Accounting for the Brownfields: Writing-Off Urban Environmental Remediation Expenses

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I. Introduction

A. The Source of the Debate

In the San Francisco Bay Area, a visit to Bayview/Hunters Point or West Oakland quickly reveals a common threat facing many of our nation's industrial cities: the presence of closed or underutilized contaminated industrial facilities concentrated in low-income, minority communities. These sites, termed "brownfields" by the Environmental Protection Agency ("EPA"), represent significant problems in the form of environmental degradation, and urban blight. The expensive process of cleaning brownfields represents a huge barrier for redeveloping and reusing urban land for the benefit of the communities who live next to them. It is estimated that brownfields will require up to a half billion dollars worth of remediation expenditures. Estimates for the cost of environmental remediation in general currently ranges upwards of $1 trillion dollars. At least 37,000 industrial sites and landfills must be cleaned up pursuant to regulations imposed on facilities engaged in the treatment, storage, or disposal of hazardous waste. This cleanup is expected to cost several hundred billion dollars. Superfund sites and leaking underground petroleum storage tanks require an additional $218 billion in cleanup costs. At the threshold of this era of...
increasing environmental responsibility looms the question of who will pay for the cleanup of such properties, and in what manner.

Environmental legislation increasingly makes industry liable for the cost of remediation. To mitigate the financial impact, industry favors an immediate deduction of these costs and points to a long string of legal precedent to support its position. The Internal Revenue Service, concerned with the loss of revenue that will result if such deductions are allowed, recently required the capitalization of some remediation expenses in three technical advice memoranda ("TAMs"). Following a storm of controversy and protest by taxpayers, the IRS issued Revenue Ruling 94-38 in 1994 which resurrected the case law reasoning that preceded the IRS technical advice. However, questions remain as to how far the IRS wishes to stray from its previous holdings in the TAMs. Efforts to reconcile the differing IRS positions have caused confusion over what environmental remediation expenses are deductible. This note suggests that environmental advocacy groups unhappy with a tax policy that allows environmental remediation deductions should concentrate on non-tax policy arguments to change current IRS practice. This suggestion stems from a recognition that those parties in favor of a remediation deduction rest their arguments on long-standing tax policy. In addition, current legislative proposals reflect a growing acceptance of the accounting principles which support an environmental remediation deduction. However, the U.S. Supreme Court's opinion in INDOPCO, Inc. v. Commissioner should raise concerns for those wishing to increase the scope of what expenses may be deductible. A strict interpretation of INDOPCO could successfully limit the increasing applicability of environmental remediation deductions. In any case, the true source of this debate, a long history of inadequate business practices in regards to the environment, is a consideration that all policy-makers should consider during each step in the analysis of whether to deduct or capitalize environmental remediation costs.

B. Statutory Background

The interested taxpayer must read several sections of the IRC together in order to determine the deductibility of environmental remediation expenses as ordinary and necessary business repairs. First, Internal Revenue Code section 162 provides for the deduction of all "ordinary and necessary" business expenses paid or incurred during the taxable year in carrying on any trade or business. Second, repairs are deductible as an ordinary and necessary business expense under Section 1.162-4 of the Income Tax Regulations. To be considered a repair under the regulations, the following conditions must be satisfied: (1) the repair must be incidental; (2) the cost must not materially add to the value of the property; (3) the repair must not appreciably prolong the useful life of the property; and (4) the purpose of the expenditure must keep the property in efficient operating condition.

Third, Section 263(a)(1) of the Code provides that no deduction shall be allowed for "[a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." Fourth, Section 263(a)(2) states that no deduction shall be allowed for "[a]ny amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made." Fifth, Regulation Sections 1.263(a)-1(a) and (b) set out a three-factor test for determining whether an expenditure may be deducted as a repair or capitalized as an improvement. The test requires the capitalization of amounts expended towards: (1) increasing the value of the property; (2) substantially prolonging its useful life; or (3) adapting the property to a new and different use. Finally, Section 263A provides that certain direct and indirect costs allocable to the production activities of a trade or business are capitalized. "Production" is defined to include construc-

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9. Anderson & Dinkins, see supra note 5.
10. 26 I.R.C. section 6110(i)(3) (West 1996) provides that a technical advice memorandum may not be used or cited as precedent. A TAM addresses only the concerns of the taxpayers who requested it, on a case-by-case basis. The ruling in a TAM will be modified or revoked by adoption of temporary or final regulations. However, TAMs are commonly used to gauge the IRS's views on similar matters.
11. Private letter rulings, similar to TAMs, arise from audits made by the IRS where a taxpayer desires the opinion of the National Office. Unlike a TAM they reflect current policy and may be cited.
tion, installing, building, manufacturing, developing, or improving, under Section 263A(g)(1).²²

C. Parties Favoring Deductions

Most taxpayers, especially industry groups, would prefer the option of having their environmental cleanup expenditures deducted as ordinary expenditures under Section 162.²³ This preference reflects the concern that capitalization results in larger cleanup costs if the improvements are capitalized and amortized over the class life of the property.²⁴ Moreover, if the property is non-depreciable and the remediation costs are recovered only when it is sold,²⁵ a deduction on the other hand, allows taxpayers to time their remediation expenditures for a maximum tax benefit. For example, taxpayers may offset their taxable net income in years they incur deductible remediation costs.²⁶

