

September 2005

TAX  
ADMINISTRATION

Systematic  
Information Sharing  
Would Help IRS  
Determine the  
Deductibility of Civil  
Settlement Payments



G A O

Accountability \* Integrity \* Reliability



Highlights of [GAO-05-747](#), a report to the Committee on Finance, U.S. Senate

## Why GAO Did This Study

Although some civil settlement payments are deductible, their deterrence factor could be lessened if companies can deduct certain settlement payments from their income taxes. GAO was asked to (1) identify federal agencies that negotiated some of the largest dollar civil settlements, (2) determine whether selected federal agencies take tax consequences into account when negotiating settlements and officials' views on whether they should address payment deductibility in settlement agreements, (3) determine whether companies with some of the largest civil settlement payments deducted any of the payments on their federal income taxes, and (4) determine what information the Internal Revenue Service (IRS) collects on civil settlements reached by federal agencies.

## What GAO Recommends

GAO recommends that IRS work with federal agencies to develop a cost-effective means of systematically obtaining information on civil settlements that would benefit IRS in ensuring the correct tax treatment of settlement payments.

IRS agreed with the recommendation and will form an executive-led team to implement it. EPA generally supported our recommendation and the other agencies did not address the recommendation.

[www.gao.gov/cgi-bin/getrpt?GAO-05-747](http://www.gao.gov/cgi-bin/getrpt?GAO-05-747).

To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek at (202) 512-9110 or [brostekm@gao.gov](mailto:brostekm@gao.gov).

## TAX ADMINISTRATION

# Systematic Information Sharing Would Help IRS Determine the Deductibility of Civil Settlement Payments

## What GAO Found

The Environmental Protection Agency (EPA), Securities and Exchange Commission (SEC), and Department of Justice (DOJ) negotiated civil settlements that were among the largest in the federal government in fiscal years 2001 and 2002. Also, the Department of Health and Human Services (HHS) was involved in negotiating some of the largest dollar False Claims Act (FCA) health-care civil settlements for which DOJ has primary responsibility. The largest civil settlements at these agencies ranged from about \$870 thousand to over \$1 billion.

Officials in the four agencies we surveyed said that they do not negotiate with settling companies about whether settlement amounts are tax deductible. They said it was IRS's role to determine deductibility. In preparing to negotiate environmental settlements, EPA and DOJ may consider certain tax issues in calculating the amounts they propose to seek. This calculation estimates a company's economic benefit, that is, the financial gain from not complying with the law. Some DOJ environmental settlements with civil penalties have language stating that penalties are not deductible. DOJ officials said since the law is generally clear that civil penalties paid to a government are not deductible, stating so in the agreement was merely restating the law and is not necessary.

The majority of companies responding to GAO's survey on how they treated civil settlement payments for federal income tax purposes deducted civil settlement payments when their settlement agreements did not label the payments as penalties. GAO received responses on 34 settlements totaling over \$1 billion. For 20 settlements, companies reported deducting some portion or all of their settlement payments.

IRS does not systematically receive civil settlement information from all four agencies. IRS officials said that a permanent system for agencies to provide information would be useful. IRS obtains information on a case-by-case basis from public sources and agencies. IRS also has two temporary compliance projects focusing on tax issues that affect settlement payment deductibility. In 2004, IRS introduced a tax schedule to provide information on a company's fines, penalties, and punitive damages.

### Approximate Ranges and Cumulative Values of the 20 Largest Civil Settlement Agreements at the Four Agencies Contacted in Each Year for Both Fiscal Years 2001 and 2002

Agency	Smallest	Largest	Cumulative value
EPA	\$1 million	\$1 billion	\$4.1 billion
SEC	\$870 thousand	\$114 million	\$607 million
HHS	\$3 million	\$790 million	\$2 billion
DOJ	\$12 million	\$471 million	\$3.3 billion

Source: GAO analysis of EPA, SEC, HHS, and DOJ data.

Note: Settlement values include payments to the U.S. government. EPA settlements also include estimated costs for any pollution controls, other complying actions and Supplemental Environmental Projects. HHS settlements are for FCA cases negotiated with DOJ. EPA settlements led by DOJ are included in the EPA category.

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United States Government Accountability Office  
Washington, DC 20548

September 15, 2005

The Honorable Charles E. Grassley  
Chairman  
The Honorable Max Baucus  
Ranking Minority Member  
Committee on Finance  
United States Senate

The value of civil settlements that federal regulatory agencies annually reach with those who violate laws or regulations can exceed billions of dollars. Civil settlements,<sup>1</sup> which can be used to avoid litigation, are one of the enforcement tools some agencies can use to correct violations and punish those who violate laws or regulations by imposing penalties or other actions. Many civil settlements with federal agencies may require that the entities settling with the agencies make monetary payments. When negotiating settlements, agencies consider many factors, which may include whether payments are sufficient in size to deter the violator or others from violating applicable laws or regulations in the future and mitigate any economic benefit that the violator gained from not complying.

The deterrence effect of monetary payments could be lessened if violators are able to deduct the civil settlement payments from their income taxes since deductions reduce the amount of tax violators would otherwise pay. In general, payments that are intended to punish (punitive payments) a violator are not deductible and payments made to compensate (compensatory payments) those who were harmed by a violation are deductible under federal law. Nevertheless, it may not always be clear which payments are deductible, in part because the Internal Revenue Code (IRC)<sup>2</sup> does not address the deductibility of all types of payments that may be made pursuant to a civil settlement and the statutes imposing the payments may be unclear regarding whether they are punitive, compensatory, or both. Over the last several years, concerns that some companies deducted, or planned to deduct, large civil settlement payments

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<sup>1</sup>In this report, civil settlements are formal legal agreements between agencies and alleged violators to resolve a lawsuit or potential lawsuit. The terms agencies use to refer to civil settlement agreements may vary.

<sup>2</sup>26 U.S.C. et seq.

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from their federal income taxes have heightened Congress's interest in this area.

Because of your interest in obtaining information on how agencies address tax issues for civil settlements and how companies have treated civil settlement payments on their federal income tax returns, you asked us to review some of the largest settlement agreements and determine how some companies have treated their civil settlement payments for federal tax purposes. As agreed, the objectives of this report are to (1) identify federal agencies that negotiated some of the largest dollar civil settlements in recent years, (2) determine whether the selected federal agencies having some of the largest civil settlements take tax consequences into account when negotiating settlements and officials' views on whether they should address the deductibility of payments in the agreements, (3) determine whether the companies that paid some of the largest civil settlement payments deducted any of the payments on their federal income tax returns, and (4) determine what information the Internal Revenue Service (IRS) collects on civil settlements reached by federal agencies.

To identify federal agencies that negotiated the largest dollar civil settlements in recent years, we analyzed information from various sources, including agencies' Web sites, annual reports and enforcement reports, and other available information. Based on our analysis of the information, we concluded that the Environmental Protection Agency (EPA), the Securities and Exchange Commission (SEC), and the Department of Justice (DOJ) negotiated some of largest civil settlements in fiscal years 2001 and 2002. We also included the Department of Health and Human Services (HHS) because HHS was involved in negotiating some of the largest dollar False Claims Act (FCA) health care civil settlements that DOJ has primary responsibility to negotiate.<sup>3</sup> We selected this time frame since it would allow the settling companies time to pay the settlements; determine the applicable tax treatments, if any; and file federal income tax returns. We interviewed officials in these agencies to identify and obtain copies of their largest civil settlements.

To determine whether the four federal agencies having some of the largest civil settlements take tax consequences into account when negotiating

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<sup>3</sup>HHS's role in these negotiations includes recommending an appropriate settlement amount to DOJ.

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civil settlements, we determined whether the agencies negotiate with companies about whether civil settlement amounts are tax deductible and whether the agencies considered any aspects of taxes when internally deciding on what settlement amounts they should present for the negotiations. In making these determinations, we reviewed the underlying agreements and obtained information on the agencies' civil settlement policies and procedures, including whether they address tax issues, and interviewed officials. We also obtained agency officials' views on whether they should address the deductibility of payments in the agreements.

To determine whether the companies that paid some of the largest civil settlement payments deducted any of the payments on their federal income tax returns, we developed a questionnaire to survey the companies. We did not independently verify the responses of the surveyed companies.

To determine what information IRS collects on civil settlements reached by federal agencies, we interviewed knowledgeable officials from IRS and the four agencies and reviewed supporting documentation about what information, if any, IRS obtains from the four selected agencies regarding their civil settlement agreements.

You also asked us to provide information on whether corporate taxpayers' deductions for settlement payments were being examined in IRS audits and the outcome of the audits. To obtain this information, we interviewed IRS officials concerning our work and requested information on whether corporate taxpayers' deductions for settlement payments were being examined in audits and the outcome of the audits. Appendix II provides this information.

We assessed the reliability of the lists of the largest settlement agreements identified by the agencies and found them to be sufficiently reliable for the purposes of our reporting objectives. Our work was conducted from February 2004 through June 2005 in accordance with generally accepted government auditing standards. (See app. I for a more detailed description of our scope and methodology.)

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## Results in Brief

Four agencies—EPA, SEC, HHS,<sup>4</sup> and DOJ—negotiated civil settlement agreements that were among the largest negotiated by the federal

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<sup>4</sup>HHS settlements were for FCA cases for which DOJ had primary responsibility.

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government in fiscal years 2001 and 2002. The cumulative value of their 160 largest settlements exceeded \$9 billion. The settlements ranged in size from just under \$1 million to over \$1 billion. For example, the payments required under SEC's civil settlements ranged from about \$870 thousand to about \$114 million, and the estimated value of EPA's settlements ranged from about \$1 million to over \$1 billion (see table 1 and the table notes).

Officials in the four agencies we surveyed said that they do not negotiate with settling companies about whether settlement amounts are tax deductible. Some officials said it was IRS's role to determine deductibility. Before entering into a settlement with the settling companies for environmental settlements, EPA and DOJ officials consider tax issues in determining the economic benefit a settling company gained from noncompliance. This takes into account whether a company would have incurred tax deductible costs if it had complied with the law, such as a one-time nondepreciable expenditure and applies the violator's appropriate year-specific combined state and federal marginal tax rates to the costs. Other than some settlements with civil penalties containing language stating that the penalties are not deductible, the settlement agreements we reviewed generally did not specify the deductibility of settlement amounts, which was consistent with what the agency officials told us. As an example of the exceptions, we found that some DOJ environmental settlements with civil penalties did include language in the agreement between DOJ and the settling company that the penalties would not be deducted for federal income tax purposes. DOJ officials said that including such language is not standard practice and emphasized that since the law is generally clear that civil penalties paid to a government are not deductible, stating so in the settlement agreement is merely restating the law.

