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TAX CONSEQUENCES OF ENVIRONMENTAL CLEANUP COSTS: THE UNCERTAINTY CONTINUES

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In recent years, the Internal Revenue Service has issued several advisory opinions which have attempted to resolve the question regarding the proper tax treatment of environmental cleanup costs. Unfortunately, these opinions have provided unclear answers and very little guidance in resolving this issue.

Businesses may find themselves in precarious positions because of potential liability for the substantial cleanup costs and the unclear tax consequences afforded these enormous expenditures. Today, businesses are under a tremendous amount of pressure from the government and the public to clean up contaminated and hazardous sites. In light of the recent attention given to brownfields redevelopment, the pressure to clean up seems even greater. Brownfields are commercial or industrial sites which, although contaminated, have an active potential for redevelopment or reuse.[1] It is estimated that there are approximately 450,000 brownfields sites in the United States.[2] Usually these sites are not highly contaminated and represent an unfortunate waste of commercial property.[3] In an attempt to combat this situation, the Environmental Protection Agency has developed a National Brownfields Economic Redevelopment Project which began in 1998.[4] This program enables interested parties to work together to clean up and redevelop brownfields sites to restore them to a productive use.[5] Businesses, however, may be less inclined to participate in such a program if they do not receive a favorable tax treatment for the costs involved.

This Note addresses the tax treatment of environmental cleanup costs. First, it discusses two relevant statutes under which a business might incur liability for environmental remediation expenses. Next, it considers the possible tax treatments of these costs. It then examines recent court opinions and IRS rulings on the proper tax consequences.

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[1]U.S. EPA PRESS ADVISORY, Oct. 20, 1997, 1997 WL 642978, at *1.

[2]U.S. EPA PRESS ADVISORY, Aug. 8, 1997, 1997 WL 451483, at *2.

[3]*Id.*

[4]U.S. EPA PRESS ADVISORY, Oct. 20, 1997, 1997 WL 642978, at *1.

[5]*Id.*

Finally, it concludes with a discussion of a relevant section of the Taxpayer Relief Act of 1997.

I. STATUTES COMPELLING REMEDIATION OF HAZARDOUS SUBSTANCES

A. Environmental Cleanup Costs Under CERCLA

The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) broadly defines four classes of people who are potentially liable for cleaning a site where hazardous substances have been released.[6] These parties are known as "potentially responsible parties" (PRPs) and include the following: (1) the current owner or operator of a site;[7] (2) previous owners or operators of a site;[8] (3) persons who arranged for disposal, treatment, or transport of hazardous substances disposed of at the site;[9] and (4) persons who transported hazardous substances to the site.[10] CERCLA imposes strict liability for cleanup of sites in these broad categories of PRPs.[11] Liability is also joint and several so that a PRP is potentially liable for the entire cleanup of the site.[12]

CERCLA forces PRPs to incur cleanup costs in one of three ways. First, under CERCLA, the Environmental Protection Agency (EPA) may issue an order compelling PRPs to remediate the contaminated site themselves.[13] Second, CERCLA allows PRPs to bring cost recovery actions against other PRPs for reimbursement of actual cleanup expenses incurred.[14] Third, CERCLA provides for a federal fund, the "Superfund," from which the government may use money to clean a site.[15] The government may then bring a cost recovery action against PRPs for reimbursement of these expenses.[16] Thus, even though a PRP may not actually perform the cleanup of the site, the PRP remains liable for those costs under other provisions of CERCLA.

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[6] 42 U.S.C. §9607(a) (1988).
[7] 42 U.S.C. §9607(a)(1) (1988).
[8] 42 U.S.C. §9607(a)(2) (1988).
[9] 42 U.S.C. §9607(a)(3) (1988).
[10] 42 U.S.C. §9607(a)(4) (1988).
[11] *See* New York v. Shore Realty Corp., 759 F.2d 1032 (2d Cir. 1985).
[12] *See* United States v. Monsanto Co., 858 F.2d 160 (4th Cir. 1988).
[13] 42 U.S.C. § 9606(a) (1988).
[14] 42 U.S.C. § 9607(a)(4)(B) (1988).
[15] 42 U.S.C. § 9604 (1988).
[16] 42 U.S.C. § 9607(a)(4)(A) (1988).

B. Environmental Cleanup Costs Pursuant to RCRA

Unlike CERCLA, the Resource Conservation and Recovery Act (RCRA) is primarily concerned with current waste management operations, rather than waste disposal sites that are no longer in use. The RCRA regulatory scheme contains provisions for compelling the cleanup of contaminated property at all stages of the waste management cycle, from the production of waste to the disposal of waste.