Some industry groups argue that allowing such a deduction is a matter of economic survival for a large number of their members. One particularly aggressive industry group advocating remediation deductions is the petroleum marketing industry.²⁷ Their motivation stems in large part from the EPA’s 1998 compliance deadline for upgrading underground storage tanks (“USTs”) in an effort to address the widespread urban environmental problem of leaking USTs.²⁸ The cleanup of USTs, which are commonly found under gas service stations, will soon cost hundreds of thousands of dollars to each station owner.²⁹ Soil cleanup will cost an additional $100,000 per service station outlet.³⁰

D. Parties Favoring Capitalization

As environmental remediation expenditures soar, the increasing deduction of these costs has captured the attention of the federal government, as well as environmentalists. The IRS fears the huge loss in tax revenues that will result if taxpayers, primarily businesses facing large remediation expenditures, are given environmental remediation deductions.³¹ Moreover, taxpayers may manipulate their remediation efforts to correspond with large net income tax years, which would lead to even greater tax benefits, and a corresponding loss of revenue to the government. Note that the tax code bases the calculation of taxable income on the books and records of the taxpayer.³²

Environmental groups fear that a tax policy which allows current environmental deductions could undermine environmental policy.³³ They argue that an increase in favorable tax treatment for remediation efforts will discourage sound environmental practices in the present as industry learns to manipulate the tax code for future benefit.³⁴ In other words, an industry may use the adversity of environmental regulations, forgo current environmentally sound practices, and avail themselves of future write-offs.

Tax “breaks” for polluters are controversial. Its soundness as a public policy raises concerns, chief among them its potential incompatibility with the regulations promulgated by other federal agencies. The Comprehensive Environmental Response, Compensation, and Liability Act (“CERCLA”) was enacted in large part to shift the burden and cost of cleanup from the public to the responsible parties favoring capitalization.

\[\text{Superfund Amendments and Reauthorization Act amended Subchapter IX of the Solid Waste Disposal Act (Regulation of Underground Storage Tanks) which now makes the owners and operators of underground storage tanks strictly liable for the financial responsibility of corrective action against damage caused by sudden and nonsudden accidental releases of petroleum. See 42 U.S.C. 6991b(c)(6) (West 1988).}\]


\[\text{30. Id.}\]


\[\text{32. 26 I.R.C. sect. 446(a) (West 1988). See also 26 I.R.C. sect. 461(h) (West 1988) allowing a fixed and determinable liability to be deducted in the year of payment or accrual.}\]

\[\text{33. Hearings Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means, 103rd Cong. 1st Sess. (Sept. 1993)(statement of Roy E. Heck on behalf of The Coalition to Preserve the Current Deductibility of Environmental Remediation Costs) (remarking environmental groups should not oppose, but should support a tax policy favoring remediation deductions).}\]

\[\text{34. J. Andrew Hoerner, Tax Treatment of Environmental Cleanup Costs: An Environmental View, 94 Tax Notes Tax 166-44 (Aug. 22, 1994) (electronic version).}\]
ties. It is ironic that a successful push by industry to allow tax deductions would shift this burden back to the public.

E. The Deduction as a Tool for Urban Environmental Organizations

The above concerns have resulted in a line of Tax Court decisions, IRS technical advice memoranda, and revenue rulings that leave many tax analysts and environmentalists wondering about the future of environmental remediation deductions. In a recent attempt to clarify its position, the IRS, in Revenue Ruling 94-38, indicated its support for the use of tax deductions as a means of forwarding private environmental remediation efforts. For those interested in the remediation of contaminated urban property, knowing whether the party responsible for the remediation is entitled to a deduction may help structure a transaction that ultimately leaves the land cleaned up. For example, CERCLA allows the courts to employ any equitable factor that it considers appropriate when allocating cleanup costs among potentially responsible parties. A court could consider the existence of a responsible party's favorable tax deduction when balancing the equitable considerations present in a multi-party cleanup situation. The same reasoning would apply to private settlements and agreements.

II. The Legal Precedent for an Environmental Remediation Tax Deduction

A. The Plainfield-Union Increase-in-Value Test

A line of legal precedent supports the allowance of deductions for environmental cleanup expenses. A 1962 case, 

Plainfield-Union Water Co. v. Commissioner,

the Tax Court precedent most relied upon by taxpayers seeking such a deduction. 

Plainfield-Union articulated an "increase-in-value test" which later served as the underpinning for the reasoning behind Revenue Ruling 94-38. In 

Plainfield-Union, a public utility company was permitted to deduct its expenses for the cleaning and cement lining of water pipes to prevent a loss in the pipes' carrying capacity. The pipe, originally installed in 1890 to carry well-water, was painted internally with tar. Later, the company switched from carrying well-water to river-water, which was more acidic. As a result, iron-oxides built up underneath the tar coating and diminished the carrying capacity of the pipe in a reaction called tuberculation. In 1960, the company cleaned and cement-lined one-half of one percent of all the company's pipes then in service. Afterwards, the company deducted the work as an ordinary and necessary repair. At the time, the pipes had an assigned life of 100 years and had not yet fully depreciated. The IRS disallowed the deduction, first contending that the test for determining whether an expenditure was a necessary repair. 

The Tax Court disagreed and held that the cleaning and lining did not materially increase the useful life, value, capacity or structural strength of the pipes.