The majority of the companies responding to our survey on how companies treated civil settlement payments for federal income tax purposes deducted settlement payments when their settlement agreements did not label the payments as penalties. We received responses on the companies' tax treatment of 34 civil settlements with total amounts exceeding \$1 billion. The companies reported deducting some or their entire civil settlement amount for 20 of the 34 settlements. In 2 of these settlements, company representatives said they erred in deducting the civil penalty payments totaling about \$1.9 million and told us they would file amended tax returns. For 3 of the 15 settlements for which companies deducted some or all of their DOJ FCA settlement payments, companies reported that language in their settlement agreements was a rationale for the deductions, although DOJ told us that

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language did not pertain to tax deductibility. The total amount of deductions taken by these 5 companies exceeded \$100 million. DOJ changed the language for future FCA settlements based on our findings. Furthermore, three companies that deducted FCA settlement payments reported that they did so in whole or in part because their settlement agreements contained language stating that the company denied wrongdoing. Their deductions totaled about \$15.5 million.

IRS does not generally receive civil settlement information in a systematic manner from the four agencies we surveyed, although IRS obtains some settlement information from those agencies on a case-by-case basis to use in determining whether companies properly treated settlement amounts for tax purposes. IRS officials told us that a permanent system for agencies to provide IRS with timely civil settlement information could help, for instance, in selecting firms to audit. Officials of the four agencies in our review expressed willingness to work with IRS to provide settlement information. IRS has two temporary compliance projects that collect information on tax issues that affect the deductibility of settlement amounts made pursuant to FCA and environmental settlement agreements in part to help IRS address improper deductions during examinations. In association with one of the compliance projects, DOJ recently agreed to provide information about large FCA settlements shortly after they are closed and information on all FCA cases annually for the duration of the project. In addition, in 2004, IRS introduced Schedule M-3, which could also help IRS in identifying companies with civil settlements because it captures some information on fines, penalties, and punitive damages from companies with total assets of \$10 million or more.

We are recommending that the Commissioner of Internal Revenue direct the appropriate officials to work with federal agencies that reach large civil settlements to develop a cost effective means of obtaining information on settlement agreements that would be beneficial to IRS in ensuring the correct tax treatment of the settlement amounts.

In commenting on a draft of this report (see app. III), the Commissioner of Internal Revenue agreed with our recommendation and will form an executive-led team to implement it. EPA also provided comments and said they generally supported our recommendation (see app. IV). SEC provided written comments but did not address our recommendation (see app. V). HHS sent a letter stating they had no comments but provided technical comments (see app. VI). DOJ also provided technical comments. We made changes to our report to incorporate the agencies' comments as appropriate.

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## Background

Civil settlements are one of several enforcement tools used by some federal agencies to help ensure that individuals and companies comply with the laws and regulations they enforce. For purposes of this report, civil settlements involve negotiations by federal agencies with companies to resolve issues about their compliance with laws and regulations. The negotiation process can involve discussions between agency officials and a company about each party's proposals to address the compliance problem and can end with a written agreement that reflects the terms reached by the settling parties. In such cases, the civil settlements generally require a company to agree to perform certain activities or stop engaging in certain activities. Some settlements also require that monetary payments be made to the government and to others. When determining settlement amounts, agencies consider various factors, including thresholds for fines and penalties set by federal statutes for violations and the severity of the violation.

While some agencies have administrative authority to enter into civil settlements, some cases are required to be referred to DOJ for resolution. For these cases, DOJ may settle with the defendant or take the defendant to court. Of the four agencies we contacted, DOJ is responsible for certain environmental settlements on behalf of EPA and certain civil health care fraud cases on behalf of HHS.

Section 162 of the IRC provides a deduction for all ordinary and necessary business expenses, including settlements and similar payments. This provision is subject to an exception in IRC § 162(f) that denies a deduction for any fine or similar penalty paid to the government for the violation of any law.<sup>5</sup> The definition of "fine or similar" penalty includes an amount paid in the settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal).<sup>6</sup> Furthermore, Treasury regulations provide that payments made as compensatory damages paid to a

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<sup>5</sup>Recently, several legislative proposals have been introduced, but not enacted, to modify the rules for deducting fines or similar penalties paid to the government for the violation of any law. Currently, a proposed provision in S. 1565, 109th Cong. § 207 (2005), would provide that amounts paid or incurred (whether by suit, agreement, or otherwise) to or at the direction of a government in relation to the violation of any law or the investigation or inquiry into the potential violation of any law are nondeductible. The bill contains an exception for restitution. Amounts paid to certain self-regulatory entities that impose sanctions, such as the National Association of Securities Dealers, are treated similarly for purposes of the proposal.

<sup>6</sup>Treas. Reg. § 1.162-21(b)(1)(iii).

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government do not constitute a fine or penalty.<sup>7</sup> In general, IRS views punitive payments as being nondeductible and compensatory payments as being deductible.

Although the terms used to describe a payment required as part of a civil settlement may provide an indication of whether the amount is deductible or not, according to IRS, often it is necessary to look to the intent of the law requiring the payment or the facts and circumstances of the settlement to determine whether a payment is deductible. Civil settlement agreements we reviewed use terms other than “compensatory” or “punitive” to describe settlement payments. For instance, some agencies use terms like restitution or disgorgement for payments that are intended to compensate the government or others.<sup>8</sup> Even when a term used to describe a payment may seem to indicate that a payment is not deductible, in fact, the opposite may be the case. For example, a payment labeled as a civil penalty<sup>9</sup> and that seems not deductible may be deductible if it is imposed as a remedial measure to compensate the government or other party. Or, payments that will be used for remedial or compensatory purposes and seem deductible may not be so if the law requiring the payment indicates the payment is to have a punitive or deterrent effect. IRS and courts look to the purpose of the statute, including the legislative history and administrative and judicial interpretation, to determine whether a payment serves a punitive or compensatory purpose. If the law is unclear, or if the statute serves both punitive and compensatory purposes, the facts and circumstances of the specific settlement payment, including the terms of the settlement agreement, often need to be examined to determine the purpose the parties intended the payment to serve.

Until recently, IRS did not have a tax form that could be used to identify whether a fine or penalty had been deducted for tax purposes. Effective for any tax year ending on or after December 31, 2004, corporations with consolidated assets of \$10 million or more that are required to file IRS Form 1120, the corporate income tax return, must also file Schedule M-3. Schedule M-3 requires companies to reconcile financial accounting net income (or loss) with taxable net income and expense and deduction

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<sup>7</sup>Treas. Reg. § 1.162-21(b)(2).

<sup>8</sup>Restitution is the return or restoration of some specific thing to its rightful owner or status. Disgorgement is the act of giving up something (such as profits illegally obtained) on demand or by legal compulsion.

<sup>9</sup>A civil penalty is a fine assessed for violation of a statute or regulation.

items. The 2004 Schedule M-3 line items for reconciliation include fines, penalties, and punitive damages.

## Civil Settlements Negotiated by EPA, SEC, HHS, and DOJ Were among the Largest in Fiscal Years 2001 and 2002

In fiscal years 2001 and 2002, EPA, SEC, HHS, and DOJ negotiated some of the largest civil settlements in the federal government. The civil settlements we examined ranged in size from about \$870 thousand to over \$1 billion. (See table 1.) For example, a 2001 EPA judicial settlement related to the Clean Air Act required a utility company to significantly reduce harmful air pollution from its power plants at an estimated cost of over \$1 billion and pay a \$3.5 million fine. The cumulative value for the 20 largest settlements for fiscal year 2001 and the 20 largest settlements for fiscal year 2002 at the four agencies—a total of 160 settlements—exceeded \$9 billion.<sup>10</sup>

**Table 1: Approximate Ranges and Cumulative Values of the 20 Largest Civil Settlement Agreements at the Four Agencies Contacted in Each Year for Both Fiscal Years 2001 and 2002**

Agency	Smallest	Largest	Cumulative value
EPA <sup>a</sup>	\$1 million	\$1 billion	\$4.1 billion
SEC	\$870 thousand	\$114 million	\$607 million
HHS <sup>b</sup>	\$3 million	\$790 million	\$2 billion
DOJ <sup>c</sup>	\$12 million	\$471 million	\$3.3 billion

Source: GAO analysis of EPA, SEC, HHS, and DOJ data.

Notes: For settlements identified by SEC, HHS, and DOJ, the total value of settlements reflects payments payable to the U.S. government and other recipients such as the relator, also known as the whistleblower. For settlements identified by EPA, the total value of settlements included payments payable to the U.S. government; the estimated cost of any Supplemental Environmental Projects; and the estimated costs of pollution controls, monitoring equipment, or other complying actions that companies are required to take to come into compliance with environmental laws. The penalty portion ranged from approximately \$500,000 to almost \$10 million, and the cumulative value of the penalty amount for these settlements was about \$124.3 million.

<sup>a</sup>EPA settlements, including those for which DOJ led the negotiations, are included under the EPA category.

<sup>b</sup>The settlements identified by HHS include only FCA settlements. HHS officials told us FCA settlements, which DOJ negotiates, are the largest of the agency's civil settlements.

<sup>c</sup>The list of settlements obtained from DOJ was of cases closed in fiscal years 2001 and 2002. The dollar values of settlements provided were net of relators' fees.

<sup>10</sup>This total differs from the sum of the agency cumulative value in table 1 because we excluded 7 of the FCA settlements identified by HHS that were also included in DOJ's list of the 20 largest civil settlements for fiscal year 2001 and the 20 largest civil settlements for fiscal year 2002.

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## The Four Agencies Do Not Negotiate the Tax Deductibility of Settlement Amounts, but Two Agencies Consider Aspects of Taxes in Determining Amounts for Negotiations

Officials in the four agencies said that they do not take tax consequences into account during negotiations with settling parties, that is, they do not negotiate with companies about the deductibility of settlement amounts.<sup>11</sup> They said they generally do not have tax expertise and that determining deductibility of settlement amounts is IRS's role. When negotiating, officials said they look to the relevant laws and regulations and the facts and circumstances of the case, including the severity of the violation and the strength of the evidence against the violator to determine the settlement amount to seek. In preparing for negotiations, two agencies—EPA and DOJ—consider certain tax issues in calculating the amounts they propose to seek in negotiating environmental settlements. This calculation estimates a company's financial gain from not complying with the law, that is, their economic benefit. The agencies factor in whether the company would have incurred tax deductible expenses to stay in compliance and apply the violator's year-specific combined state and federal marginal tax rates to the costs of complying on time and complying late. Except for some settlement agreements stating that civil penalties are not deductible, the agencies' written civil settlement agreements we reviewed generally did not specify the deductibility of settlement amounts. As an exception to this general practice, we found that some DOJ environmental settlements with civil penalties included language indicating that the penalties would not be deducted for federal income tax purposes. DOJ Environmental and Natural Resources (ENR) Division officials explained that when a settlement agreement includes civil penalties, their attorneys have discretion about whether to include such language in an agreement. The officials emphasized that the law is generally clear that civil penalties paid to a government are not deductible and stating so in the agreement is essentially restating the law and is not necessary. In addition, in 2003, subsequent to the time frame of the settlements we reviewed, SEC adopted a policy of requiring settlement agreements with civil penalties to include language stating that the settling parties would not deduct civil penalties for tax purposes.