RCRA permits private citizens to bring an action in federal court to obtain an order ceasing any release of solid or hazardous waste which poses an "imminent and substantial endangerment" to the environment.[17] Under this provision of RCRA, the general remedy is injunctive relief, but parties may recover past response costs.[18] RCRA may force owners of underground storage tanks to remediate any releases from such tanks.[19]

RCRA, although not as broad as CERCLA, can pose a risk of compelled remediation of contaminated property upon owners and operators in certain circumstances. In most instances, RCRA simply broadens the liability imposed under CERCLA.

In addition to CERCLA and RCRA, parties associated with contaminated property must also be cognizant of potential liability arising from state statutory provisions, local regulations, and contract provisions.

II. TAX TREATMENT OF ENVIRONMENTAL CLEANUP COSTS

A. An Underlying Theory: The Matching Principle

Throughout the Internal Revenue Code (Code), a general attempt is made to match expenses with the corresponding revenues for which those expenses are incurred in order to arrive at an accurate measurement of a taxpayer's net income. This principle is helpful in determining whether certain expenses should be currently deductible or capitalized.

In general, under the matching principle, expenditures should be capitalized if they result in the creation of an asset or provide

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[17]42 U.S.C. § 6972(a)(1)(B) (1988).

[18]*See* KFC W., Inc. v. Meghrig, 49 F.3d 518 (9th Cir.), *cert. granted*, 116 S.Ct. 41(1995).

[19]42 U.S.C. §6991 (1988).

significant future benefits.[20] However, other expenses arising from liabilities incurred in the course of yearly trade or business activities can be deducted in the current taxable year.[21]

B. Ordinary and Necessary Business Expenses: Section 162 of the Internal Revenue Code

Section 162 of the Code allows deductions for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."[22] Courts have interpreted the meaning of "ordinary" and "necessary" in the context of §162.

Deputy v. Du Pont[23] construed the meaning of "ordinary" as used in §162. The United States Supreme Court determined that an expense is an "ordinary" expense if it is a common one in the course of one's business.[24] The Court then stated that a particular expense could be "ordinary" even though it occurred only once in the taxpayer's existence, but that the transactions that produce the expense must be of common occurrence in the type of business in which it is incurred.[25] Whether an expense is an ordinary expense depends upon the transactions from which it arose and its "normalcy" in the particular business in which it was incurred.[26]

In *Commissioner v. Tellier*,[27] the United States Supreme Court construed the "ordinary and necessary" requirement. In *Tellier*, the issue presented to the Court was whether expenses incurred by a taxpayer in the unsuccessful defense of a criminal prosecution qualified for deduction from taxable income under §162 of the Code. The Court determined that the legal expenses were "ordinary and necessary" within the meaning of §162.[28] The Court emphasized that the term "necessary" required only that the expense be "appropriate and helpful" to the taxpayer's business.[29] The Court then determined that the term "ordinary" in §162 was used primarily to distinguish between those expenses that are currently deductible and those expenses that are

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[20] I.R.C. §263; INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 83 (1992).
[21] I.R.C. §162; *INDOPCO, Inc.*, 502 U.S. at 83.
[22] I.R.C. §162(a).
[23] Deputy v. Du Pont, 308 U.S. 488 (1940).
[24] *Id.* at 495.
[25] *Id.*
[26] *Id.*
[27] Commissioner v. Tellier, 383 U.S. 687, 689 (1966).
[28] *Id.* at 690.
[29] *Id.* at 689 (quoting Welch v. Commissioner, 290 U.S. 111, 113 (1933)).

capital in nature and must be amortized over the useful life of the asset.[30]

In view of the relevant case law, an expense may be currently deductible under §162 if it is appropriate and helpful in conducting the taxpayer's business and if it is commonly and frequently incurred in the type of business that the taxpayer conducts. An expense may still qualify as ordinary even though only incurred once in the lifetime of a business. This last conclusion is significant for a taxpayer confronting environmental cleanup costs because such costs may only be incurred once in the lifetime of a particular business.

Section 1.162-4 of the Treasury Regulations accompanying §162 of the Code addresses the issue of incidental repairs to property. Under §1.162-4, a repair will qualify for a current deduction only if all of the following conditions are met: (1) the expenditure is incidental; (2) the expenditure does not materially increase the value of the property; (3) the expenditure does not significantly prolong the useful life of the property; and (4) the purpose of the expenditure is to keep the property in an ordinarily efficient operating condition.[31] Section 1.162-4 further provides that repairs in the nature of replacements must be capitalized and depreciated to the extent that the repairs slow deterioration and appreciably prolong the life of the property.[32] This regulation is significant in environmental cleanup cases because taxpayers often attempt to show that cleanup costs constitute incidental repairs that should be currently deductible as ordinary and necessary business expenses.