In doing so, the court announced that the test for determining whether an expenditure materially enhances an asset would be an increase-in-value test. This test would compare the status of the asset prior to the condition necessitating the expenditure with the status of the asset after the expenditure. Using this test, the court rejected the IRS's claim that the repair resulted in a material enhancement because, as the court noted, any properly performed repair adds value. First, the court reasoned that when the after-repair value of an asset is compared with its condition immediately preceding the time of repair, it becomes too easy to claim that the repair has added value to the asset. The court noted that the IRS position could conceivably require the capitalization of nearly all environmental remediation expenditures.


36. CERCLA supplements RCRA by establishing cleanup liability for potentially responsible parties. However, this is tempered by the observation that Superfund is supported in part by an environmental tax on industry. See 26 U.S.C. § 9907 (1988) which provides for the creation of a Hazardous Substance Superfund supported by tax appropriations.


41. 39 T.C. 333 (1962).

42. Id. at 334.

43. Id. at 338.

44. Id. at 335.

45. Id. at 336 (noting that the company had not previously cleaned or lined any of its tar painted pipe).

46. Id. at 338.

47. Id. at 337.

48. Id. at 338.

49. Id.

50. Id. at 338.

51. Id.

52. Id.
Second, the court found that the cement lining used to repair the pipes had merely restored the pipes to their original condition before the tuberculation; the taxpayer had merely engaged in the deductible activity of repairing the pipe. The court then defined a repair as follows:

A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property, nor does it appreciably prolong its life. It merely keeps the property in an operation condition over its probable useful life for the uses for which it was acquired. Expenditures for that purpose are distinguishable from those for replacements.\(^3\)

Third, the court found no material increase in the capacity of the company's operations because the pipes carried only as much water as they had before the repairs.\(^4\) Fourth, the cement lining did not render the pipes suitable for any new or additional use by the company.\(^5\) Fifth, the repairs on such a small fraction of pipe did not comprise a general plan of improvement in the court's interpretation of the tax code.\(^6\) Finally, the cement lining was only a temporary solution since the utility company expected it to wash away within a few years.\(^7\) The court noted that capital expenditures are generally considered to be more permanent in nature.\(^8\)

The Service next argued that capitalization was appropriate because blame for the tuberculation was attributable to the utility company's prior management decisions.\(^9\) The court rejected this claim, responding that the company could not have anticipated the need for cement lining when it switched to carrying river water.\(^10\) The court made clear that an unusual, unexpected or sudden event was not necessary to render a repair deductible.\(^11\) Management decisions, and external factors could also lead to deductions.\(^12\)

B. The Technical Advice Memoranda

Until recently, taxpayers could rely on the Plainfield-Union increase-in-value test when requesting deductions for repairs provided the expenditures did not (1) extend property life; (2) increase property value; or (3) render the property suitable for a different use.\(^13\) However, in the early 1990's, the IRS increased taxpayer concern and sent industry groups into a state of "near frenzy" over the deductibility issue with the issuance of three technical advice memoranda (TAMs) focusing on environmental cleanup costs.\(^14\)

1. Capitalization of Asbestos Removal

In the first TAM, the IRS concluded that asbestos removal costs incurred by a manufacturing firm should be charged to its capital account and not deducted.\(^15\) The taxpayer had deducted the costs of removing and replacing asbestos insulation in its paper manufacturing equipment in response to new Occupational Health and Safety Act regulations. The taxpayer, relying on the Plainfield-Union "increase-in-value test," argued that the replacement of the asbestos with alternate insulation merely restored the property to its pre-hazard condition and did not increase the value of the operation.\(^16\)

The IRS rejected the taxpayer's claim, concluding the removal and replacement expenditures increased the property's value and constituted a capital expenditure under 1.263(a)-(b).\(^17\) The IRS formulated a test, substantially different from the Plainfield-Union test, that focused on the value of the property after the remediation expenditure.\(^18\) The IRS took into consideration the extent of the damage, the type of repair, and the reason for the repair. The IRS also considered the presence of asbestos, the type and location of the asbestos, and the cost of the cleanup. The IRS concluded that the repair was deductible if it was considered to be a capital expenditure.

\(^3\) Id. at 337.
\(^4\) Id.
\(^5\) Id. at 338.
\(^6\) Id. at 339.
\(^7\) Id. at 337.
\(^8\) Id. at 337.
\(^9\) Id. at 340.
\(^10\) Id.
\(^11\) "Indeed, in 1954 [taxpayer] merely cleaned the relevant pipe, did not line it until 1957, and the tuberculation could have been removed by periodic cleaning".
\(^12\) Id.
\(^13\) Anderson & Dinkins, supra note 5. Cf. Gsby, supra note 14, which discusses alternate lines of case law precedent supporting the idea of a current environmental remediation deduction.
\(^14\) Id. The idea of a current environmental remediation deduction was not supported by the referenced line of cases
\(^15\) Anderson & Dinkins, supra note 5. Id. The taxpayer had deducted the costs of removing and replacing asbestos insulation in its paper manufacturing equipment in response to new Occupational Health and Safety Act regulations. The taxpayer, relying on the Plainfield-Union "increase-in-value test," argued that the replacement of the asbestos with alternate insulation merely restored the property to its pre-hazard condition and did not increase the value of the operation.
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account intangible benefits, such as a reduction in health risks, greater worker safety, and a reduced risk of civil liability, that it believed increased the property's value. The IRS also viewed the increased marketability of the property in its cleansed state as requiring capitalization. One commentator analogized the IRS's advice to requiring the capitalization of a paint job since it too increases the marketability of an asset.

Tax analysts strongly criticized the IRS for creating an apparent tax disincentive for taxpayers who wish to completely remove asbestos and other hazardous material from their property.