Table 2 describes the four agencies' practices regarding how they consider tax issues during their settlement negotiation processes, including drafting the terms of their settlement agreements. The settlement agreements we reviewed were consistent with the practices described to us by the agencies' officials. These practices are current as of June 2005. Because

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<sup>11</sup>Although DOJ has lead responsibility for negotiating FCA cases on behalf of HHS, HHS is involved in the negotiations process, including recommending settlement amounts to DOJ.

each settlement agreement is unique, settlements negotiated by these agencies can have some exceptions to the practices listed in the table.

**Table 2: Practices of Four Federal Agencies regarding Tax Issues They Consider during Settlement Negotiations and in Settlement Agreements**

<b>Agency</b>	<b>Does the agency negotiate with settling parties about whether settlement amounts are tax deductible?</b>	<b>Does the agency consider any aspects of taxes when calculating its proposed settlement amount?</b>	<b>Does the written settlement agreement include specific information about the deductibility of the settlement amount?</b>
EPA Administrative environmental settlements	No.	Yes, if applicable to determine the economic benefit portion of a civil penalty and if applicable as part of valuing Supplemental Environmental Projects (SEP) a company agrees to undertake as part of a settlement.	Yes, when settlements include civil penalties, some agreements state that civil penalties are not deductible. Also when a company has said it will not deduct the cost of a SEP, the government takes this into account when determining the value of the SEP, and the agreement will specify that the company will not deduct the costs of the SEP.
SEC settlements <sup>a</sup>	No.	No.	Yes, since 2003, settlements that include civil penalties are to state that the civil penalties are not deductible.
HHS settlements <sup>b</sup>	No.	No.	No.
DOJ FCA settlements	No.	No.	No.
Judicial environmental settlements	No.	Yes, if applicable to determine the economic benefit portion of a civil penalty and if applicable as part of valuing SEPs a company agrees to undertake as part of a settlement.	Yes, when settlements include civil penalties, some agreements state that civil penalties are not deductible. Also when a company has said it will not deduct the cost of a SEP, the government takes this into account when determining the value of the SEP, and the agreement will specify that the company will not deduct the costs of the SEP.

Source: GAO analysis.

<sup>a</sup>In 2003, SEC implemented a policy that settlements with civil penalties are to include language stating that the civil penalties would not be deducted. Agreements negotiated before SEC implemented this policy do not include such language.

<sup>b</sup>The HHS settlements we reviewed were FCA civil health care fraud cases negotiated by DOJ.

As table 2 shows, the selected agencies do not negotiate with companies about whether they can deduct any portion of their settlement from their income taxes. In determining their negotiating position and any changes to agree to during negotiations, officials generally look to factors such as the relevant laws and regulations and the facts and circumstances of the case, including the severity of the violation and the strength of evidence against

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the violator. Officials in the four agencies said that determining deductibility is IRS's role, and they generally do not have the expertise to address the deductibility of payments during negotiations or to specify the tax consequences of amounts in the settlements. IRS staff agreed and said that if agencies were to specify whether a settlement amount is deductible, there could be a risk that the agencies might concede tax consequences in order to reach a settlement.

The following information summarizes the policies, procedures, and views of the agencies on taking taxes into account during negotiations and specifying the tax deductibility of settlement payments in the agreements.

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## EPA

EPA's mission is to protect the environment and address related human health impacts. EPA can reach civil administrative and judicial enforcement settlements against violators of environmental laws, and its priorities in negotiating settlements are to ensure that violators come into compliance with the law, punish past violations and deter future violations, obtain restoration of environmental damage resulting from violations, and impose civil penalties sufficient to recover any economic benefit gained as a result of the violator's noncompliance and deter future violations. EPA negotiated the civil administrative settlements under its own authority without a judicial process. Cases that are brought and settled by DOJ on behalf of EPA are referred to as civil judicial enforcement settlements. DOJ's policies, procedures, and officials' views for these cases are discussed in the DOJ section of this report.

All EPA civil settlements we reviewed included payments labeled as civil penalties for violations of environmental laws or regulations. In addition, the value of the settlements sometimes included estimated amounts a company may incur to achieve and maintain compliance with the environmental laws and regulations, such as installing a new pollution control device to reduce air pollution or prevent emissions of a pollutant. Also, some settlements included SEPs, which are projects a company agrees to undertake in addition to complying actions. IRS is currently reviewing the deductibility of SEPs.

Civil penalties in EPA settlements are generally composed of two parts: economic benefit and gravity. Economic benefit represents the financial gains that a violator accrues by delaying expenditures necessary to comply with environmental regulations, avoiding them, or both. Under EPA's civil penalty policy, the goal of recovering the economic benefit of noncompliance is to place the violator in the same position as if

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compliance had been achieved from the start. The amount EPA includes in a civil penalty to account for the seriousness of the violation is referred to as the gravity portion of the penalty. EPA includes the gravity portion of the penalty to provide deterrence against future noncompliance. When calculating the gravity portion of the initial civil penalty amount, EPA adjusts the gravity-based penalty on various case-specific factors, including the strength of evidence against the company and the company's degree of cooperation and history of noncompliance.

When calculating the economic benefit portion of civil penalties, EPA uses an economic computer model to estimate any financial advantage a company gained from not complying with environmental laws. EPA's economic computer model takes into account whether a company would have incurred tax deductible costs if it had complied with the law, such as a one-time nondepreciable expenditure, in estimating the economic benefit a company gained by not complying with environmental laws or regulations. The computer model applies the appropriate year-specific combined state and federal marginal tax rates of the violator in calculating economic benefit along with standard financial cash flow and net present value analysis techniques to calculate the costs of complying on time and of complying late.

When calculating the gravity portion of civil penalties, EPA officials consider the facts surrounding each violation, including factors such as the actual or possible harm caused by the violation, the size of the violation, and the goals of the specific environmental program. EPA officials acknowledged that they negotiate with violators about the size of the gravity portion of the penalty, but said in doing so they consider factors such as the strength of their position and not whether the violator may be able to claim a tax deduction.

When EPA settlements include civil penalty payments,<sup>12</sup> EPA's practice is to explicitly label these payments as civil penalties. In some settlements with civil penalties, the settlement agreements also reference IRC § 162(f), which states that penalties payable to a government are nondeductible. Officials noted that including language referencing IRC § 162(f) is not EPA's usual practice. EPA officials said that they believe the law is clear that civil penalties payable to a government are generally nondeductible,

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<sup>12</sup>In some cases, such as when the settlement only requires a company to come into compliance, a settlement does not include a civil penalty payment.

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so they do not see inclusion of such language in settlement agreements as necessary.

As part of some settlements, companies perform SEPs, which are projects not required by law, that are voluntarily undertaken by a respondent in exchange for possible penalty mitigation.<sup>13</sup> EPA may mitigate the civil penalty ultimately assessed as part of the settlement, when a respondent agrees to undertake a SEP. EPA still collects a civil penalty as part of the settlement in accordance with its 1998 SEP policy, which calls for collecting the greater of 25 percent of the gravity component of the penalty, or 10 percent of the gravity, plus economic benefit. To determine the value of SEPs, EPA uses an economic computer model, and if a company tells EPA that it plans to deduct the SEP costs, EPA factors the company's decision into valuing the SEP through the model. EPA officials said that they are not involved in a violator's decision to deduct the SEP costs and that they take the violator's decision at face value.

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## SEC

SEC is responsible for administering and enforcing federal securities laws and regulations and fostering fair and efficient markets for the trading of securities. SEC enforcement officials told us that in enforcing the securities laws, they aim to protect investors and punish violators. In performing its enforcement role, SEC may, among other actions, negotiate civil settlements with those who violate securities laws. When appropriate, SEC provides that violators make monetary payments that generally include amounts for civil penalties and disgorgement. The SEC settlement agreements we reviewed included penalties for violations of the securities laws. These settlements also included disgorgement, in which SEC attempts to ensure that violators of securities laws or regulations do not profit from their illegal activity, and when appropriate, these disgorged profits are returned to investors.

The IRC does not specifically address the deductibility of disgorgement. Although IRS looks at the individual facts and circumstances of a case to

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<sup>13</sup>In B-247155 (July 7, 1992) we concluded that EPA lacked authority to settle certain EPA actions by entering into SEPs. Further, in B-247155.2 (Mar. 1, 1993) we concluded that the Miscellaneous Receipts Act, 21 U.S.C. § 3302, which requires all federal agencies to remit all penalties to the U.S. Treasury, was circumvented when alleged violators were allowed to make payments to an institution other than the federal government. According to EPA officials, subsequent to our decisions, EPA made substantial changes to its SEP policy to address our concerns. We did not assess the changes to EPA's SEP policy.

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determine deductibility, it has generally regarded disgorgement payments as compensatory, and therefore tax deductible. As previously discussed, Treasury regulations provide that in civil actions, compensatory damages paid to a government do not constitute a fine or a penalty.<sup>14</sup>

SEC's Chief Counsel for Enforcement emphasized that SEC's decision on how much of a settlement payment is penalty versus disgorgement is based solely on the facts and circumstances of the case, including the law violated, the degree of harm, and the seriousness of the violation. However, the official further said that although SEC does not negotiate with settling parties about the deductibility of settlement payments, settling parties may initiate negotiations with SEC about how the settlement payment is to be allocated between penalty and disgorgement. Although settling parties may seek a larger disgorgement amount because it is generally tax deductible, SEC staff make recommendations for disgorgement and penalties based on their analysis.

In 2003, SEC implemented a policy requiring all civil settlement agreements with penalties to include language that expressly prohibits the settling party from taking a tax deduction or seeking to recover from an insurance carrier the penalty portions of the settlement payment. SEC adopted standardized language prohibiting deductions as a result of the Global Research settlement, in which 10 Wall Street companies settled for a combined \$875 million in civil penalties and disgorgement. There were reports that some of the settling companies were planning to take deductions for the civil penalty portion of the settlement payments that would be placed into funds for investors who were harmed by the companies' violations. The Sarbanes-Oxley Act of 2002 allows SEC, in appropriate cases, to add penalties to the disgorgement fund for the benefit of harmed investors, pursuant to the "fair fund" provisions of the act.<sup>15</sup> SEC provides in its standardized settlement language that such amounts are to be treated as penalties for tax purposes. SEC's settlement agreements are silent on the tax deductibility of disgorgement. Senior SEC officials noted that in their view, decisions about the deductibility of disgorgement should be left to IRS.

