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Focus on Capitalization v. Deductibility - Environmental Remediation

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**FOCUS ON CAPITALIZATION V. DEDUCTIBILITY --
ENVIRONMENTAL REMEDIATION**

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I. BASIC RULES OF DEDUCTION VERSUS CAPITALIZATION --

A. Deduction -- There shall be allowed as a deduction all of the ordinary and necessary expenses paid or incurred during a taxable year in carrying on any trade or business. Sec. 162(a), I.R.C.

a. The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition are currently deductible. Reg. §1.162-4.

b. EXAMPLE: Repairs which would be deductible include costs for painting, replacing part of a leaky pipe or roof, or replastering a hole in a wall.

B. Capitalization -- No deduction is allowed for any amount paid for permanent improvements or betterments made to increase the value of any property. Sec. 263(a), I.R.C.

a. No deduction shall be allowed for (i) amounts paid for new buildings or permanent improvements or betterments made to increase the value of the property or (ii) amounts expended in restoring property or in making good the exhaustion for which an allowance is or has been made in the form of a deduction for depreciation, amortization or depletion. Reg. §1.263(a)-1(a).

b. Capital expenditures are those which are paid or incurred (i) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or (ii) to adapt property to a new and different use. Reg. §1.263(a)-1(b).

c. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall be capitalized. Reg. §1.162-4.

d. EXAMPLE: Generally, capital expenditures would include replacement of a heating system or replacement of the pipe in a pipeline.

II. ENVIRONMENTAL COSTS AS NECESSARY -- Environmental remediation costs should easily meet the necessary threshold for deduction because leaving contaminating hazards "as is" will ultimately threaten a taxpayer's ability to continue to hold an investment in the property. Thus, remediation will be helpful to the taxpayer in holding onto his investment.

III. REMEDICATION OF TAXPAYER CONTAMINATED LAND -- Taxpayers who contaminate land or groundwater with hazardous waste may deduct the costs to remediate the land. Rev. Rul. 94-38, 1994-25 I.R.B. 4.

A. Scope of Ruling -- This ruling applies regardless of the particular type of contamination and whether the remediated land is used in the taxpayer's business or is left idle. Rev. Rul. 94-38, 1994-25 I.R.B. 4. Remediation costs should also be deductible if the contamination is on property which is not owned by the taxpayer, but the taxpayer is responsible for cleanup.

B. Analysis --

1. Facts -- The Service posited a situation where a taxpayer purchased land which was not contaminated. The taxpayer buried hazardous waste which was produced from its manufacturing operations, contaminating the land and the groundwater. In order to comply with presently applicable and reasonably anticipated Federal, state and local environmental requirements, the taxpayer remediated the land by excavating the contaminated soil, transporting it to a containment facility and filling the excavations with uncontaminated soil. A facility was built to extract, treat and monitor the groundwater.

2. Groundwater Facilities -- The cost to build the groundwater treatment facility was a capital expense because the plant had a useful life substantially beyond the taxable year in which it was constructed. However, the ongoing groundwater monitoring was a deductible cost.

3. Soil Remediation -- The soil remediation expenditures were deductible because the costs did not produce permanent improvements or otherwise provide significant benefits.

a. Value test -- The Service stated that the value of the property was not increased because the taxpayer restored its soil and groundwater to their approximate condition before they were contaminated. Plainfield-Union Water Co. v. Comm'r, 39 T.C. 333 (1962), nonacq. on other grounds 1964-2 C.B. 8. The Ruling modifies Rev. Rul. 88-57, 1988-2 C.B. 36, to the extent it implies that Plainfield-Union cannot be an appropriate test in any case other than one in which there is sudden and unanticipated damage to an asset.

b. Other Capitalization Tests -- The Service noted that the expenditures did not prolong the useful life of the land, nor adapt it to a new and different use.

c. Restoration -- The Ruling states that the land was restored, but, because it was not subject to an allowance for depreciation, there was no need to capitalize the costs.

C. Importance -- This Ruling is important because the Service changed from a position of capitalization to deduction with respect to the remediation of land. Contrast Priv. Ltr. Rul. 9315004 (December 17, 1992).

IV. REMEDICATION OF PURCHASED CONTAMINATED LAND -- Treasury has stated that Rev. Rul. 94-38 does not apply to the purchase by a taxpayer of already contaminated land, thereby signaling that its position may be that remediation of such land must be capitalized. Bob Kilinskis, Remarks at a Panel Discussion sponsored by American Council of Capital Formation (June 8, 1994), reported in BNA DTR at G-7 (June 9, 1994).

V. REMEDICATION OF LEAKING STORAGE TANKS -- In dealing with a leaking tank, the taxpayer must fix the tank and remediate the soil.

A. Soil Remediation -- Remediating the soil should be deductible based on Rev. Rul. 94-38, 1994-25 I.R.B. 4.

B. Tank Remediation -- In remediating the tank, the taxpayer can either patch the tank or replace it.

1. Patching -- If the taxpayer patches the tank, the tank is repaired. The tank has not increased in value. Its useful life is not longer, and it has not been adapted to a new and different use. This would be the prototypical deductible repair.