The IRS's motivation to question its longstanding policy of allowing remediation deductions may have been prompted by the U.S. Supreme Court's ruling in INDOPCO v. Commissioner of Internal Revenue which was delivered in the same year as the asbestos-TAM. In INDOPCO, the Court held that certain investment banking fees and expenses surrounding a merger-acquisition did not qualify as ordinary and necessary business deductions under Section 162(a) of the I.R.C. An accounting of the intangible future benefits that followed from the merger resulted in the capitalization of the costs at issue. While the Court would not allow a mere incidental future benefit to disallow a deduction, it noted that future benefits are "undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization." The Court paid special attention to the language of Section 263(a)(1) which requires an inquiry into the "duration and extent of the benefits" that permanent improvements and betterments grant to the taxpayer. The Court's concern that a proper matching of current income and expense attributable to that income occur under the Code caused it to focus on the future benefits created by the remedial activity. The Court believed that this "matching principle" results in a more accurate reflection of net income for tax purposes. The Court's application of the future-benefits test demonstrated its concern over the broadening scope of deductible expenses.

The Court also wanted to narrow the applicability of the ordinary and necessary business deduction:

The notion that deductions are exceptions to the norm of capitalization finds support in various aspects of the Code. Deductions are specifically enumerated and thus are subject to disallowance in favor of capitalization. Nondeductible capital expenditures, by contrast, are not exhaustively enumerated in the Code. For these reasons, deductions are strictly construed and allowed only "as there is a clear provision therefor."

When considered in this light, the IRS determination in the TAM that the cost of removing the asbestos should be charged to the taxpayer's capital account is more understandable. Subsequent IRS advice justifies the capitalization of remedial expenses by focusing on the existence of intangible substantial future benefits.

2. Capitalization of Soil Remediation Costs

In the second TAM, the IRS ruled that the taxpayer's removal of PCBs from its soil was a capital expenditure. For years the taxpayer dumped PCBs, commonly used for lubrication, into earthen pits surrounding its oil pipelines. The EPA, under CERCLA, eventually sued the taxpayer to conduct a cleanup, conduct annual audits, and provide for ongoing remedial activities beyond those required for the cleanup at hand. The taxpayer, asserting the Planfield-Union test, deducted its expenditures for the soil cleanup.

In rejecting the taxpayer's claim for a deduction, the IRS distinguished the facts in Planfield-Union that justified the Tax Court's application of the increase-in-value test. Unlike the minor repairs made in Planfield-Union, the cleanup costs incurred here indicated substantial improvements to the land. The PCBs had accumulated over many years, no regular maintenance plan was used, and now the taxpayer...
was engaging in a large scale systematic plan to permanently improve its property. The IRS applied the “general plan of rehabilitation doctrine” in light of these facts and circumstances. This judicially crafted doctrine requires the capitalization of repair expenditures when they occur in conjunction with capital expenditures meant to improve or prolong the life of an asset as part of a general plan. To support this application, the IRS referred to Wolfen Land & Cattle Co. v. Commissioner where the general plan of rehabilitation doctrine required the taxpayer to capitalize the costs of dredging his ranch’s irrigation ditches. For a decade the taxpayer had forgone annual ditch maintenance which ultimately required a massive dredging operation which required the removal of a significant amount of accumulated silt.

The court found that these dredging expenditures would have a significant impact on the value of the property. The court concluded that these expenditures, considering their magnitude, were not merely incidental. Rather, the taxpayer’s plan to rehabilitate all the ranch’s ditches was more in the nature of a systematic capital ‘replacement’ that requires capitalization under 263A.

Similarly, the IRS blamed the taxpayer’s lack of a regular maintenance program in the PCB TAM for the denial of an IRC Section 162 ordinary and necessary business expense deduction. The IRS noted that disposal of the PCBs on a periodic basis would have obviated the need for such an extraordinary cleanup. Citing Wolfen, the IRS substituted the general plan of rehabilitation doctrine instead of the Plainfield-Union test by looking to the extensive nature of the taxpayer’s remediation efforts in cleaning the PCBs.

3. Capitalization of Costs Surrounding a Change in Use

The third TAM focusing on remediation expenditures dealt with the capitalization of costs surrounding the removal and encapsulation of asbestos insulation. The costs were incurred subsequent to the taxpayer’s conversion of a former boiler house into garage and office space. The taxpayer asserted that the expenses incurred did not increase the value of the property. The IRS disagreed and capitalized the expenditure for removal of the asbestos, noting that its removal increased the property’s value. Moreover, the IRS linked the asbestos removal to the conversion of the boiler house and found the removal was part of a conversion to a new and different use of the property. In this manner, the IRS avoided application of the Plainfield-Union test. However, the mere encapsulation of the asbestos-pipe did not result in an increase in the property’s value. The IRS reasoned the expenditures were deductible because they reduced, but did not eliminate, the threat of airborne asbestos fibers.

Opposition to all three TAMs coalesced rapidly. Petroleum marketers, facing large soil and groundwater remediation expenditures, were especially concerned with the potential impact of the PCB TAM. Real estate developers, worried by the impact of these TAMs on their urban redevelopment plans, also comprised an influential group of concerned taxpayers. The third TAM was also criticized for dissuading taxpayers from engaging in more comprehensive repairs to remove outright harmful substances rather than merely treating and monitoring such substances on-site.