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<sup>14</sup>Treas. Reg. § 1.162-21(b)(2).

<sup>15</sup>Pub. L. No. 107-204, § 308, 116 Stat. 745 (2002).

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## HHS

HHS is the principal federal agency responsible for protecting the health of American citizens and providing essential human services. HHS's largest civil settlements are generally FCA cases relating to civil health care fraud. FCA generally provides that anyone who knowingly submits false claims to the government is liable for damages up to three times the amount of the damages sustained by the government plus penalties from \$5,500 to \$11,000 for each false claim submitted. Although many FCA cases involve civil health care fraud against the Medicare and Medicaid programs that HHS administers, the act is also used in settling other types of fraud perpetrated against the federal government, such as defense contractor fraud. A civil health care FCA case, for example, could involve a health care provider who grossly overcharged for medical services rendered and then filed claims for reimbursement at the overcharged rates. Usually, civil health care fraud cases are based on referrals from federal and state investigative agencies and private persons.<sup>16</sup>

DOJ is responsible for representing the United States in FCA cases and therefore negotiates the FCA settlements. DOJ's Civil Division carries out those responsibilities along with U.S. Attorneys' Offices located across the country. Accordingly, DOJ sets the overall policy for civil health care fraud FCA settlements. For health care settlements, HHS's Office of Inspector General (OIG) provides DOJ assistance in several ways, including investigating individuals and companies that may have abused the HHS health care programs, and sometimes works with DOJ to determine the amount of single damages, that is, the amount of loss sustained by the government due to the violator's actions.

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## DOJ

DOJ negotiates settlement agreements on behalf of other federal agencies, including some cases involving HHS and EPA. The DOJ settlement agreements we reviewed were limited to FCA settlements negotiated by DOJ's Civil Division and judicial environmental settlements negotiated by DOJ's ENR Division. The FCA cases negotiated by DOJ that we reviewed contained a single payment labeled as a settlement amount, which does not characterize the extent to which payments are for single or multiple damages or civil penalties. All of the DOJ-led environmental settlement agreements that we reviewed included amounts labeled as penalties and some included SEPs.

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<sup>16</sup>Private persons, known as relators, can bring actions for violations of FCA. 31 U.S.C. § 3730.

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In negotiating FCA civil settlement agreements, DOJ Civil Division officials said that they do not consider or discuss any aspects of taxes. In calculating the settlement amount for FCA cases, DOJ first assesses the amount of damages the violation cost the government and seeks to recover the full amount. It also considers the severity of the violation in determining whether the settling company should pay a multiple of the assessed damages and civil penalties.

DOJ Civil Division officials stated that they do not include language on the deductibility of payments in their written FCA settlement agreements. In fact, according to the officials, all FCA settlements contain DOJ's standard settlement agreement language, which states that nothing in the agreement characterizes the payments for federal income tax purposes. DOJ Civil Division officials said that this language supports the agency's policy of not addressing the tax treatment of settlement payments in settlements agreements.

DOJ Civil Division and IRS officials told us that the agencies came to a mutual agreement that DOJ's tax-neutral practices on the deductibility of civil settlement payments are appropriate. Furthermore, officials added that the settlement agreements refer to the payments as a settlement amount because the negotiations with the settling party usually involved agreeing on a lump sum amount without characterizing the payment into categories such as single, double, or treble damages and civil penalties. Officials said they do not categorize the payments more specifically because doing so would add complexity to the negotiation process by adding additional factors on which to obtain agreement between the parties. Thus, the agreement does not characterize the extent to which the settlement payment is punitive or compensatory. According to IRS staff, single damages are generally considered compensatory and therefore tax deductible, and any multiple damages and civil penalties are generally considered punitive and therefore nondeductible.

Officials in DOJ's Civil Division and HHS's OIG said that even though FCA allows for the assessment of penalties in addition to multiple damages, penalties are not always sought. The HHS officials said that penalties are not generally sought in FCA settlements because collecting a multiplier of damages is sufficient to compensate the government and provide a deterrence.

DOJ also negotiates environmental cases on behalf of EPA. EPA refers to cases it sends to DOJ to settle as judicial cases since they are not resolved under EPA's administrative authority. EPA staff assist DOJ staff in

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building these cases and EPA's civil penalty policies generally apply to DOJ environmental settlements. However, DOJ—not EPA—has primary settlement authority for these cases, and DOJ is not bound by EPA's penalty policies.

Like EPA, in preparing for negotiations and determining the amount to seek at settlement, DOJ considers aspects of taxes in calculating the economic benefit a violator received from not complying with environmental laws. However, DOJ ENR Division officials told us that their position is to be neutral on tax issues. DOJ sometimes uses the EPA economic benefit computer model to calculate economic benefit amounts but may also obtain outside experts. Similar to EPA's administrative settlements, some DOJ-negotiated environmental settlements may involve SEPs, which can be used to offset a portion of the civil penalty that DOJ would otherwise seek. The officials reiterated that they do not negotiate with the violator about the deductibility of the SEP costs, but would factor in the violator's stated intentions about deducting the SEP costs in establishing its value as part of the settlement.

As with EPA civil administrative settlements, when DOJ-negotiated environmental settlements include civil penalties, the practice is to explicitly label these payments as civil penalties. Also, in some settlements with civil penalties, DOJ-negotiated environmental settlement agreements reference IRC § 162(f), which states that fines or similar penalties payable to a government are nondeductible. DOJ ENR Division officials said that having settlement agreements reference IRC § 162(f) is not standard practice and would be at the discretion of officials involved in the settlement negotiations. According to these officials, the law is generally clear that civil penalties payable to the government are nondeductible and stating so in agreements is merely restating the law. The officials said they do not negotiate with the settling companies about whether the amounts are deductible.

We observed that one large settlement agreement negotiated by DOJ's ENR Division contained language stating that the settling company was not allowed to take a deduction for funding of remediation work and that its chief financial officer must submit a certification that deductions were not taken. DOJ's ENR Division officials told us that a case such as this one likely involved particular negotiating circumstances and strategies. They emphasized that this was an exception rather than their usual practice of not specifying the tax treatment of settlement amounts in the settlement agreement.

## A Majority of the Surveyed Companies Deducted Civil Settlement Payments, Generally When Settlement Agreements Did Not Label Payments as Civil Penalties

In responding to our survey,<sup>17</sup> companies that paid some of the largest civil settlement payments at the four agencies we reviewed generally reported that they deducted civil settlement payments when the settlement agreements did not label the payments as penalties. Conversely, when the settlement agreements labeled the payments as penalties, the companies generally reported that they did not deduct the payments. Overall, for 20 of the 34 settlements for which we received survey responses, companies stated that they deducted some or all of their civil settlement payments.<sup>18</sup> The total value of settlement amounts of the 34 settlements for which we received responses was over \$1 billion. Table 3 summarizes the overall responses from the companies, and table 4 provides survey results on deductions categorized according to how the settlement agreements labeled the settlement payments.

**Table 3: Company Responses on Whether They Deducted Civil Settlement Payments from Their Federal Income Taxes**

Agency	Company deducted some or all	Company deducted none <sup>a</sup>
SEC settlements	1	2
DOJ environmental settlements <sup>b</sup>	4	11
DOJ FCA settlements	15	1
<b>Total</b>	<b>20</b>	<b>14</b>

Source: GAO.

Note: We did not verify the companies' responses with IRS.

<sup>a</sup>Because some companies with SEPs did not report whether they deducted the SEPs, the number of settlements listed for which companies did not make any deduction may be overstated.

<sup>b</sup>In table 1, environmental cases handled by DOJ are reported under EPA cases. In this table, they are reported as "DOJ environmental settlements." To the extent that any of these settlements contained estimates of compliance costs, those were not among the costs included in our survey.

<sup>17</sup>We sent surveys on 47 civil settlements to companies in which we identified a representative who could address our survey questions. Our results are limited to the 34 settlements for which we received responses. Three of the companies we surveyed responded for 2 settlements each. See app. I for more details on our methodology.

<sup>18</sup>One surveyed company stated that it planned to take a deduction for the SEP portion of its civil settlement payment, but had not yet done so at the time of our survey. For purposes of this report, we categorized this company's response as deducted.

**Table 4: Company Responses on Whether They Deducted Various Types of Civil Settlement Payments**

Agency	Classifications of settlement payments in settlement agreements							
	Civil penalty		Settlement amount <sup>a</sup>		SEP <sup>b</sup>		Disgorgement	
	Deducted	Not deducted	Deducted	Not deducted	Deducted	Not deducted	Deducted	Not deducted
SEC	1	2	N/A	N/A	N/A	N/A	1	0
DOJ environmental <sup>c</sup>	2	13	N/A	N/A	2	2	N/A	N/A
DOJ FCA	0	0	15	1	N/A	N/A	N/A	N/A
<b>Total</b>	<b>3</b>	<b>15</b>	<b>15</b>	<b>1</b>	<b>2</b>	<b>2</b>	<b>1</b>	<b>0</b>

Source: GAO.

Note: Totals in this table do not add up to 34 because the following settlement agreements contain more than one classification of settlement payment: one SEC settlement contains both a civil penalty and disgorgement and 10 DOJ-led EPA settlements contain both civil penalties and SEPs.

<sup>a</sup>Settlement amount includes only those settlements in which the entire settlement payment was labeled as a settlement amount and was the only payment in the settlement.

<sup>b</sup>For six of the survey responses for settlements with SEPs, the companies did not respond as to whether they had deducted SEPs associated with the settlement.

<sup>c</sup>In table 1, environmental cases handled by DOJ are reported under EPA cases. In this table, they are reported as “DOJ environmental.” To the extent that any of these settlements contained estimates of compliance costs, those were not among the costs included in our survey.

As shown in table 4, for 15 of the 16 DOJ FCA settlements, companies reported deducting their payments. Of these 15 settlements, 12 survey responses showed that companies deducted the full amount of the payment, while 3 responses showed they deducted a percentage of the full amount—ranging from 43 to 89 percent. Consistent with DOJ’s usual practice for FCA civil settlements, these FCA settlement agreements referred to the settlement payment as the settlement amount, which does not characterize whether the settlement amount included a penalty or was punitive or compensatory in nature.