In the seminal case of *Illinois Merchants Trust Co.*,[33] the United States Board of Tax Appeals distinguished between incidental repairs and capital improvements based on the purpose of the expenditure.[34] The court noted that the purpose of a repair is to keep property in an ordinarily efficient operating condition.[35] In contrast, the purpose of a capital improvement is to prolong the life of the property, increase its value, or make it adaptable to a new or different use.[36]

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[30] *Id.*
[31] Treas. Reg. § 1.162-4 (1960).
[32] *Id.*
[33] Illinois Merchant Trust Co., 4 B.T.A. 103 (1926).
[34] *Id.* at 106.
[35] *Id.*
[36] *Id.*

C. Capital Expenditures: Section 263 of the Internal Revenue Code

Section 263 of the Code prohibits current deductions for capital expenditures.[37] Section 263(a)(1) provides that no deduction is 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."[38] Section 263(a)(2) of the Code provides that no deduction is 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 in the form of a deduction for depreciation, amortization, or depletion."[39] The Regulations accompanying §263 of the Code provide guidance as to what constitutes a capital expenditure. Section 1.263(a)-1(b) of the Regulations states that capital expenditures include amounts incurred "(1) [T]o add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as a plant or equipment, or (2) to adapt property to a new or different use."[40] An example of a capital expenditure is provided in §1.263(a)-2(a) of the Regulations as: "The cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year."[41]

Significantly, many courts have held that costs incurred as part of a general plan of rehabilitation, modernization, or improvement of property must be capitalized.[42] The courts have reached this conclusion even though the same costs might be currently deductible as ordinary and necessary business expenses, if incurred independently.[43]

III. OPINIONS AND RULINGS ON THE TAX TREATMENT OF ENVIRONMENTAL CLEANUP COSTS

A. The Plainfield-Union Test

Plainfield-Union Water Co. v. Commissioner[44] sets forth a value of property standard that many taxpayers have argued to justify

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[37]I.R.C. §263(a).
[38]I.R.C. §263(a)(1).
[39]I.R.C. §263(a)(2).
[40]Treas. Reg. §1.263(a)-1(b).
[41]Treas. Reg. §1.263(a)-2(a).
[42]*See* Mountain Fuel Supply Co. v. United States, 449 F.2d 816, 820-22 (10th Cir. 1971).
[43]*See id.* at 820; United States v. W.J. Wehrli, 400 F.2d 686, 689 (10th Cir. 1968).
[44]Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333 (1962).

a current deduction of cleanup costs. In *Plainfield-Union*, the taxpayer was a public utility which supplied water to its customers via a system of water mains and pipes.[45] When these pipes were originally installed, they were painted internally with tar.[46] Acidic water eventually forced the tar coating to push up which reduced the carrying capacity of the pipes.[47] The taxpayer was forced to clean and reline the pipes with cement in order to restore the carrying capacity of the pipes.[48] The taxpayer deducted these cleaning and lining expenses as ordinary and necessary business expenses.[49] The Tax Court agreed with the taxpayer that the costs of cleaning and lining the pipes was a repair which could be properly deducted in the taxable year in which the costs were incurred.[50] In reaching this conclusion, the court stated that the proper test considers "whether the expenditure materially enhances the value, use, life expectancy, strength, or capacity as compared with the status of the asset prior to the condition necessitating the expenditure."[51] The court felt that the cleaning and lining of the pipes did not prolong the useful life of the taxpayer's assets, nor did it change or enhance the use or capacity of the assets.[52] Additionally, the court noted that these costs were not incurred as part of a general plan of rehabilitation.[53] Given these findings, the court held the costs were an ordinary and necessary business expense which could be deducted currently.

B. IRS Rulings on the Tax Treatment of Environmental Cleanup Costs

The Internal Revenue Service has issued several Tax Advice Memoranda (TAMs) and Revenue Rulings on the tax treatment of environmental cleanup costs. Although both types of advisory opinions are instructive as to the Service's viewpoint, the TAMs are less helpful than revenue rulings because they carry no precedential value.[54]

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[45] *Id.* at 334.
[46] *Id.*
[47] *Id.* at 335.
[48] *Id.* at 336.
[49] *Id.*
[50] *Id.* at 337.
[51] *Id.* at 338.
[52] *Id.*
[53] *Id.*
[54] I.R.C. §6110(j)(3) (1988).