In the face of widespread protest, the IRS began to reconsider its position. By 1993, in the absence of Treasury department action to resolve the uncertainty caused by the TAMs, Congress began searching for a legislative solution. Some members of Congress, under pressure to lower the deficit and disallow “tax breaks” for business, felt one possible solution would be a more stringent capitalization requirement for environmental remediation.

87. Id. at 5-6.
88. See Mountain Fuel Supply Co. v. United States, 449 E2d 816 (1971), cert. denied, 405 U.S. 989 (1972) where taxpayer’s expenditures towards repair of a natural gasline were coupled with expenditures which also extended the useful life of the underlying asset and doubled its operating pressure thus requiring capitalization of all costs.
90. 72 T.C. 1 (1979).
91. Id. at 8.
92. Id. at 17.
93. Id. at 18.
94. However, the cleanup costs were amortized to the taxpayer’s facilities, and were deprecable over the useful life of the facilities. This fact was overlooked when the TAM was released, as reported in: Environmental Cleanup Costs Addressed At Two ABA Tax Section Meetings, 93 Tax Notes Toove 165-7 (Aug. 9, 1993)(electronic version).
95. Id. at WL*12.
98. Id.
99. Id.
102. N.Y.U. INSTITUTE, supra note 64.
C. Industry Response to the TAMs

In 1993, industry representatives, such as the Coalition to Preserve the Current Deductibility of Environmental Remediation Costs, appeared before the House Ways and Means Select Revenue Measures Committee to testify that a capitalization requirement for environmental remediation would change tax law for the worse. Capitalization, they argued, would discourage efficient cleanup efforts and run contrary to long-standing tax policy. The tax counsel for Shell Oil Company claimed that "99.9% of practitioners" urged the application of the Plainfield-Union "increase-in-value test."109

The petroleum industry also endorsed legislation in the House that would allow deductions for business expenditures incurred under CERCLA mandated cleanup of petroleum-contaminated soil and groundwater. Ultimately, Treasury Secretary Lloyd Bentsen, at the urging of a bipartisan majority of both the Senate Finance Committee and the House Ways and Means Committee, launched a task force to resolve the confusion.111 The IRS, realizing its position was inconsistent with that of the business community and with the Clinton Administration's evolving stance on environmental cleanup, issued Revenue Ruling 94-38 which articulated a position contrasting sharply with the IRS opinion expressed in the previous three TAMs.

III. Revenue Ruling 94-38: The IRS Adopts the Plainfield-Union Test

The IRS finally provided guidance regarding the deductibility of environmental cleanup costs in Revenue Ruling 94-38. In that ruling, the IRS allowed a current business deduction for soil remediation and groundwater treatment costs.112 The corporation purchased the land in an uncontaminated state in 1970 and subsequently operated a manufacturing plant on the property. By 1993, the soil and groundwater beneath the property was contaminated by the onsite burial of hazardous waste discharged by the plant.113 Later, in compliance with federal and state environmental requirements, the company excavated the contaminated soil and replaced it with 'clean' soil. A groundwater treatment facility, which included wells, pipes, pumps and groundwater monitoring equipment were also installed. The treatment facilities are expected to operate until the year 2003.114

In its analysis, the IRS recognized first that although a particular expense may occur only once in the lifetime of a business, the expenditure may still qualify as an ordinary and necessary business expense deduction under Section 162. To qualify, the expenditure must be: 1) appropriate and helpful in carrying on the business; 2) commonly and frequently incurred in the taxpayer's type of industry; and 3) not a capital expenditure. To justify this rule the Service focused on the extent to which the remediation expenditure created a significant future benefit. To determine whether the expenditure creates a significant future benefit, the Service followed the Plainfield-Union test to determine whether the post-contamination value of the property had increased in value after the expenditure when compared to its pre-contamination value. The Service noted that an accurate comparison could be drawn since the land was uncontaminated when the taxpayer purchased it.

Second, the Service found that neither the groundwater treatment nor soil remediation costs increased the value of the taxpayer's property. Rather, "X [the taxpayer] has merely restored its soil and groundwater to their approximate condition before they were contaminated by X's manufacturing operations."116 Third, the Service concluded the expenditure would not result in a prolongation of the property's useful life. The Service reasoned that when a repair leads to no permanent improvement, and merely restores a property to its original condition, capitalization is not required under IRC Section 263(a)(2). Therefore, the Plainfield-Union test required a deduction for these expenditures as an ordinary and necessary business expense under IRC section 162.

108. Id.
111. Holthouse & Shiao, supra note 63, at WL*7.
112. Rev. Rul. 94-38, 1 C.B. 35.
113. Id.
114. Id.
115. Id.
117. Id.
118. Id. at 36.
119. Id.
120. Id.
121. Id.
122. Id.
123. Id.
124. Id.
125. Id.
The ruling also narrowly interprets the Supreme Court's INDOPOCO future-benefits test the IRS adopted in the first asbestos-TAM. While the IRS acknowledged the test when it noted that consideration of significant future benefits is important, it departed from INDOPOCO by not accounting in its valuation of the property for future intangible benefits such as improved worker health and safety, reduced liability, and the property's increased marketability. It remains unclear how this IRS demarcation of the INDOPOCO test will apply to other environmental remediation efforts.

Not all the remediation expense incurred by the taxpayer was deductible. The IRS required the capitalization of the cost of building and installing the groundwater treatment facility. The groundwater facility provided a future benefit to the taxpayer because its useful life extended beyond the taxable year in which it was constructed. The resulting future benefit to the taxpayer requires capitalization under section 263A.