In addition, of the 15 settlements for which companies settled DOJ FCA cases and deducted payments, companies in 7 settlements told us that they deducted payments because, in their view, the settlement amounts were restitution or compensatory in nature. However, minutes of a healthcare fraud settlements meeting between IRS and DOJ show that IRS believes FCA settlement payments usually include a punitive portion to punish violators and to deter future violations. Also, according to DOJ’s technical comments on the draft of this report, in most FCA settlements (apart from

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those that recover strictly penalties), some of the amounts paid are in the nature of compensatory reimbursement and may be deductible.<sup>19</sup>

Five companies we surveyed reported that a sentence in their FCA settlement agreements indicating that the settlement was not punitive in purpose or effect was a basis for them taking deductions. The settlement amounts deducted by these five companies totaled over \$100 million. According to a director in DOJ's Civil Division, DOJ does not intend for the language in FCA settlement agreements that the companies mentioned to refer to tax treatment. The DOJ official said that this sentence is not intended to imply that the settlement amounts are compensatory for tax purposes, but rather to ensure that the amounts are not punitive for double jeopardy purposes or prohibitions on excessive fines.<sup>20</sup> The DOJ official added that a subsequent statement that is standard in all FCA settlement agreements articulates DOJ's position on deductibility, that is, that the agreement does not characterize the payment for federal income tax purposes. Based on our discussions with DOJ and our survey evidence showing that some companies cited this sentence in support of their tax deductions, DOJ revised the relevant portions of the FCA settlement agreement model language. Effective June 2005, the new language removes references to the settlement not being punitive in purpose or effect.

Furthermore, three companies that deducted FCA settlement payments reported that they did so in whole or in part because their settlement agreements contained language stating that the company denied wrongdoing. Their deductions totaled about \$15.5 million. Two of these three companies also cited the sentence discussed in the prior paragraph as another reason for deducting the amounts.

Also, as shown in table 4, three other companies reported deducting settlement payments even though they were labeled as civil penalties. Two of these companies reported that our survey made them aware that their deductions were improperly taken, and they plan to file amended tax returns. These deductions totaled about \$1.9 million. The other company

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<sup>19</sup>DOJ cited *Cook County, Illinois v. U.S. ex rel. Chandler*, 538 U.S. 119 (2003).

<sup>20</sup>The Double Jeopardy Clause in the U.S. Constitution prohibits anyone from being prosecuted twice for substantially the same crime. U.S. Const. amend. V. The Excessive Fines Clause of the U.S. Constitution prohibits the imposition of excessive fines. U.S. Const. amend. VIII.

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reported that it deducted the civil penalty because it was paid to a self-regulatory organization, which the company believed was not a government agency. This settlement agreement contained language indicating that the self-regulatory organization settled with the company on behalf of a federal agency.

Ten companies that responded to our survey had environmental settlement agreements negotiated by DOJ that contained SEPs.<sup>21</sup> Our analysis of the settlement agreements for the 10 companies showed that four agreements contained language stating that the SEP costs are not deductible. Two companies with settlements that contained this language reported to us that they did not deduct the costs, and the other 2 companies did not respond to the survey question. Of the 6 companies with SEPs for which the settlement agreements did not state whether the costs were deductible, 2 companies reported deducting the SEP costs and the other 4 companies did not indicate whether they deducted SEP costs.

Some of the companies that reported not deducting any settlement payments gave us varying reasons for not taking deductions. The reasons included references to IRC § 162(f), which states, in part, that penalties paid to a government are not deductible, and provisions in their settlement agreements specifying that they would not deduct the settlement payments.

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## No Permanent System Is in Place for Agencies to Routinely Inform IRS of Civil Settlements or Provide Other Settlement Information That IRS Would Find Useful

The four federal agencies do not systematically provide IRS with civil settlement information that would be useful to IRS for compliance purposes, although the agencies do provide such information on a case-by-case basis at IRS's request, such as for audits of companies with settlement agreements. The agencies told us they were willing to work with IRS to develop a permanent system for routinely providing appropriate information. DOJ Civil Division and EPA have established means for providing IRS with information on civil settlement agreements as part of IRS's temporary compliance research projects. In 2004, IRS introduced Schedule M-3, which could potentially help IRS identify corporations with some settlements because it captures information on fines, penalties, and punitive damages from companies with assets of \$10 million or more.

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<sup>21</sup>In settlement agreements for the surveyed companies, some SEPs are referred to as Beneficial Environmental Projects or Environmental Beneficial Projects.

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## Settlement Information from Agencies Could Help IRS with Its Audit Strategy and Facilitate Pre-filing Agreements

In general, the four federal agencies do not routinely notify IRS when a civil settlement has been reached or provide other settlement-related information that IRS would find useful, although they provide IRS with settlement information on a case-by-case basis. To identify settlements that have been reached, IRS officials search agency Web sites and press releases. DOJ ENR Division, EPA, and SEC officials said that their Web sites generally post most of their civil settlement agreements. IRS usually contacts the agencies on a case-by-case basis to obtain information to use during audits in assessing whether companies properly treated their settlement payments on their income tax returns. For example, to determine the facts and circumstances of a settlement, IRS contacts DOJ officials to obtain information on FCA settlements, including written exchanges between the agency and the company and the tracking forms that are used by DOJ to allocate settlement amounts to various government accounts. According to IRS staff, the tracking form and the other information it obtains from DOJ about a settlement can provide leads for determining nondeductible punitive damages in FCA cases.<sup>22</sup>

The agencies have expressed willingness to notify IRS when a settlement has been reached and to work with IRS on providing other appropriate information. Some steps in this direction have already been taken. For example, EPA has designated staff to work with IRS to provide specific settlement information.

IRS officials said that it would help IRS's compliance efforts if agencies systematically notified IRS that a settlement has been reached and provided additional information, such as their intent regarding the breakdown of the settlement payment by category (i.e., punitive versus compensatory). According to an IRS Director in the Large and Mid-Size Business Division, such information could play a role in determining which firms to audit and, when an audit occurs, whether a settlement should be covered. Further, the IRS Director said that in some cases IRS

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<sup>22</sup>IRS recently issued a technical advice memorandum, TAM 200502041 (Jan. 14, 2005), that concluded that the tracking form was not relevant "since the proper allocation [between punitive and compensatory aspects of a FCA recovery] depends on intent at the time the settlement was reached, not on events occurring after that time." A TAM is a written response to a technical or procedural question on the interpretation and proper application of tax authority to a specific set of facts. A taxpayer may not rely on a TAM issued to another taxpayer.

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would like to offer pre-filing agreements to settling companies,<sup>23</sup> which would resolve the tax treatment of settlement payments before tax returns are filed. The Director focused on large settlements for which IRS enforcement action was more likely than on smaller settlements.

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### DOJ and EPA Are Providing IRS Settlement Information as Part of IRS's Temporary Compliance Research Projects

IRS is collecting information on certain settlements through two compliance projects. IRS uses compliance projects to collect information and conduct research in order to target audits in particular issue areas. It intends to use the project results on the degree to which companies incorrectly deduct civil settlement payments to make data-driven business decisions on how to correct the noncompliance.

In 2003, IRS initiated a fraud settlements compliance project focusing on the deductibility of payments made in the settlements involving fraud, primarily FCA settlements. The fraud settlements compliance project targets multimillion-dollar settlements where at least part of the settlement payment may be punitive although the agreements may not specify punitive damages. During February 2005 discussions between IRS and DOJ, DOJ officials agreed to notify IRS promptly of FCA settlements they reach of \$10 million and more and provide a list of smaller dollar FCA settlement agreements annually for the duration of the project. DOJ officials told us they would be willing to continue providing IRS with this information after the completion of this compliance project. IRS officials said that this information would be useful to them in targeting and conducting audits. According to the compliance project description, IRS staff have found that for settlements involving Medicare fraud, companies are claiming deductions for the full amount of the settlement. However, IRS staff told us that these settlement payments generally contain a punitive portion. This compliance project is scheduled to be completed in 2006.

In 2004, IRS initiated an environmental settlements compliance project, which focuses on four components of environmental settlements that may result in an income tax issue—civil penalties; SEP costs; complying actions; and other payments and requirements, which may include

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<sup>23</sup>IRS's Pre-filing Agreement Program encourages taxpayers to request consideration of an issue before the tax return is filed and thus resolve potential disputes and controversy earlier in the examination process. IRS intends such agreements to reduce the cost and burden associated with post-filing examinations, to provide companies a level of certainty regarding a transaction, and to make better use of taxpayer and IRS resources.

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punitive sanctions. For the project, IRS says it needs access to negotiating files, court documents, settlement documents, databases, personnel, and attorneys at the relevant settling agencies. EPA has agreed to provide IRS with certain case-specific information. To obtain an initial sample of approximately 30 recently negotiated significant environmental settlements, IRS staff searched agency press releases and Web sites and contacted EPA and DOJ staff for settlement information on a case-by-case basis. The initial review of this sample suggests that companies may be noncompliant when deducting, capitalizing, amortizing, or depreciating SEP costs. The compliance initiative description also said that some IRS staff have questioned the appropriateness of deducting SEP costs if SEP costs are payments in lieu of a penalty because it appears that such costs are not deductible under IRC § 162(f).<sup>24</sup> IRS officials said that IRS's National Office plans to issue a technical advice memorandum (TAM) that will address SEP deductibility and capitalization issues. The compliance project staff told us that this compliance project is scheduled to be completed in late 2005, although it may be extended.

According to IRS's fraud settlements compliance project description, the compliance projects also provide IRS with the necessary information to evaluate the potential for negotiating pre-filing agreements with settling companies. Under pre-filing agreements, IRS and companies resolve whether all or a portion of a settlement payment can be deducted before the companies file their tax returns. The project description says that for those cases for which a pre-filing agreement is not executed, IRS examiners can more timely develop the facts and reach a position on deductibility, which can reduce examination time on this issue while enhancing IRS compliance results. IRS officials told us they are in discussions with one company that reached a civil settlement regarding a pre-filing agreement and are offering pre-filing agreements to other settling companies.

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<sup>24</sup>According to EPA, SEPs are projects, not already required by law, undertaken voluntarily by a respondent/defendant in an enforcement action. A respondent/defendant's agreement to perform a SEP may be taken into account as a mitigating factor in assessing the ultimate civil penalty in a particular case. To calculate the value of an SEP, EPA's economic model considers, among other things, the entity's tax status, the penalty payment date, the estimated project costs, the project's operation date, the combined state and federal tax rate, and the tax deductibility of onetime nondepreciable expenditures.

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## Schedule M-3 Provides IRS with Some Settlement Information from Companies

IRS has a new source of information that could help it identify companies with settlements. In 2004, IRS introduced Schedule M-3, which is designed to reconcile differences in financial accounting and taxable income (or loss). The schedule is being used by corporations with assets of \$10 million or more and is to be phased in for use by other corporations in 2005 and 2006. Because Schedule M-3 collects information on fines, penalties, and punitive damages, it may help IRS identify settlements that should be considered if a company is audited. Schedule M-3 as currently designed may not capture settlement payments that were not labeled as fines, penalties, or punitive damages in the written settlement agreement. Based on our discussions, IRS officials responsible for Schedule M-3 said that they were considering options to address this situation.