1. Technical Advice Memorandum 92-40-004

Technical advice memorandum (TAM) 92-40-004 considered whether the costs of removing and replacing asbestos insulation in manufacturing equipment should be deducted or capitalized. The taxpayer's manufacturing facility contained equipment insulated with asbestos.[55] The taxpayer employed an asbestos abatement program as required by certain state and federal regulations and to enhance the health and safety of its workers.[56] Accordingly, the taxpayer removed the asbestos insulation from its equipment and replaced it with less efficient insulation.[57] The taxpayer then deducted these removal costs as deductible repair expenses in the year in which they were incurred.[58]

The taxpayer presented several justifications for its tax treatment of these costs. First, the taxpayer argued that the removal and replacement costs did not add value to the equipment nor did they prolong the useful life of the equipment.[59] The taxpayer also argued that the replacement costs did not convert the equipment to a new or different use.[60] The new insulation performed the same function as the old asbestos insulation.[61] Moreover, the taxpayer argued that the expenditures were not incurred as part of a general plan of rehabilitation and thus should not be capitalized as such.[62] Finally, the taxpayer contended that these were costs for incidental repairs, not permanent improvements.[63]

The IRS held that the taxpayer's removal and replacement costs should be capitalized.[64] These costs increased the value of the taxpayer's equipment due to the elimination of the health risks posed by the asbestos.[65] Also, the taxpayer's property was more marketable to potential buyers after the asbestos was removed.[66] Additionally, the IRS refused to apply the *Plainfield-Union*[67] value test.[68] The IRS noted

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[55]Tech. Adv. Mem. 92-40-004 (June 29, 1992).
[56]*Id.*
[57]*Id.*
[58]*Id.*
[59]*Id.*
[60]*Id.*
[61]*Id.*
[62]*Id.*
[63]*Id.*
[64]*Id.*
[65]*Id.*
[66]*Id.*
[67]Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333 (1962).
[68]Tech. Adv. Mem. 92-40-004 (June 29, 1992).

that the value test was only applicable where repairs to the property are necessitated due to progressive deterioration.[69] Here, the replacement of the insulation was not necessitated by the deterioration of the equipment but because of human health risks.[70] Furthermore, the IRS stated that the value test could not be applied because the taxpayer's equipment was manufactured with asbestos and therefore could not be valued prior to the existence of the asbestos.[71]

The IRS further stated that reparations made to bring property into compliance with governmental regulations increase the value of the repaired property because it allows the taxpayer to continue its operations.[72] Finally, the IRS noted that the replacement of insulation was a permanent change to the property that would produce benefits beyond the taxable year in which the expenses were incurred.[73] The future benefits that would accrue to the taxpayer included safer working conditions, reduced risk of liability, and increased marketability.[74]

2. Technical Advice Memorandum 93-15-004

In April 1993, the IRS issued TAM 93-15-004[75] which held that the costs of particular environmental cleanup activities were capital expenditures. The costs incurred by the taxpayer, and addressed by the IRS, were associated with a plan to remediate soil and equipment contaminated with polychlorinated biphenyls (PCBs).[76] The PCB contamination resulted from the past operation of equipment, and from previous PCB removal and disposal undertakings.[77] The taxpayer was in violation of several statutes including RCRA and the Toxic Substances Control Act[78] (TSCA).[79] The taxpayer agreed to remediate the property and treated all the costs of remediation, except for the costs of remediation equipment and groundwater monitoring wells, as current expenses.

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[69] *Id.*
[70] *Id.*
[71] *Id.*
[72] *Id.*
[73] *Id.*
[74] *Id.*
[75] Tech. Adv. Mem. 93-15-004 (April 16, 1993).
[76] *Id.*
[77] *Id.*
[78] 15 U.S.C. §§2601-2692 (1988 & Supp. V 1993).
[79] Tech. Adv. Mem 93-15-004 (April 16, 1993).

In its claim that the remediation expenses were currently deductible, the taxpayer first argued that the costs were repairs.[80] The IRS disagreed holding that the costs were replacements and betterments, not incidental repairs.[81] The IRS first noted that the expenditures resulted from the taxpayer's choice to forego regular maintenance which eventually necessitated an extensive cleanup.[82] The IRS believed the taxpayer could have avoided any extraordinary cleanup costs by properly disposing of the wastes initially.[83] Significantly, the IRS stated that the taxpayer's unawareness as to the appropriate disposal method was irrelevant.[84] Instead, the proper focus was on the "work being performed" in the cleanup, not on the taxpayer's knowledge or good intentions.[85] Next, the Service found that the expenditures were incurred as part of a systematic plan of remediation that required capitalization of such expenditures.[86] Finally, the IRS found that the taxpayer's property would be more valuable after the remediation signifying an improvement to the property rather than a repair.[87]