By not allowing a complete deduction for the costs incurred in building, installing, and operating the groundwater waste management system, the ruling demonstrates the ongoing and prolonged tug-of-war over what must be capitalized and what may be deducted. However, the explicit adoption of the Plainfield-Union test in Revenue Ruling 94-38 may provide a clearer understanding of where the Service is headed in regards to deduction allowances. For those who view the tax code as an underutilized tool for environmental remediation, Revenue Ruling 94-38 a step in the right direction. However, the alternate conclusions contained within the TAMs discussed above still pose significant questions.

IV. Applicability of the TAMs after Rev. Rul. 94-38

Taxpayers should note that the IRS adoption of the Plainfield-Union test in Revenue Ruling 94-38 does not necessarily require its wholesale application to the fact patterns in the TAMs discussed above. However, some reasonable conclusions may be drawn. Under the Plainfield-Union test, the return of soil to its original state does not result in an increase in the value of the property when compared with the value of the property prior to its contamination. This result is inconsistent with the IRS advice given previously in the second TAM. Therefore, the taxpayer should have been allowed a deduction for the costs incurred in the removal of PCBs from the property.

A. Depreciability

The questions raised by the first and third TAMs, whether deductions are allowed for the removal of asbestos from buildings, or the replacement of equipment containing asbestos, cannot be answered with certainty. In Revenue Ruling 94-38 the taxpayer restored only non-depreciable property, so arguably deductions should be limited only to cases involving non-depreciable property, such as unimproved land. However, in Plainfield-Union the court allowed a deduction for pipe repairs that had not yet been fully depreciated. Revenue Ruling 94-38 did not resolve this inconsistency. In that ruling, the IRS accepted the Plainfield-Union test without distinguishing between depreciable and non-depreciable property.

A related issue is how to determine which tangible property used in the process of remediation will be considered dépréciable property, and non-deductible. Examples include the plastic liners used in groundwater treatment facilities, and certain equipment and fixtures necessary to remediate buildings and equipment. Taxpayers should capitalize such property on the grounds that the expenditures have restored a depreciable allowance for the unrepaired property so the costs must be recovered over the useful life of the asset. To capitalize, however, may sometimes require a difficult separation of certain tangible assets from the remediation process itself. Moreover, as noted above, it remains unclear whether the IRS wishes to distinguish between depreciable and non-depreciable property.

B. Acquisition of Contaminated Property

The IRS should not avoid applying the Plainfield-Union test to all fact patterns involving the acquisition of contaminated property. If the purchaser has no knowledge of the latent defect, a deduction should be allowed after the contamination is discovered. Adoption of the Plainfield-Union test would facilitate brownfields restoration by granting an incentive to prospective purchasers and developers.

126. Id.
127. Id.
128. Id.
129. Id. The Service also notes the construction of the facility falls within the definition of "production" under 26 I.R.C. 263A(g)(1) (West 1988).
131. Id.
132. 39 T.C. 333 at 338 n. 7.
135. Id.
of vacant, urban land. Relieving potential purchasers of some of the weight of uncertain liability would encourage private redevelopment of urban land. In contrast, the acquisition of contaminated land, with knowledge of its contamination, should not be accorded such treatment. The IRS generally considers the payment of contingent liabilities related to acquired property a capital expenditure, rather than an ordinary and necessary expense.

In David R. Webb, the Tax Court held that contingent liability payments should be considered capital expenditures regardless of how the previous owner would have treated them. Contingent environmental liabilities should also be capitalized because the purchase of property with a pre-existing liability generally involves a discounted purchase price. Furthermore, in a recently issued TAM, the IRS limited the application of Revenue Ruling 94-38 to taxpayers who acquire 'clean' property and then contaminate it themselves in the course of everyday business operations. This ruling implies the IRS will disallow a deduction for land acquired in an already contaminated state. This TAM was later revoked, but its issuance is a significant demonstration of how restrictively the IRS may interpret the principles encompassed in Revenue Ruling 94-38.

1. Recent IRS Advice

In TAM 9541005, released nearly two years after Revenue Ruling 94-38, the IRS concluded the taxpayer would not receive a deduction for soil remediation costs on land acquired in a contaminated condition. The taxpayer made a charitable contribution of land to a local county. The taxpayer initially used the land as a farm, but for the fifteen years preceding the contribution the land became a disposal site for chemical wastes and coke oven by-products. The county, planning to convert the land to a recreational park, discovered the contamination and conveyed the land back to the taxpayer for one dollar. The following year, the EPA conducted tests which revealed the soil was contaminated with enough hazardous waste to qualify the land as a Superfund site under CERCLA. The taxpayer was held liable for response costs under CERCLA.

The taxpayer entered into a consent order with the EPA to complete a "Remedial Investigation and Feasibility Study" to determine the extent of remedial activity to be performed. The taxpayer also requested advice from the IRS regarding the deductibility of its remediation costs, including fees paid to an environmental consulting and engineering firm, as well as the legal expenses incurred in drafting the consent order. The taxpayer relied on Revenue Ruling 94-38 to support its view that all such costs are deductible as ordinary and necessary business expenses.