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## Conclusions

When settlement agreements specify civil penalties, the law is generally clear that they are nondeductible. However, when the settlements do not contain penalties, deductibility may be less clear because the IRC and the statutes imposing the payments may be silent regarding whether the payments are punitive or compensatory in nature. Moreover, many settlement agreements do not contain language addressing the tax deductibility of settlement payments. To determine the deductibility of settlement payments during audits or in reaching pre-filing agreements, IRS examines settlement information that would provide the relevant facts and circumstances in a particular case.

Given this situation, one way to help IRS better ensure that companies are properly treating settlement payments for tax purposes is to have agencies systematically notify IRS when they have reached a settlement that requires significant dollar payments and provide information that IRS may find useful. With such information, IRS can better determine which companies to examine and whether settlement payments should be part of the examination. In addition, with a regular flow of information on settlements as they are reached, IRS would be able to contact companies when appropriate to obtain pre-filing agreements on how the settlement payments should be treated on their tax returns. This may be especially useful in cases such as the DOJ FCA settlement agreements, which may not contain useful information for the settling company and IRS to determine the tax treatment of the settlement amounts.

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## Recommendation for Executive Action

We recommend that the Commissioner of Internal Revenue direct the appropriate officials to work with federal agencies that reach large civil settlements to develop a cost effective permanent mechanism to notify IRS when such settlements have been completed and to provide IRS with other settlement information that it deems useful in ensuring the proper tax treatment of settlement payments.

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## Agency Comments and Our Evaluation

We sent a draft of this report to IRS, EPA, SEC, HHS, and DOJ for comment. We received written comments from IRS, EPA, SEC, and HHS. DOJ provided written technical comments.

In his August 26, 2005, letter, the Commissioner of Internal Revenue (see app. III) said that he agreed with our recommendation and said that it would be beneficial for IRS to work with federal agencies to develop a systematic method for obtaining information on civil settlements contemporaneous with those settlements. He said that IRS will form an executive led team to work with each agency with significant civil settlements to reach agreement on what information will be provided, the format of the information, and the frequency of delivery. IRS also provided technical comments which we incorporated in our report.

EPA's Assistant Administrator, Office of Enforcement and Compliance Assurance stated in an August 26, 2005, letter (see app. IV) that EPA generally supports our recommendation and believes that EPA already has mechanisms to provide IRS with settlement information useful in determining the proper tax treatment of settlement amounts. The Assistant Administrator said that EPA's publicly available Web site contains 3 years of information on concluded enforcement settlements and other EPA online enforcement databases with settlement information could be made available to IRS. EPA believes that these mechanisms are more cost effective than developing a specific notification process for IRS. While we agree that EPA has mechanisms in place to provide IRS a means to access its settlement information, we believe that it would be useful if EPA notified IRS directly of its significant settlements contemporaneously so IRS could ensure that it is aware of all significant settlements and be better positioned to contact companies sooner to initiate pre-filing agreements with them. Regarding our reference to IRS officials needing access to information such as negotiating files and documents to help determine the proper tax treatment of settlement payments, the Assistant Administrator expressed concern that making such information available to IRS could result in a waiver of any protective privilege associated with such information and might jeopardize pending settlements and ongoing

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enforcement actions. This issue was not within the scope of our study and in our view is among the type of issues that can be addressed as IRS and agency officials work together to establish information sharing arrangements regarding significant settlement agreements.

The Assistant Administrator also commented on how we characterized the value of EPA settlements and, in particular, stated that our comparison of EPA settlement values to those of the other agencies we surveyed is dissimilar. The Assistant Administrator said that we should only include monetary payments for EPA civil penalties in valuing EPA settlements to make them comparable to the value of settlements in the other agencies. In our view, and as consistently reflected in our report, the value of an agency's settlements includes all components that are reflected in settlement agreements. This was also consistent with how the agencies we surveyed valued their settlements. We believe it would be misleading to show the value of settlements based on civil penalties alone when the negotiated settlement agreement clearly included other components. Further, some settlements we reviewed, such as DOJ FCA settlements, did not contain penalties. EPA also made some technical comments which we have incorporated into the report to clarify and more fully present certain information.

In a letter dated September 1, 2005, an SEC Enforcement Division director did not specifically comment on our recommendation but said that the Commission takes seriously the importance of meaningful sanctions in its enforcement program (see app. V). HHS provided a letter stating they had no comment on the draft but sent technical comments which we incorporated into our report (see app. VI). DOJ provided some technical comments which we included in our report to more accurately reflect information about their settlements.

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As agreed with your offices, unless you publicly release its contents earlier we plan no further distribution of this report until 30 days from its date. At that time, we will send copies to interested congressional committees, the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. We will also make copies available to others on request. In addition, the report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact me at (202) 512-9110 or [brostekm@gao.gov](mailto:brostekm@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page

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of this report. GAO staff who made major contributions to this report are listed in appendix VII.

A handwritten signature in black ink that reads "Michael Brostek". The signature is written in a cursive style with a large initial "M".

Michael Brostek  
Director, Tax Issues  
Strategic Issues

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# Appendix I: Scope and Methodology

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The objectives of this report were to (1) identify federal agencies that negotiated some of the largest dollar civil settlements in recent years, (2) determine whether the selected federal agencies having some of the largest civil settlements take the tax consequences of the companies into account when negotiating civil settlements and officials' views on whether they should address the deductibility of payments in the agreements, (3) determine whether the companies that paid some of the largest civil settlement payments deducted any of the payments on their federal income tax returns, and (4) determine what information the Internal Revenue Service (IRS) collects on companies with civil settlements reached by federal agencies. In addition, we sought to identify whether companies' deductions for settlement payments were being examined in audits and the outcome of the audits.

To identify federal agencies that negotiated civil settlements involving companies with some of the largest civil settlement payments, we analyzed information on settlements reached by various federal agencies because we were unable to identify any single, reliably searchable, comprehensive source or database that was known to contain such information governmentwide. We limited our scope to settlements that were negotiated in fiscal years 2001 and 2002 involving companies that file IRS Form 1120, U.S. Federal Corporate Tax Return.<sup>1</sup> We selected this time frame since it would allow the settling companies time to pay the settlements; determine applicable tax treatments, if any; and file federal income tax returns.

As a starting point to identify agencies with large settlements in those years, we used information in the 1998 Federal Financial Management Status Report and Five-Year Plan that summarized assessments and collections of civil monetary penalties by federal agencies for fiscal year 1997.<sup>2</sup> The information in the report was based on data compiled from 76 federal agencies and showed which of those agencies were responsible for the majority of the civil monetary penalty assessments and collections in fiscal year 1997. Consolidated information on federal agency assessments of civil penalties was not available for subsequent years because the

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<sup>1</sup>We excluded flow-through entities, such as partnerships that do not file IRS Form 1120. We also excluded individuals, governments, and not-for-profit entities.

<sup>2</sup>This document was jointly written by the Chief Financial Officers Council and the Office of Management and Budget.

Federal Reports Elimination Act of 1998<sup>3</sup> eliminated the annual requirements for federal agencies to report this information.

Generally, we then sought to determine if the same agencies that were responsible for the majority of the civil monetary assessments and collections in fiscal year 1997 were likely to have some of the largest settlement amounts in fiscal years 2001 and 2002. We did this by reviewing such material as agency press releases on settlement agreements, annual reports, enforcement reports, and other data on agency Web sites. In addition, we also performed more general searches of commercially available databases that contain archived content from newspapers, magazines, legal documents, and other printed sources and other federal Web sites that provided information about corporate civil settlements to help us gauge whether the settlements we were identifying at these agencies were among the largest being reported from various publication sources.

As part of our analysis of this information, we comparatively assessed, to the extent possible, whether agencies tended to have relatively fewer individual settlements with typically large-dollar assessments (millions of dollars per individual settlement) or more numerous individual settlements of relatively low-dollar amounts. We chose those agencies that appeared to have a larger settlement amount per case.

We did not include IRS in the agencies we analyzed since tax settlements are not tax deductible. We also excluded the Federal Reserve System from consideration because its reported total settlement amounts could incorporate settlements by multiple agencies.

By comparing and analyzing such information across the leading agencies for overall civil assessments in 1997, we selected the Environmental Protection Agency (EPA), the Securities and Exchange Commission (SEC), and the Department of Justice (DOJ) for further review after concluding that they were among those agencies responsible for negotiating the largest individual civil settlements in fiscal years 2001 and 2002 that we could identify. Also, during these 2 fiscal years, we determined that the Department of Health and Human Services (HHS) was involved in negotiating some of the largest dollar False Claims Act health-

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<sup>3</sup>Pub. L. No. 105-362, § 1301(a), 112 Stat. 3280 (1998).

care-related civil settlements that DOJ has primary responsibility for negotiating.

We contacted each of the four agencies and requested information on its largest civil settlements, that is, cases in which the largest dollar amounts were to be paid to the federal government or others. In discussing our request for lists of settlements, agency officials advised that lists of cases based on largest settlements would likely include cases of entities not required to file IRS Form 1120. (See table 1 in the body of this report for information received from the four agencies on their 20 largest civil settlements for fiscal years 2001 and 2002, which includes settlements with some entities not required to file IRS Form 1120.)

We took several steps to assess the reliability of the agencies' automated systems that provided the lists of settlement agreements. We interviewed agency officials who were knowledgeable about compiling, entering, and checking the data in the databases used to provide the lists; reviewed related documentation about the quality and accuracy of the data and the systems that produced them; and to the extent possible, cross-checked the lists with other sources. For example, we compared selected information, such as settlement amount from copies of the actual settlement agreements with the amount shown on the list obtained from the agencies. We also asked the companies to confirm this information. Likewise, the companies confirmed whether they had paid the settlement. We determined that the lists of largest settlements and associated settlement amount information were sufficiently reliable for the purposes of this report.

To determine whether the federal agencies take the tax consequences of the companies into account when negotiating civil settlements and their views on whether they should address the deductibility of payments in settlement agreements, we interviewed officials in each of the four agencies about their settlement policies and negotiation processes. We obtained and reviewed the underlying agreements and documentation on the agencies' policies, procedures, and processes for negotiating and structuring civil settlements with monetary payments.

We also interviewed officials in the four agencies to determine if their settlement policies and procedures were different now than they were during fiscal years 2001 and 2002. We obtained documentation supporting any major policy or procedural changes that addressed how settlement payments are treated for tax purposes.

