The possibility of SEP legislation and lessons to learn from the fifty states

By Nicholas Targ, Steven Bonorris, and Chelsea Holloway

The time may be ripe for legislation formally authorizing the Environmental Protection Agency's (EPA's) use of Supplemental Environmental Projects (SEPs) in enforcement settlements. The convergence of congressional interest, environmental groups bringing perceived deficiencies to the attention of members of Congress, and a recent Internal Revenue Service (IRS) decision has set the stage. If SEP legislation proceeds, useful lessons may be gleaned from the use of SEPs at the state level.

Background on SEPs

SEPs are environmentally beneficial projects that a company or other environmental defendant voluntarily promises to undertake, in consideration of which, EPA may mitigate the penalty imposed. EPA has encouraged the use of SEPs for more than a decade. This past fiscal year, the agency and environmental defendants agreed to include SEPs valued at $78 million in 220 administrative and federal court settlements, according to EPA statistics. With all but two states using SEPs as an enforcement settlement tool, SEPs have become an integrated part of the enforcement process.

SEPs are popular with community members, regulators, and environmental advocates because they involve actions that go beyond what is required by law and provide an environmental and/or public health benefit. In addition to the SEP itself, the process of negotiating a SEP can help restore frayed relationships that can result from a violation. Of major importance to environmental defendants, SEPs can substantially mitigate penalties, based on the cost of the SEP. To preserve the deterrence effect of environmental laws, however, EPA's SEP Policy establishes minimum penalties.

The IRS decision and its implications for SEPs

A May 2007 IRS directive, affirming a year-old IRS Technical Advice Memorandum, may spur federal SEP legislation. IRS Industry Director Directive on Govt. Settlements Directive #1, LMSB-04-0507-042 (May 30, 2007) (IRS directive); IRS Tech. Adv. Mem. 2006-29030 (Mar. 31, 2006) (IRS decision). Both the IRS directive and decision hold that the portion of SEP costs used to mitigate the initially calculated penalty is analogous to a penalty, and hence not deductible or depreciable. Further, the IRS directive requires IRS examination of all SEPs greater than $1 million, to ensure compliance with the directive. While the IRS directive does not directly address EPA's SEP Policy, questions are raised about the nature of SEPs.

The IRS decision involved a facility with emissions in excess of those allowed under the Clean Air Act (CAA). Instead of paying a civil penalty and bringing its existing systems into compliance, the taxpayer/defendant proposed to undertake a state SEP-variant (referred to as a "Beneficial Environmental Project" or "BEP"). Specifically, it agreed to perform a major project to convert its equipment to a design that would reduce emissions well below standards required under the CAA. The resulting emissions-reduction credits would be shared equally between the state and the facility. The state agreed to the proposal and included it in an enforceable settlement agreement.

The IRS concluded that the cost of the BEP should not be deductible because "the purpose of the civil penalty, i.e., the portion of the [BEP] imposed in the settlement of those potential penalties . . . was to punish Taxpayer and to deter future violations." The IRS reasoned that

> if the Taxpayer had settled its civil penalty by making a cash payment to [the State], that payment would be a nondeductible fine or penalty . . . The result should not change because the Taxpayer settled its penalty by agreeing to incur the costs of performing a project to benefit the environment instead of incurring a direct cash payment.

The IRS directive and decision's characterization of SEPs as comparable to a penalty implicates the nature of SEPs. In the IRS' view, environmental settlement agreements are comprised of penalties (punitive or deterrent, and not deductible), injunctive relief (compensatory or remedial, and deductible) and SEPs (comparable to penalties, and not deductible). EPA's SEP Policy defines a SEP as an environmentally beneficial action voluntarily undertaken by an environmental defendant. Utilizing its enforcement discretion, EPA may reduce the penalty assessed in consideration of the defendant's legally binding commitment to perform the SEP. Under this rubric, EPA does not compel the defendant to undertake the SEP, and the SEP is not considered a "penalty."

Federal appropriations law necessitates this construction and, as implemented by EPA, requires further that SEPs have a nexus to the violation (e.g., a SEP addressing air-quality issues will likely have a nexus to a violation of the CAA). Nexus may be established by a SEP addressing the same pollutant, or the health effects, caused by the violation. In addition, nexus is more readily established if the SEP has a geographic proximity to the violation.

Were SEPs characterized as penalties, they would be an amount "due and owing to the United States," under the Miscellaneous Receipts Act and required to be deposited into the General Treasury. 31 U.S.C. § 3302(b). Moreover, if SEPs were characterized as penalties, additional concerns would be raised under the Anti-Deficiency Act (31 U.S.C. § 1341(a) (prohibiting agency expenditure in excess of Congressional appropriations).