In response, the IRS announced that Revenue Ruling 94-38 does not apply to the factual situation in TAM 9541005. In the TAM, the taxpayer technically acquired the land in an already contaminated state. In Revenue Ruling 94-38, the taxpayer purchased the land free of contamination. According to the IRS, the former factual scenario does not allow for an application of the Plainfield-Uion test. In Plainfield-Uion, the taxpayer's expenditures did not increase the value, useful life, or strength of the asset in question, but merely restored it to its original capacity. The IRS interpretation of this "restoration principle" makes it inapplicable to the purchase of already contaminated land. The restoration principle envisions that the taxpayer acquire the property in clean condition, contaminate the property in the course of its everyday business operations, and incur costs to restore the property to its condition at the time the taxpayer acquired the property.

The interpretation of Revenue Ruling 94-38 in TAM 9541005 is narrow. It appears especially rigid when considering the taxpayer was merely reacquiring the property charitably given to the county.

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138. 77 T.C. 1134 (1981), aff'd 708 F.2d 1254 (7th Cir. 1983).
139. Id.
141. Id.
142. Id.
143. Id.
144. Id.
145. Id.
146. Id.
147. Id.
148. Id.
149. Id.
150. Id.
151. Id.
152. Id.
153. Id.
154. Id.
155. In Rev. Rul. 95-74, 1995-46 C.B. 6 the IRS allowed a remediation deduction for land acquired in a 16 I.R.C. sec. 351 (West 1988) exchange. The IRS reasoned the congressional intent of sec. 351 to facilitate tax free corporate restructuring required a remedial deduction. The deduction was granted to the transferee just as if the sec. 351 transaction had never occurred and it was the original title holder who requested the deduction. The significance of this ruling to other fact patterns remains unclear.
After receiving criticism of its advice, the IRS revoked TAM 9541005 and in a new TAM found that the interim break in ownership should not bar a deduction. The IRS held that "ials with the expenditures at issue in Rev. Rul. 94-38, the costs at issue here did not create or enhance an asset, nor did they produce a long-term benefit. 198 Significantly, the IRS concluded the environmental study fees were deductible under the same reasoning. 199 This issue had not previously been dealt with by the IRS in Revenue Ruling 94-38.

C. Latent Environmental Defects

It is difficult to value property prior to the abatement of a latent defect, such as asbestos insulation or lead paint, because the defect most likely was not in the property when manufactured or built. This difficulty was one reason why the IRS declined to apply the Plainfield-Union increase-in-value test in the first asbestos-TAM. However, the discovery of an unexpected defect did not prevent the Plainfield-Union court from allowing a deduction. Rather, the court noted the taxpayer in that case could not have realized at the time it installed its tar-lined pipes that someday it would switch from carriage of fresh water to carriage of a more acidic river water which would result in tuberculation. The future use of acidic river water was a state of affairs that did not exist when the pipes were installed with a tar lining. The utility company, by replacing the tar lining with cement, was remedying a latent defect in the pipes (tar lining) brought about by a new state of affairs (the carriage of river water). The utility company did not increase the value of its pipes, nor incur a future benefit, by way of its remedy because the pipes' carriage capacity did not increase.

In regards to latent defects, taxpayers could argue that new environmental regulations, and an increased awareness of the dangers posed by toxic substances, are a state of affairs that did not exist when the property was in use. For example, it was not until the early 1980's that it became generally known that asbestos fibers posed a health risk. Presumably, the use of toxins during the construction or maintenance of tangible property was unintentional. Therefore, a deduction should be allowed because the remedial expenses relate more to this recent state of affairs than to the future. A deduction becomes more possible in the absence of a future benefit.

Revenue Ruling 94-38 did not discuss the possibility of allowing a repair deduction for the remedy of latent defects. In that ruling, the taxpayer purchased uncontaminated land, thereby allowing a comparison of the value of the land before and after contamination. Therefore, the possibility of a remediation deduction for latent defects such as asbestos and lead paint remains an issue.

D. Replacement of Underground Storage Tanks and Other Facilities

Underground storage tanks ("USTs") pose a significant remediation challenge to urban renewal efforts. Whether a deduction is allowed after Revenue Ruling 94-38 for the removal and replacement of leaking underground storage tanks, monitoring wells, and other containment facilities is unclear. The replacement or massive repair of a UST, like the groundwater treatment facility in Revenue Ruling 94-38, should be capitalized because of the future benefit it will provide to the taxpayer beyond the current tax year. An issue also exists whether a UST is considered a "structure" under Section 280B. Section 280B disallows deductions for demolition losses surrounding structures. The IRS, if it interprets "structure" to include USTs, may not allow a deduction. A revenue ruling is needed to clarify this issue. Despite these possible interpretations, note that petroleum marketers were prime proponents of remediation cost deductions for UST cleanup, and have already won a deduction for soil remediation costs. A further expansion of tax policy to allow the deductibility of more of the remedial costs surrounding USTs is possible.

156. This new Tech. Adv. Mem. has not yet been issued.
159. Id.
161. 39 T.C. at 340. ("We do not find that petitioner expected in 1990 that there would be a need for a cement lining.")
163. Id.
164. See generally U.S. ENVIRONMENTAL PROTECTION AGENCY FACT SHEET, supra note 21.
166. See Rev. Rul. 94-38, 1 C.B. 35.
E. Reconciling the Expanding Scope of the Environmental Remediation Deduction with INDOPCO

In Revenue Ruling 94-38, the IRS narrowly interprets the Supreme Court's future-benefits test, applied in INDOPCO and initially followed by the IRS in the first asbestos-TAM, by not taking intangible benefits into account when analyzing whether current remediation expense leads to significant future benefits. The INDOPCO decision recognized that intangible benefits, in some circumstances, result in a significant increase in the asset's value. These future benefits must match up with the revenues of the taxable period to which they are properly attributable in order to accurately calculate net income for tax purposes. Under what circumstances the IRS may discount the significance of intangible benefits, such as an increase in a property's marketability due to remedial action, is an issue that should be resolved by the IRS or the courts.