3. Technical Advice Memorandum 94-11-002

TAM 94-11-002 considered the proper tax treatment for two types of asbestos cleanup costs: 1) costs associated with the removal of asbestos from a portion of the taxpayer's property; and 2) costs associated with the encapsulation of asbestos on a portion of the taxpayer's property.[88] The taxpayer was a corporation that rented warehouse space.[89] The property involved consisted of a warehouse and a boiler house located on the same land.[90] In order to obtain financing from a bank, the taxpayer was required to remove asbestos-containing equipment from the boiler house and to correct its asbestos problems in its warehouse facility.[91] The taxpayer completely cleared the boiler house of all asbestos-containing equipment and subsequently

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[80] *Id.*
[81] *Id.*
[82] *Id.*
[83] *Id.*
[84] *Id.*
[85] *Id.*
[86] *Id.*
[87] *Id.*
[88] Tech. Adv. Mem. 94-11-002 (March 18, 1994).
[89] *Id.*
[90] *Id.*
[91] *Id.*

converted the boiler house into a garage and office space.[92] Within the warehouse, the taxpayer re-wrapped and encapsulated damaged portions of pipe containing asbestos insulation.[93] The encapsulation procedure involved applying canvas and plastic wrapping over damaged portions of pipe.[94] The taxpayer then deducted both removal and encapsulation costs as ordinary and necessary business expenses.[95]

As to the removal costs associated with the boiler house cleanup, the IRS disagreed with the taxpayer's treatment and held that these costs should be capitalized.[96] The taxpayer argued that these costs were incidental repair costs that should be currently deducted.[97] The IRS, however, held that these costs added to the value of the property and adapted the property to a different use.[98] First, the Service noted that the complete removal of asbestos permanently eliminated any future health risks.[99] Next, the IRS noted that the removal of asbestos increased the value of the property for potential buyers.[100] Also, removal costs were not incurred to return the boiler house to its original condition, but rather to enhance its usefulness and capacity.[101] The boiler house had been adapted to a new and different use that necessitated capitalization of the costs involved in this process.[102] Finally, the IRS noted that the removal of the asbestos was not a temporary repair, but rather a permanent improvement which eliminated all the contamination in the boiler house.[103]

In contrast, the IRS agreed with the taxpayer that the encapsulation costs for the warehouse property could be currently deducted.[104] In so holding, the IRS believed that these were temporary measures that could be characterized fairly as incidental repairs.[105] These costs did not appreciably increase the value of the property, prolong its useful life, or completely eliminate the threat of exposure to asbestos in the warehouse.[106]

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[92] *Id.*
[93] *Id.*
[94] *Id.*
[95] *Id.*
[96] *Id.*
[97] *Id.*
[98] *Id.*
[99] *Id.*
[100] *Id.*
[101] *Id.*
[102] *Id.*
[103] *Id.*
[104] *Id.*
[105] *Id.*
[106] *Id.*

4. Revenue Ruling 94-38

Revenue Ruling 94-38 instructed that cleanup costs incurred to treat land groundwater that a taxpayer contaminated with hazardous waste from its business are deductible by the taxpayer as ordinary and necessary business expenses under §162 of the Code.[107] The ruling further instructed that consideration expenses for groundwater treatment facilities are capital expenditures under §263.[108]

The pertinent facts of the ruling are as follows. The taxpayer owned and operated a manufacturing plant it built on land that was uncontaminated when purchased by the taxpayer.[109] During the plant's operations, it discharged hazardous waste which it buried on portions of the land.[110] In complying with anticipated federal, state, and local environmental regulations, the taxpayer undertook remediation of the soil and groundwater.[111] Additionally, the taxpayer installed a groundwater monitoring system to guarantee that the remediation had removed all the hazardous waste and to provide for continual future monitoring of the land.[112] The soil remediation and groundwater treatment was undertaken to restore the taxpayer's land to the same physical condition that existed prior to the contamination.[113]

The ruling first considered the extent to which the expenditure would produce significant future benefits.[114] The Service determined that the newly constructed groundwater treatment facilities had a useful life substantially beyond the taxable year in which they were constructed and were therefore capital expenditures under §263.[115] The ruling then stated that the soil remediation expenditures and the ongoing groundwater treatment expenditures (other than the costs of constructing the facilities) were not permanent improvements to the taxpayer's land and did not otherwise provide significant future benefits.[116] They merely restored the soil and groundwater to their pre-

[107]Rev. Rul. 94-38, 1994-1 C.B. 35.
[108]*Id.*
[109]*Id.*
[110]*Id.*
[111]*Id.*
[112]*Id.*
[113]*Id.*
[114]*Id.*
[115]*Id.*
[116]*Id.*

contamination condition.[117] Thus, these expenditures were ordinary and necessary business expenses that were currently deductible.[118]

