in ICIS, enforcement staff should enter the minimum required expenditure for the SEP as reflected in the settlement document. OECA is updating the case conclusion data sheet to reflect this change in reporting.

Conclusion

We appreciate your commitment to negotiate and include SEPs in settlements. SEPs are important to the Agency's mission to protect human health and the environment. We realize that there may be questions associated with this advisory, and case-specific circumstances that need additional consideration. Should you have any questions, please contact Susan O'Keefe, Acting Director of the Special Litigation and Projects Division (202-564-4021), or contact Beth Cavalier (202-564-3271) or Melissa Raack (202-564-7039), the National SEP Coordinators.

cc: Regional and HQ SEP Coordinators
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