The current IRS interpretation of INDOPCO, found in Revenue Ruling 94-38, is supported in the Fifth Circuit's decision in Placid Oil v. Internal Revenue Service. The Fifth Circuit held that not all of the costs incurred as a result of a bankruptcy reorganization need to be capitalized as a result of the INDOPCO decision. The IRS cannot ignore the reality, however, that environmental remediation has a value-adding effect on property valuation and is taken into account by property appraisers and state property tax assessment statutes.

The Tax Court recently acknowledged that environmental concerns affect the value of real estate. The court allowed a taxpayer refund because the tax appraisal of the property in question did not reflect its extensive environmental contamination. This effect on value was also noted in the first asbestos-TAM. The IRS noted that modifications made to bring property into compliance with local regulations increase the value of the affected property. Therefore, whether the increasing scope of environmental deductions allowed under the Tax Code comports with the matching principle espoused by the Supreme Court in INDOPCO remains an issue.

VI. Conclusion

Revenue Ruling 94-38 demonstrates IRS willingness to allow deductions of some environmental remediation expenses as ordinary and business expenses under IRC Section 162. Robert Killinski, attorney-advisor in the Office of Tax Policy, remarked, "Agents were capitalizing and taxpayers were deducting. We think everyone gets what they want with 94-38." Yet, the TAMs serve as a cautionary note to the taxpayer that many unresolved issues remain. The IRS has been urged to issue more revenue rulings to further clarify its policy. Until then, taxpayers should consider whether, in light of Revenue Ruling 94-38, they should capitalize all of their remediation expenses.

Moreover, recently proposed legislation may significantly change the treatment of environmental remediation deductions within the Internal Revenue Code itself. Senator Coyne of Pennsylvania has proposed an amendment to the IRC to allow a credit for the cleanup of qualified contaminated industrial sites. The proposed legislation, termed "The Brownfields Redevelopment Act of 1996," recognizes that contaminated property located in urban communities poses health problems, reduces the value of property, and deters investment within those communities. Another proposed amendment to the IRC, introduced by Senator Abraham of Michigan, was recently termed an 'addition' under Michigan's state property tax assessment Act 42. Michigan — Property Tax: Various Definitions Amended, CCH Tax Day: State, July 20, 1995 (electronic version); also, Texas statute Ch. 43 now requires its state appraisers to take into account the value-reducing impact of environmental response requirements, which necessarily require taxpayers to take into account the value-adding impact of the satisfaction of such requirements. See Texas — Property Tax: Environmental Response Costs Affect Market Value Appraisal, CCH Tax Day: State, Sept. 8, 1995. See Necastro Est. v. Commissioner, T.C.M. (CCH) 94352 (1994).
Michigan, would permit a deduction for certain environmental remediation expenses that occur within the distressed urban communities that Congress has designated "empowerment zones" and "enterprise communities." Most significantly, the Clinton Administration has also proposed similar changes to the I.R.C. The Administration hopes the estimated $2 billion tax incentive will produce $10 billion in private cleanup investment. This flurry of legislation indicates that the government's attitude towards the environmental remediation deduction is undergoing a dramatic change. A broader application of the Planfield-Uman test by the IRS should be expected.

The effectiveness of achieving environmental goals through tax deductions is an unresolved issue. Proponents of the environmental remediation deduction rely on long-standing and widely-accepted tax accounting principles. Opponents to the use of the tax code as a means of bettering the urban environment also rely on convincing policy concerns. A focus on the IRS's divergent approach to the future benefits test outlined in INDOPCO should raise an interesting and perhaps effective challenge to the efforts of industry to broaden the applicability of the environmental remediation deduction. In the final analysis, however, the current attentiveness paid by Congress, industry and some environmentalists to the environmental remediation deduction ensures its viability as a tool to be used by either business or environmental advocates in the urban environmental setting.

177. The bill reads in part:

(a) Treatment as Expense. A taxpayer may elect to treat any environmental remediation cost as an expense which is not chargeable to capital account. Any cost so treated shall be allowable as a deduction for the taxable year in which the cost is paid or incurred.

(b) Environmental Remediation Cost. For purposes of this section—

(1) In general. The term 'environmental remediation cost' means any cost which—

(A) is chargeable to capital account

(B) is paid or incurred in connection with the abatement or control of environmental contaminants at a site located within an empowerment zone or enterprise community.


178. An amendment to Part VI of subchapter B of chapter I of the Internal Revenue Code will read:

(a) In General. A taxpayer may elect to treat any qualified environmental remediation expenditure which is paid or incurred by the taxpayer as an expense which is not chargeable to capital account. Any expenditure which is so treated shall be allowed as a deduction for the taxable year in which it is paid or incurred.

(b) Environmental Remediation Cost. For purposes of this section—

(1) In general. The term 'qualified contaminated site' means any area—

(i) which is held by the taxpayer for use in a trade or business or for the production of income, or which is property described in section 1221(1) in the hands of the taxpayer, (ii) which is within a targeted area, and (iii) which contains (or potentially contains) any hazardous substance.

(b) Taxpayer must receive a statement from State environmental agency.