The ruling adopted the value test as set forth in *Plainfield-Union Water Company v. Commissioner*[119] for determining whether a particular expenditure increases the value of property.[120] The test compares "the status of the asset after the expenditure with the status of that asset before the condition arose that necessitated the expenditure."[121] The ruling compared the condition of the land after the cleanup with the condition of the land before it was contaminated.[122] Because the taxpayer had merely returned the land and groundwater to their conditions before the contamination, the soil remediation and ongoing water treatment expenditures did not result in improvements that increased the value of the taxpayer's property.[123] This ruling affected Revenue Ruling 88-57.[124] It rejected the prior revenue ruling's implication that the value test was the appropriate test only in a case where there was sudden and unanticipated damage to property.[125] Therefore, the value test is appropriate where there is sudden and unanticipated contamination of property and where the damage to property is a foreseeable result of continuous or long-term contamination.

In September 1995, the IRS issued a memorandum that casts doubt on the current deductibility of cleanup costs. The TAM suggested that most costs associated with the cleanup of property contaminated prior to purchase by the taxpayer must be capitalized.[126] A corporate predecessor of the taxpayer purchased property that had been used as a site for the disposal of wastes.[127] Several years later, the taxpayer donated the land to the county government for use as a public park.[128] After discovering the contamination, the county reconveyed the property to the taxpayer.[129] Subsequently, the property was investigated

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[117] *Id.*
[118] *Id.*
[119] 39 T.C. 333, 338 (1962).
[120] Rev. Rul. 94-38, 1994-1 C.B. 35.
[121] *Id.*
[122] *Id.*
[123] *Id.*
[124] Rev. Rul. 88-57, 1988-2 C.B. 36.
[125] Rev. Rul. 94-38, 1994-1 C.B. 35.
[126] Tech. Adv. Mem. 95-41-005 (Oct. 13, 1995).
[127] *Id.*
[128] *Id.*
[129] *Id.*

and placed on the National Priorities List under CERCLA.[130] The taxpayer then entered into a Consent Decree with the Environmental Protection Agency and agreed to perform an investigation into the extent of the contamination and the development of plans for a cleanup of the property.[131]

At the time the TAM was sought, the taxpayer had not yet incurred any actual remediation costs.[132] The taxpayer had incurred three other types of costs: (1) consulting costs for the investigation of the site; (2) legal fees related to negotiation and drafting of the Consent Decree; and (3) consulting fees for lobbying, public relations, and engineering.[133] The TAM noted that current tax deductions are a matter of legislative grace.[134] Capitalization of costs is the norm and the taxpayer must meet its burden of proof in order to show that costs should be currently deductible.[135] The taxpayer in this advice memorandum failed to meet its burden of proof with regard to all three types of claimed expenses.[136]

The taxpayer argued that following Revenue Ruling 94-38 these expenditures were currently deductible as ordinary and necessary business expenses.[137] The IRS ruled that Revenue Ruling 94-38 did not apply to the taxpayer's situation.[138] TAM 95-41-005 states that Revenue Ruling 94-38 only applies if the taxpayer acquired the property in an uncontaminated condition, contaminated the property in the course of its everyday business operations, and later incurred costs to restore the property to its condition at the time of acquisition.[139] The IRS construed the facts such that the taxpayer acquired the land when the property was reconveyed by the county, not when the taxpayer originally purchased the land.[140] The TAM suggests that costs associated with the cleanup of preexisting contamination must always be capitalized.

The TAM also explained that, under appropriate circumstances, a taxpayer could deduct the costs of performing an environmental

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[130] *Id.*
[131] *Id.*
[132] *Id.*
[133] *Id.*
[134] *Id.*
[135] *Id.*
[136] *Id.*
[137] *Id.*
[138] *Id.*
[139] *Id.*
[140] *Id.*

investigation or study under §162 of the Code if the taxpayer demonstrated that the amounts were incurred in the ordinary course of business.[141]

As to the legal fees, the TAM explained that the determination of whether legal fees are deductible under §162 or capitalized under §263, is made by examining the nature of the matter with respect to which the costs were incurred.[142] Legal fees are appropriately capitalized if they were incurred to facilitate the cleanup.[143]

The main importance of the TAM is its narrow reading of Rev. Rul. 94-38. The facts of TAM 95-41-005 are very similar to the facts of Rev. Rul. 94-38 which suggests that their tax outcomes should be similar. Yet, the IRS held that the cleanup costs in the revenue ruling should be deductible currently while holding that the costs in the TAM should be capitalized. Apparently, the IRS refuses to apply the revenue ruling to situations where the taxpayer acquires contaminated property and then undertakes remediation of the property to restore the land to an uncontaminated condition.