To determine whether the companies that paid some of the largest civil settlement payments deducted any of their payments on their federal income tax returns, we developed a data collection instrument (DCI) to collect the information. We collected information from the four agencies on their largest dollar civil settlements, that is, cases that included payments to the federal government or others. Agency officials advised us that the lists of the largest settlements would likely include some settlements with entities that were not required to file IRS Form 1120. When such a settlement was among the 20 largest, we selected additional settlements that otherwise met our criteria.<sup>4</sup> In contrast to SEC, HHS, and DOJ, from which we obtained information on the largest civil settlements payable to the federal government and other parties such as relators, EPA settlement amounts included costs incurred for companies to comply with environmental laws and regulations. We selected the largest EPA settlements that had a civil penalty because our focus was on how payments were treated for tax purposes. We requested copies of settlement agreements for the cases appearing on the lists from the agencies.<sup>5</sup>

We sent the DCI we developed to 44 companies for which we were able to obtain copies of the settlement agreements and find cognizant representatives who were familiar with the settlements and the tax treatment of the settlement payments and who agreed to participate in our survey. These 44 companies were required to file IRS Form 1120. In the end, we received DCI responses from 31 companies concerning 34 of the settlements. We told companies that we would only report information we collected in summary form so company names are not specifically identified.

We examined the settlement agreements for the 34 settlements reached by companies that responded to our DCI to determine if they contained specific language that addressed how civil settlement payments are to be

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<sup>4</sup>We selected to survey companies on 5 settlements outside of the 20 largest for 4 DOJ-led HHS False Claims Act settlements and 1 DOJ-led EPA settlement—for reasons including the following: we were not always able to identify a cognizant representative or obtain a settlement agreement for each of the 20 largest for each fiscal year.

<sup>5</sup>In some instances, we did not need to request copies of the EPA settlement agreements because EPA posted the agreements on its Web site.

treated for federal income tax purposes.<sup>6</sup> In those instances where we found specific language that addressed how civil settlement payments are to be treated for federal income tax purposes, we followed up with agency officials to corroborate how this treatment related to the specific agencies' policies and procedures.

The settlement agreements we examined are not a representative sample of settlements for these agencies in these fiscal years, and the results of our examination cannot be generalized to other settlement agreements. Likewise, the information we obtained through our DCI represents the responses of each company that voluntarily completed the instrument with regard to a specific settlement. Their responses cannot be generalized to any other population of settlements. Other than verifying the settlement amount and that the amount was paid by the companies when possible, we did not verify the other company responses to our survey questions.

To determine what information IRS collects on companies with civil settlements reached by federal agencies, we interviewed knowledgeable officials from IRS and the four agencies and reviewed supporting documentation about what information, if any, IRS obtains from the four selected agencies regarding their civil settlement agreements.

To determine the results of IRS's audits of companies concerning the tax treatment of settlement payments, we obtained information from knowledgeable IRS auditing staff.<sup>7</sup> An IRS technical advisor (TA) manager provided us readily available information on IRS's industry groups in its Large and Mid-Size Business Division on the results of corporate audits where the deductibility of civil settlement payments was an issue.<sup>8</sup>

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<sup>6</sup>We did not examine SEC settlement agreements to determine if they contained specific language addressing federal tax treatment of payments because SEC officials told us that the agency did not include language addressing tax consequences in settlement agreements prior to 2003.

<sup>7</sup>Because IRS databases do not have indicators to track audit cases with settlements, a systematically identified set of cases involving settlements was not available for us to examine.

<sup>8</sup>According to an IRS TA Manager, IRS examiners are likely to consult TAs and TA managers in examining such issues as deduction of settlement amounts. TAs are nationwide experts who ensure consistent treatment of all taxpayers' issues within their specific industries or issue areas.

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We conducted our work at EPA, SEC, HHS, DOJ, and IRS regional and headquarters offices, from February 2004 through June 2005 in accordance with generally accepted government auditing standards.

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# Appendix II: Selected IRS Audit Results Information on Companies with Civil Settlement Payments

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According to selected information IRS provided on 46 companies that claimed settlement payment deductions on their income tax returns, IRS adjusted or proposed adjustments for approximately half of these companies. The 46 companies settled with varying agencies, including EPA, HHS, and DOJ. In the 24 cases for which IRS adjusted or proposed adjustments to the amount deducted as settlement payments on the tax return, the adjustments ranged from “not substantial” to 100 percent, according to the IRS examiners’ notes for the cases.

According to IRS staff, only a portion of the amount listed as a settlement payment would be nondeductible. Because these portions would be deemed to be penalties, the balance would be a deductible compensatory expense. IRS collected this information under compliance research projects and from additional information from staff familiar with audits of companies in which the deductibility of settlement payments was an issue.

This information, which covers multiple years, is limited to these particular companies. As IRS staff selected the 46 companies for audit or research because of potential noncompliance, these audit results cannot be projected to other companies with civil settlements.

# Appendix III: Comments from the Internal Revenue Service



COMMISSIONER

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

August 26, 2005

Mr. Michael Brostek  
Director, Tax Issues  
United States Government Accountability Office  
Washington, D.C. 20548

Dear Mr. Brostek:

Thank you for giving us the opportunity to review and provide comments on your draft report titled, "Tax Administration: Systemic Information Sharing Would Help IRS Determine the Deductibility of Civil Settlement Payments" (GAO-05-747). Your audit report is comprehensive and provides a balanced picture of settlement negotiations and agreements at Federal regulatory agencies, and the IRS' efforts with respect to civil settlements. We are pleased that the four Federal agencies you interviewed during the course of the audit are willing to work with the IRS on a permanent basis to routinely inform us about civil settlements and provide related documents that would help us determine the deductibility of large settlements, improve our audit strategies, and facilitate pre-filing agreements with companies settling civil cases.

As mentioned in your report, section 162 of the Internal Revenue Code (IRC) provides a deduction for all ordinary and necessary business expenses, including settlements and similar payments. However, this provision is subject to an exception in IRC § 162(f) that denies a deduction for any fine or penalty paid to a government for the violation of any law. It is often necessary to look at the pertinent statute that underlies the settlement payment and the facts and circumstances of the settlement to determine deductibility. Moreover, the IRS' most difficult obstacle in this area is, and will continue to be, the ability to determine the amount of the penalty on a case-by-case basis. Therefore, we will continue to explore options for making penalty determinations more readily ascertainable.

We agree with your recommendation that it would be beneficial for the IRS to work with Federal agencies to develop a systematic method for obtaining information on civil settlements contemporaneous with those settlements. The IRS will follow your recommendation to create better interagency information sharing. As mentioned in your report, the IRS has been working with some government agencies on a case-by-case basis to request information on civil settlements in connection with taxpayer examinations and for temporary compliance research projects. We will continue to do so until a permanent program is put in place to receive civil settlement information. The following is our planned corrective action in response to your audit recommendation.

2

Corrective Action

The IRS will form an executive-led team to work with each agency with significant civil settlements to reach agreement as to 1) what information will be provided, 2) the format of the information, and 3) the frequency of delivery.

Implementation Date

June 30, 2006

Responsible Official

Director, Pre-filing and Technical Guidance (Large and Mid-Size Business Division)

If you have any questions, please call me or Kathy Petronchak, Director, Pre-filing and Technical Guidance at (202) 283-8280.

Sincerely,



Mark W. Everson



# Appendix IV: Comments from the Environmental Protection Agency

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



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

AUG 26 2005

OFFICE OF  
ENFORCEMENT AND  
COMPLIANCE ASSURANCE

**Via Federal Express and  
Facsimile**

Mr. Charlie Daniel  
Assistant Director, Tax Issues  
Strategic Issues Team  
Rm 2C38  
U.S. Government Accountability Office  
441 G Street, N.W.  
Washington, DC 20548

Re: EPA Comments on the U.S. Government Accountability Office's  
Draft Report, "Tax Administration: Systematic Information Sharing  
Would Help IRS Determine the Deductibility of Civil Settlement  
Payments," GAO-05-747

Dear Mr. Daniel:

Thank you for the opportunity to comment on the Government Accountability Office's (GAO's) above-titled draft report. Because your report discusses enforcement settlement agreements reached by the Environmental Protection Agency (EPA or Agency), the Administrator referred the draft to the Office of Enforcement and Compliance Assurance (OECA) for review and comment. We appreciate GAO's efforts throughout the development of this draft report to seek EPA input on our civil enforcement settlements.<sup>1</sup>

EPA generally supports GAO's recommendation that EPA work with the Internal Revenue Service (IRS) to develop a cost-effective means of sharing information on civil enforcement settlements. Indeed, as explained in further detail below, EPA believes that it already has systems in place to provide the IRS with the information it needs to evaluate the tax consequences of EPA settlements. In addition, we have several other comments we would like to

<sup>1</sup>As previously noted in our May 2005 informal comments, EPA's comments will only apply to administrative enforcement settlements; any comments regarding judicial settlements would be provided by the U.S. Department of Justice (DOJ).

be considered as GAO prepares its final report.

**I. Recommendation to Share Settlement Information with the IRS**

GAO recommends that the IRS Commissioner “direct the appropriate officials to work with federal agencies...to develop a cost-effective permanent mechanism to notify IRS when such settlements have been completed and to provide IRS with other settlement information that it deems useful in ensuring the proper tax treatment of settlement payments.” (See Draft Report at page 38). On page 35, the draft provides that the “IRS says that it needs access to negotiating files, court documents, settlement documents, personnel, and attorneys at the relevant settling agencies.”<sup>2</sup>

As we have discussed with both GAO and the IRS, EPA believes that the Agency already has systems in place to provide the IRS with the enforcement settlement information it needs to evaluate the tax implications of environmental enforcement settlements. While GAO’s draft report recommends that EPA develop a system to notify the IRS when settlements are completed, EPA believes that its current enforcement data systems are far more cost-effective than developing a specific notification process for the IRS. Because the IRS can access this data at any time, coupled with the fact that this data is updated regularly, it is EPA’s view that it would be an unnecessary expenditure of resources to create a separate system for notifying the IRS whenever EPA settles an enforcement case.

Specifically, EPA’s publicly available website, the Enforcement and Compliance History Online (ECHO) found at [www.epa.gov/echo](http://www.epa.gov/echo), contains three years of information on concluded enforcement settlements, including penalties, the estimated costs of injunctive relief and the value of supplemental environmental projects (SEPs). In addition, EPA has informed the IRS that it may access EPA’s Online Tracking Information System (OTIS), that provides multiple data on EPA cases and regulated facilities. OTIS is only available to EPA’s state and tribal partners, as well as to other federal agencies that have received approval from EPA for access.<sup>3</sup> The information contained in OTIS goes back more than three years. It provides, via an easy to use website, details on settlements, including information on the amount of penalties assessed and the estimated costs to be incurred as a result of the respondent/defendant performing complying actions (i.e., injunctive relief), and SEPs, where applicable. At least one IRS staff person has been granted access to OTIS, and EPA would welcome the opportunity to provide access and training on OTIS to more IRS staff.