These concerns were raised in U.S. General Accounting Office (GAO) opinions in the early 1990s, and were, in part, the impetus behind EPA's issuance of its 1998 SEP Policy, establishing the present construction of SEPs.

The IRS directive and decision make clear that the IRS will not allow the deductibility of the portion of SEP costs used to mitigate the initially calculated penalty. A legislative response may be necessary to clarify the nature and authority of SEPs.

Lessons from the fifty states

The SEP policy arena has been fast evolving at the state level. Many states are not bound by appropriation laws analogous to those at the federal level, and eleven states have legislation specifically authorizing the use of SEPs or similar practices. Consequently, if federal legislation is contemplated, lessons can be drawn from the states as to the desirability and contours of SEP practices that are shaped solely by enforcement and other policy objectives.

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A new, authoritative study, *Supplemental Environmental Projects: A Fifty State Survey with Model Practices*, prepared by the American Bar Association's Section of Individual Rights & Responsibilities and the UC Hastings College of the Law, with the cosponsorship of the ABA Section of Environment, Energy, and Resources and the ABA Section of State & Local Government Law, details federal and state SEP laws, policies, and practices. This report demonstrates how SEP policies can be designed to improve conditions in communities faced with environmental violations. It guides policy-makers through the options that are available in designing effective SEP policies. The report was also designed to provide practicing attorneys and community advocates with the state-specific information they need to make effective use of SEPs. The report is available for download at no cost on the UC Hastings Web site at www.uchastings.edu/site_files/plri/ABAHastingsSEPreport.pdf.

The study makes a number of key findings and recommendations germane to those considering revisions to SEP laws and policies. These findings and recommendations are supportive of EPA's SEP Policy but recommend increased flexibility in some aspects. They are summarized as follows:

Finding: *SEPs are a common and accepted part of the enforcement and compliance assurance process.* The report shows that most states have followed the EPA example in adopting some kind of SEP law, policy, or practice. Twenty-seven states and the District of Columbia have instituted formal, published polices through legislation, regulations, or guidelines, up more than 50 percent from ten years ago, when the only other fifty-state SEP study was conducted. The study further shows that another twenty-one states rely on informal policies or unwritten SEP practices. Only two states, North Carolina and South Carolina, have rejected the use of SEPs.

Finding: *While some state SEP Policies closely track EPA's, many states have SEP Policies that afford greater flexibility.* This flexibility can reduce the transaction cost of negotiating a SEP and allow settling parties to tailor projects that they, communities, and others want. By way of example, some state laws and policies allow donations of funds to nongovernmental organizations for the purpose of undertaking specific projects (e.g., purchase and maintenance of ecologically important lands).

Recommendations: The report identifies several key model practices drawn from the experience of states that could be considered in federal SEP legislation or its implementation:

1. Nexus: *SEP practices should include a mandatory connection between a violation and the negotiated SEP.* This element can help ensure that affected communities themselves benefit from the SEPs. However, the nexus requirement need not be as stringent as EPA's. The report also endorsed the nexus requirement to limit the possibility that the SEP will depart from the agency's core environmental mission.

2. Penalty: *SEP policies should recapture a significant portion of the economic benefit of noncompliance.* The report observes that, "SEPs may dramatically reduce the amount of cash penalty paid, therefore, regulators must ensure that the use of SEPs in settlements does not weaken the deterrent effect of environmental laws."

3. Community input: *SEP policies should include a mechanism for community input, which can lead to SEPs tailored to local needs and potentially heightened participation and oversight in project implementation*. The report notes that community input may also bring increased transparency to the enforcement process.

4. Environmental justice: *SEP policies provide a platform for furthering environmental justice and fostering a new environmental enforcement model.* The fifty-state survey found that nine states include environmental justice as a factor in their SEP policies. It further concluded that, "[i]n view of the strong correlation between environmental violations and minority and/or low-income populations, SEP policies that do not require a relation back to the community miss a valuable opportunity to redress longstanding environmental inequities." Therefore, a geographic nexus is desirable.

Roadmap for federal legislation?

Whether the time is appropriate for SEP legislation is a matter left for Congress. The opportunity for clarification of the law and response to the lessons of the fifty states is, however, available. In expressly establishing EPA's authority to approve SEPs, Congress could pave the way for a revamped SEP policy that responds flexibly to business, environmental, and social justice priorities.

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