5. Technical Advice Memorandum 97-19-007

In May 1997, the IRS issued a TAM that instructed that the costs incurred by the taxpayer for the design, acquisition, and construction of a Spent Nuclear Fuel Interim Storage Facility (SNFISF) were capital expenditures under §263.[144] The taxpayer was a public utility operating a nuclear-steam powered electric generating plant.[145] Fuel assemblies in the plant were handled underwater and temporarily stored in spent fuel pools for cooling.[146] The taxpayer and other utilities anticipated that the spent nuclear fuel would be removed from the spent fuel pool after ten years of cooling and then sent away for reprocessing.[147] However, the anticipated reprocessing facilities were never constructed in the United States.[148] The taxpayer then entered into a contract with the Department of Energy under which the Department agreed to hold taxpayer's spent fuel until the radioactive

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[141] *Id.*
[142] *Id.*
[143] *Id.*
[144] Tech. Adv. Mem. 97-19-007 (May 9, 1997).
[145] *Id.*
[146] *Id.*
[147] *Id.*
[148] *Id.*

isotopes decayed to a safe level.[149] Even with the contract, the taxpayer realized that a storage facility could not be established by the government before the taxpayer's spent fuel pools reached capacity.[150] To avoid shutting down the plant, the taxpayer chose to build its own interim storage facility and selected on-site dry cask encapsulation to handle its spent fuel.[151] The taxpayer then entered into a contract with another corporation for the design and acquisition of several dry casks.[152] Once the dry casks were built, they could not be used for transporting the spent fuel to the government's storage facility. As a result, the casks were to be scrapped once permanent storage became available.[153] Additionally, the taxpayer was forced to design and construct a concrete pad on which to place the casks.[154]

The taxpayer sought advice on how to treat the numerous types of costs involved. These costs included: costs for design, acquisition, and construction of the SNFISF, the concrete pad, the dry casks and related equipment; costs of environmental studies; and costs of regulatory approvals related to the acquisition and construction of the SNFISF.[155]

The taxpayer argued that the costs were ordinary and necessary business expenses that should be currently deductible.[156] First, the taxpayer argued that the purpose of the expenditures was to temporarily store hazardous materials, not to produce future income or generate any future benefit.[157] The taxpayer contended that the expenditure for the SNFISF added no appreciable value to its plant.[158] The IRS rejected these arguments stating that the taxpayer had incurred costs to construct capital assets with a useful life beyond the taxable year.[159] All costs associated with the design, acquisition, and construction of the facility were expenditures for permanent improvements to the taxpayer's plant that increased the property's value under §263.[160] The IRS felt that the taxpayer's situation was analogous to the taxpayer's situation in Revenue Ruling 94-38 in that the taxpayer in that ruling was required

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[149] *Id.*
[150] *Id.*
[151] *Id.*
[152] *Id.*
[153] *Id.*
[154] *Id.*
[155] *Id.*
[156] *Id.*
[157] *Id.*
[158] *Id.*
[159] *Id.*
[160] *Id.*

to capitalize the portion of its costs relating to the construction of its groundwater treatment facilities.[161] The IRS pointed out in that ruling it was found that the newly constructed facilities constituted the construction of an asset with a useful life substantially beyond the taxable year in which it was built.[162]

The taxpayer then argued that the authority of *H.G. Fenton Material Co. v. Commissioner*[163] controlled.[164] In *Fenton,* the taxpayer operated a mining business.[165] The taxpayer disposed of waste products by hauling them and depositing them on other property it owned.[166] Subsequently, the taxpayer attempted to currently deduct all the related costs as ordinary and necessary business expenses.[167]

The Tax Court agreed with the taxpayer that the expenses were currently deductible.[168] First, the court determined that the disposal costs were ordinary and necessary business expenses because they were necessarily incurred in order to avoid clogging the mine.[169] Second, the court found that the taxpayer's use of its own property for dumping was not determinative of capitalization because taxpayer could have paid another party to remove the waste and this expense would have been currently deductible.[170] The court then concluded that any present benefit to the property was merely incidental and any future benefit to the property was purely speculative.[171]

In TAM 97-19-007, the IRS did not believe that the taxpayer's situation was analogous to *Fenton.*[172] Unlike *Fenton,* the IRS found that capital effect of taxpayer's expenditures was not incidental or speculative.[173]