<sup>2</sup>In addition, IRS officials have indicated that receiving information from agencies that shows the intent regarding the breakdown of the settlement payment into what is considered “punitive” and “compensatory” would be helpful to IRS in making tax determinations. (See Draft Report at page 33.)

<sup>3</sup>For example, the Securities and Exchange Commission (SEC) recently received training on OTIS and now has access to the system.

3

With regard to GAO's reference to IRS's stated need for access to documents such as negotiating files and settlement documents, EPA is concerned that releasing such privileged information to the IRS could result in a waiver of any protective privilege associated with such documents, including those designated as enforcement confidential and/or attorney-client privileged. As noted in GAO's draft report, in 2004, the IRS sought specific settlement information on approximately thirty environmental enforcement settlements as part of the IRS's temporary compliance project. EPA discussed the request with IRS counsel, who advised EPA that the IRS would consider any privilege associated with such documents to be waived, even if documents were designated as enforcement confidential and/or attorney-client privileged. As such, EPA is concerned that releasing privileged information would jeopardize pending enforcement settlements and/or ongoing enforcement actions with other respondents.

EPA believes that providing the IRS with access to EPA's data systems will balance EPA's need to protect enforcement sensitive and privileged settlement information from public disclosure with the IRS's need to receive information on settlements to ensure that settlement payments are treated appropriately for tax purposes.

**II. EPA Settlement Components and Characterization as "Settlement Payments" or "Payment Amounts"**

Throughout the draft report, GAO refers to EPA civil settlements as including "payment amounts" or "settlement payments." Although it is not clear from the draft report, it appears that the terms "payment amounts" and "settlement payments" include costs to be incurred by a respondent as a result of an enforcement settlement, in addition to civil penalties assessed pursuant to a civil settlement. To clarify any ambiguity, we recommend that the text of the report distinguish between monetary payments made directly to a governmental entity (e.g., civil penalties) and costs to be incurred by a defendant/respondent as a consequence of performing the actions required under the civil settlement agreement. Because GAO's draft report defines "civil settlements" as "formal legal agreements between an agency and an alleged violator to resolve a lawsuit or potential lawsuit (see Draft Report at page 1, footnote 1 and page 8), monetary payments made to governmental entities pursuant to EPA enforcement settlements are limited to civil penalties, generally payable to the U.S. Treasury.<sup>4</sup> In addition, many EPA settlements include injunctive relief provisions – actions required to be taken by the respondent to come into compliance, or to clean up environmental contamination. Finally, some EPA settlements include SEPs. A SEP is not performed "in lieu of a penalty," as stated at page 35 of the draft report. Rather, a SEP is a project voluntarily undertaken by a respondent as part of a settlement with EPA. In exchange for undertaking a SEP, EPA may mitigate the ultimate civil penalty assessed.

<sup>4</sup>Pursuant to section 107 of the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), 42 U.S.C. § 9607, EPA may recover all costs of removal or remedial action incurred by the U.S. government not inconsistent with the National Contingency Plan. Settlements resolving liability pursuant to CERCLA § 107 are not civil settlements to resolve alleged noncompliance and are hence outside the scope of GAO's draft report.

See comment 1.

**III. Statements Regarding EPA's Consideration of Taxes in Assessing a Respondent's Economic Benefit of Non-Compliance**

The draft report includes several statements that are misleading with respect to EPA's consideration of taxes when assessing a respondent's economic benefit of noncompliance. Specifically, the document states that the Agency "considers the aspects of the tax situation of the settling company when calculating amounts they propose to seek in negotiating environmental settlements. For example, they consider the economic benefit a settling company gained from noncompliance and, in doing so, they estimate a company's financial gain from not complying with the law including the effects on the company's tax liabilities."

It appears that GAO has misunderstood EPA's activities with respect to the development of the economic benefit and tax consequences. On pages 3 and 12, the draft states that EPA takes into account the violator's tax liability. The tax liability is the money owed to the U.S. Treasury on a year-to-year basis. We almost never consider a violator's tax liabilities. In calculating the economic benefit of noncompliance, we do assume that the violator is deducting/depreciating the cost of compliance. We also assume the maximum marginal tax rate for settlement purposes. If the violator insists on a corporate specific rate, we look at their taxes and apply that rate, although this is rather unusual.

**IV. H.R. 3, 109<sup>th</sup> Cong. § 5509 (2005)**

GAO references a proposed provision in H.R. 3, 109<sup>th</sup> Cong. § 5509 (2005), that would modify Internal Revenue Code § 162(f), to disallow certain deductions from taxes. (See Draft Report at page 9, footnote 3.) Specifically the bill provides that amounts paid or incurred (whether by suit, agreement or otherwise) to or at the direction of a government in relation to a violation of law, or the investigation or inquiry into the potential violation of any law are nondeductible.

Based on recent conversations with GAO staff, and our review of the Conference Report on H.R. 3, it is our understanding that this provision was not included in the bill recently signed by the President.<sup>5</sup> Accordingly, we request that this footnote be deleted or clarified to reflect that this was not included in the enacted legislation.

**V. Valuation of EPA Settlements in the Charts**

On the summary page and in Table 1 at page 11, the draft report purports to summarize the approximate ranges and cumulative values of the twenty largest civil settlement agreements for each of the four agencies reviewed, including EPA, for fiscal years 2001 and 2002. While the other agencies' settlements appear to include only payments made to the U.S. government or other recipients (e.g., whistle blowers), the value of EPA settlements reflected in the chart

<sup>5</sup>See House Report No. 109-203 at 1166-1168 and 1179.

See comment 2.

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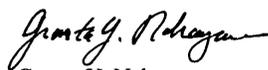
includes civil penalties plus the estimated costs incurred by a respondent under the terms of the settlement agreement (e.g., the estimated cost of installing pollution control equipment). That is, the value of EPA civil settlements summarized in the charts include the estimated dollar value of the injunctive relief as well as the dollar value of any SEPs that the respondent may have agreed to undertake as part of the settlement.

EPA is concerned that because the chart is not comparing like "payments," the cumulative value of EPA's settlements is misleading. As currently arrayed, the chart compares monetary payments under settlements with the SEC, the Department of Health and Human Services, and the Department of Justice with monetary payments (i.e., civil penalties) plus estimated costs to be incurred by respondent in performing injunctive relief and SEPs, where applicable, pursuant to EPA settlements. To make these amounts comparable, we strongly urge GAO to revise the chart in Table 1 to include only monetary payments made pursuant to EPA settlements (i.e., civil penalties). We would be happy to provide GAO with information on the twenty largest civil settlement agreements that require the payment of civil penalties and were concluded in FY01 and FY02.

**VI. Conclusion**

Thank you once again for the opportunity to review and provide input on GAO's draft report. In addition to the foregoing comments, we are enclosing for GAO's consideration technical comments on the draft report. In the event that you have questions or concerns regarding any of our comments, please do not hesitate to contact Susan O'Keefe of my staff at (202) 564-4021. Susan is the Associate Director of the Special Litigation and Projects Division, within OECA's Office of Civil Enforcement.

Sincerely,



Granta Y. Nakayama  
Assistant Administrator

Attachment

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## GAO Comments

1. We reviewed the text in our draft report and believe that it adequately distinguishes between monetary payments made directly to a governmental entity and costs to be incurred by a defendant as a consequence of performing actions required under a civil settlement agreement. To illustrate, a note to table 1 in our draft report stated that “For settlements identified by EPA, the total value of settlements included payments payable to the U.S. government; the estimated cost of any Supplemental Environmental Projects; and the estimated costs of pollution controls, monitoring equipment, or other complying actions that companies are required to take to come into compliance with environmental laws.”
2. As the Assistant Administrator suggested, we have revised our report to show that a proposed legislative provision mentioned in a footnote to disallow tax deductions for amounts paid to or at the direction of a government in relation to a violation was not included in the bill signed into law. However, our report shows that a new provision has since been introduced.

# Appendix V: Comments from the Securities and Exchange Commission



DIVISION OF  
ENFORCEMENT

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

September 1, 2005

Michael Brostek  
Director, Tax Issues  
Strategic Issues Team  
U.S. Government Accountability Office  
Washington, DC 20548

Re: Proposed Report, GAO-05-747 (450296)

Dear Mr. Brostek:

Thank you for the opportunity to review and comment upon the draft report primarily concerning tax administration and the deductibility of civil settlement payments. The report discusses how the Internal Revenue Service identifies and evaluates returns from taxpayers who have paid money pursuant to civil settlements with governmental agencies. The report includes an analysis of certain settlements reached by four federal agencies, including the Securities and Exchange Commission, and further discusses whether and to what extent each of these agencies takes into account tax considerations in negotiating settlements.

We note that the concluding recommendation in the draft report is not specifically directed towards the Commission. Nevertheless, please be assured that the Commission takes seriously the importance of meaningful sanctions in our enforcement program, and we are constantly evaluating the best means to effectuate the Commission's goal of investor protection.

We appreciate the courtesy that the GAO has extended to the Commission in connection with the preparation and finalization of this report and its recommendation. If we can be of further assistance, please feel free to contact me at (202) 551-4894 or Joan McKown at (202) 551-4933.

Yours Truly,

A handwritten signature in black ink, appearing to read "Linda Chatman Thomsen".

Linda Chatman Thomsen  
Director

cc: Charlie W. Daniel  
DanielC@gao.gov

# Appendix VI: Comments from the Department of Health and Human Services



DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Washington, D.C. 20201

AUG 22 2005

Mr. Michael Brostek  
Director, Tax Issues  
Strategic Issues Team  
U.S. Government Accountability Office  
Washington, DC 20548

Dear Mr. Brostek:

The Department has reviewed your draft report entitled, "TAX ADMINISTRATION: Systematic Information Sharing Would Help IRS Determine the Deductibility of Civil Settlement Payments" (GAO-05-747), and has no comments at this time.

The Department provided technical comments directly to your staff.

The Department appreciates the opportunity to comment on this draft report before its publication.

Sincerely,

*Larry J. Goldberg*  
for Daniel R. Levinson  
Inspector General

The Office of Inspector General (OIG) is transmitting the Department's response to this draft report in our capacity as the Department's designated focal point and coordinator for U.S. Government Accountability Office reports. OIG has not conducted an independent assessment of these comments and therefore expresses no opinion on them.

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# Appendix VII: GAO Contact and Staff Acknowledgments

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## GAO Contact

Michael Brostek (202) 512-9110

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## Acknowledgments

In addition to the contact named above, Thomas Beall, Danielle Bosquet, Charlie Daniel, Keira Dembowski, Jeanine Lavender, Cheryl Peterson, Michael Rose, Amy Rosewarne, and Jennifer Wong made key contributions to this report.

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Washington, D.C. 20548