2. Replacement -- Replacement of the tank causes the cost of the new tank to be capitalized. The replacement tank is a new and separate asset with a useful life substantially beyond the taxable year. This is the prototypical capitalized cost.

VI. ASBESTOS REMEDIATION -- A taxpayer will generally have two choices in dealing with asbestos, either removal or encapsulation with continuous monitoring.

A. Removal -- The cost of removal is considered to be a capitalized cost by the Service. See Priv. Ltr. Ruls. 924004 (June 29, 1992) (the Equipment Decision) and 9411002 (Nov. 19, 1993) (the Building Decision).

1. The Building Decision -- In this Technical Advice Memorandum, the taxpayer removed the asbestos from a boiler house and converted it into a garage.

a. Rationale -- Clearly, the conversion of the boiler house should have been capitalized because the property was adapted to a new and different use. However, the Service

stated that the costs were capitalizable for other reasons as well.

b. Value Test --The Service stated that capitalization was required because of an increase in value in the use and capacity of the boiler house due to the elimination of the health risks which (a) created better operating conditions and prevented any further contamination of employees and lessees, (b) made the property more attractive to potential buyers, investors, lenders and customers and (c) enhanced the usefulness and capacity of the taxpayer's property by enabling the taxpayer to provide office space and a garage.

(1) The taxpayers argued that Plainfield-Union was applicable to determine an increase in value, with the proper comparison of value being the value of the asset following asbestos abatement compared with the value of the asset before asbestos was known to be a health hazard.

(2) The Service's position is that Plainfield-Union is not determinative because (i) the test only applies in situations where property has progressively deteriorated; (ii) it is impossible to value the asset prior to the existence of asbestos; and (iii) the increase in value of the equipment is attributable to subjective factors.

c. Permanent Cure -- The Service also made the argument that the removal of asbestos from the boiler house resulted in a permanent cure.

(1) According to the Service, a repair is not a permanent cure but remedies immediate consequences, citing American Bemberg Corp. v. Comm'r, 10 T.C. 361 (1948), aff'd 177 F.2d 200 (CA6 1949).

(2) This argument is weak. It is not important that the expenditures permanently remedy the dysfunction. Instead, the focus should be on whether the expenditures produce future benefit.

2. The Equipment Decision -- In this Technical Advice Memorandum, asbestos insulation was removed and replaced in manufacturing equipment.

a. Value Test -- The Service found the equipment's value to have increased by (a) decreasing the risk of liability to employees who were impacted, (b) making the property more marketable, and (c) increasing operating efficiencies related to the equipment. In addition, the Service stated that the value of the equipment was enhanced because modifications made to bring property into compliance with local regulations significantly reduced or eliminated the possibility of the

taxpayer being forced to suspend operations. See Teitelbaum v. Comm'r, 294 F.2d 541 (CA7 1961), and Hotel Sulgrave, Inc. v. Comm'r, 21 T.C. 619 (1954).

b. Permanent Cure -- The Service also determined that the removal of asbestos from the equipment resulted in a permanent cure.

c. Increased Value to Other Assets -- The Service determined that the taxpayer increased the value of its other assets because it (a) reduced the possibility of equipment interruptions due to safety violations, (b) reduced the time of ordinary equipment repair and maintenance, and (c) eliminated the need to take safety precautions when performing ordinary maintenance, which were all operating efficiencies not directly related to the operation of the equipment, citing Electric Energy, Inc. v. U.S., 87-2 U.S.T.C. ¶9587 (Cl. Ct. 1987).

B. Encapsulation -- The Service found encapsulation of exposed and damaged pipe insulation to be deductible.

1. Rationale -- The Service determined that the costs were deductible because there was no increase in value or useful life, the cure was temporary, and there was no general plan of rehabilitation.

2. The Service stated that the costs were like those incurred in Midland Empire Packing Co. v. Comm'r, 14 T.C. 635 (1950), acq., 1950-2 C.B. 3, where a concrete lining to prevent seepage of oil into the taxpayer's basement was deductible because the lining did not add value or prolong the use of the property over what it was before oil began to seep into the basement.

3. The wrapping reduced, but did not eliminate the threat of exposure to airborne asbestos fibers. The expenditures did not enable the taxpayer to operate on a changed, more efficient or larger scale.

VII. Lead Paint -- Lead paint is remediated either by scraping it off and repainting or covering it up with plaster, plywood or wallboard.

A. The treatment of the expense should be determined based on the tests set out in the Regulations under Secs. 162 and 263, I.R.C.

B. In G.C.M. 36828 (Sept. 1, 1976), the Service, in the context of analyzing whether a medical deduction was available to an individual who was protecting his children from lead poisoning, stated that scraping and painting would probably be deductible as maintenance, but that covering it up would be

capitalized because it would increase the value of the house or increase its useful life.