The taxpayer also argued that its expenditures should not be capitalized because the constructed facilities would not produce future income.[174] The IRS disagreed, stating that courts have held that costs may be capitalized even where the asset created does not directly

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[161]*Id.*
[162]*Id.*
[163]H.G. Fenton Material Co. v. Commissioner, 74 T.C. 584 (1980).
[164]Tech. Adv. Mem. 97-19-007 (May 9, 1997).
[165]*H.G. Fenton Material Co.*, 74 T.C. at 585.
[166]*Id.* at 586.
[167]*Id.* at 587.
[168]*Id.* at 587.
[169]*Id.* at 592.
[170]*Id.*
[171]*Id.* at 592.
[172]Tech. Adv. Mem. 97-19-007 (May 9, 1997).
[173]*Id.*
[174]*Id.*

produce future income.[175] The IRS then emphasized the holding in *Woolrich Woolen Mills v. United States,*[176] where the taxpayer was required to capitalize the costs of constructing a water filtration plant, although the plant was not a productive part of the taxpayer's manufacturing operations.[177] In this opinion, the Third Circuit reasoned that although the plant was not used in the taxpayer's manufacturing operations, it was an indispensable part of the total business property of the taxpayer.[178] In conclusion, in the request for technical advice, the IRS believed that the SNFISF was a part of the taxpayer's total business property even if unnecessary to the plant's primary operations.

Finally, the taxpayer argued that the temporary nature of the SNFISF prohibited the capitalization of the expenditures. The IRS rejected this argument as well, stating that the Tax Court has required taxpayers to capitalize the construction costs of temporary facilities used until the completion of permanent facilities.[179] Thus, the interim status of the dry casks was irrelevant to the consideration of whether the costs should be capitalized or currently deductible.

IV. CONCLUSION

As is apparent from these recent rulings, given the same set of facts, taxpayers and the IRS often reach different conclusions about the proper tax treatment of environmental cleanup costs. The controversial question as to whether these costs should be currently deductible or capitalized remains unsolved today and hinges on a judicious fact-intensive analysis. It seems reasonably certain that the IRS will continue to apply the *Plainfield-Union* value test to allow current deductions for costs associated with the cleanup of property that was uncontaminated before acquisition by the taxpayer. This confers a favorable tax treatment on taxpayers who remedy contamination caused by the taxpayers themselves on their own land. It appears equally certain that the IRS will continue to require capitalization of the same costs incurred to restore property which was contaminated before purchase by the taxpayer. As for other cleanup schemes, the relevant inquiry will examine all the facts and circumstances of the case. In

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[175]*See* Russel Box Co. v. Commissioner, 208 F.2d 452 (1st Cir. 1953).

[176]Woolrich Woolen Mills v. United States, 289 F.2d 444 (3d Cir. 1961).

[177]*Id.* at 449.

[178]*Id.* at 448.

[179]Tech. Adv. Mem. 97-19-007 (May 9,1997) (citing Vest v. Commissioner, T.C. Memo 1993-243).

general, the relevant factors to consider with respect to cleanup costs include: (1) creation of a new asset; (2) giving an old asset a new or different use; (3) significant increase in the life of an asset; (4) whether the costs are part of a general plan of rehabilitation; and (5) an increase in the value of an asset. If any of these factors are met, it is likely that the IRS will require capitalization of such costs.

The Taxpayer Relief Act of 1997 provided some guidance to taxpayers for expensing environmental remediation costs.[180] Enacted on August 13, 1997, §198 of the Internal Revenue Code provides that a taxpayer may elect to treat as a current deduction certain qualified environmental remediation expenditures.[181] A qualified environmental remediation expenditure is defined as one which is normally capitalized and which is incurred as a result of a hazardous substances mitigation process at a qualified contaminated site.[182] A qualified contaminated site is income-generating property held for use in a trade or business with a targeted area on which there has been a release of any hazardous substance.[183] Targeted areas include: (1) a population census tract with a poverty rate of 20 percent or more; (2) other population census tracts which are zoned for commercial and industrial use and are adjacent to at least one other population census tract; (3) any empowerment zone or enterprise community; and (4) any site the Environmental Protection Agency has announced before February 1, 1997 as a brownfields pilot project.[184] Section 198 terminates, however, and shall not apply to remediation expenditures incurred after December 31, 2000.[185] Thus, as long as the taxpayer can fit under all the provisions of §198, the taxpayer is assured that its environmental remediation costs can be currently deducted.

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[180] I.R.C. §198.
[181] I.R.C. §198(a).
[182] I.R.C. §198(b)(1).
[183] I.R.C. §198(c)(1)(A).
[184] I.R.C. §198(c)(2)(A).
[185] I.R.C. §198(h).