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The Tax Treatment of Environmental Cleanup Costs

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THE TAX TREATMENT OF ENVIRONMENTAL CLEANUP COSTS

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I. INTRODUCTION

A. Over the past two decades, businesses have faced an increasing burden of environmental regulation. In particular, under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA"), liability for cleaning up contaminated sites may attach to any potentially responsible party ("PRP").

B. In addition, businesses and landowners may be forced to incur costs to bring their property into compliance with environmental regulations -- for example, large expenses are often incurred in the removal of asbestos from buildings or equipment.

C. To date, many companies have treated environmental cleanup costs as current deductions in computing taxable income. However, in two recent Technical Advice Memoranda ("TAMs") the Internal Revenue Service (the "Service") has required taxpayers to capitalize such costs. A third TAM represents a shift by the Service towards allowing current deductions for certain environmental cleanup costs. A subsequent revenue ruling appears to have solidified this change in position.

D. Sections II and III of this outline discuss the first two recent TAMs that required capitalization of environmental cleanup costs. Section IV summarizes informal comments of the Service after these TAMs and the reactions of the private sector. Section V and VI discuss the third TAM and the revenue ruling. Section VII presents the informal comments of the Service after the revenue ruling and the reactions of the private sector. Section VIII analyzes the relevant case law, and Section IX discusses other considerations which may bear on the proper tax treatment of environmental cleanup costs.

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II. TAM 9240004 - ASBESTOS REMOVAL

A. In TAM 9240004, the taxpayer owned a manufacturing plant whose equipment was insulated with asbestos-containing materials. In response to governmental regulations covering airborne asbestos concentrations, the taxpayer decided to remove all of the asbestos-containing materials and to replace them with alternative forms of insulation. The replacement insulation was less thermally efficient than the asbestos-containing insulation which it replaced.

B. The Service concentrated on the fact that the asbestos abatement program made the taxpayer's plant more valuable by reducing or eliminating the human health risks posed by asbestos-containing insulation.

C. Plainfield-Union

1. The taxpayer argued based on Plainfield Union Water Co. v. Commissioner, 39 T.C. 333 (1962), nonacc., 1964-2 C.B. 8, that in determining if the value of property was increased by an expenditure, the proper comparison is not to the value of the property immediately before the expenditure, but rather the value of the property before the existence of the condition necessitating the expenditure.

   a. In Plainfield Union, the taxpayer, a water utility, incurred costs to clean 6,000 feet of water main and to install cement linings in the pipe.

   b. The cleaning and lining was required, in part, because the water main, installed in 1910 with tar lining, had been designed to carry well water, but in 1950 had begun to carry river water which was more acidic and hence caused "tuberculosis," which progressively reduced water flow.

   c. Rejecting the Service's contention that the expenditures must be capitalized because they increased the value of the pipe, the court noted that "any properly performed repair adds value as compared to the situation existing immediately prior to the repair. The proper test is 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." 39 T.C. at 338 (emphasis added).
2. In TAM 9240004, the Service attempted to limit Plainfield Union to facts where the expenditure was necessitated because the property progressively deteriorated over time.


   b. Both of these cases cite Plainfield Union with approval, and both involve situations where repair expenses were necessitated because of progressive deterioration, but neither indicates that the relevance of Plainfield Union was limited to such a situation.

D. Added Value

The Service relied on the fact that by removing asbestos-containing materials from its plant, the taxpayer in TAM 9240004 had increased the value of its property by bringing the plant into compliance with governmental regulations, and thus allowing the taxpayer to continue to operate its business. To support this argument, the Service cited a number of cases. Teitelbaum v. Commissioner, 294 F.2d 541 (7th Cir. 1961) (cost of converting building's electrical system from D.C. to A.C. in order to comply with city ordinance must be capitalized), cert. denied, 368 U.S. 987 (1965); RKO Theatres, Inc. v. United States, 163 F. Supp. 598 (Ct. Cl. 1958) (cost of installing new exits and fire escapes to comply with city regulations must be capitalized); Hotel Sulgrave, Inc. v. Commissioner, 21 T.C. 619 (1954) (cost of installing a sprinkler system in order to comply with order of city building department must be capitalized); Beaven v. Commissioner, 6 T.C.M. 1344 (1943) (cost of converting from oil heat to coal heat because of war-time oil conservation laws must be capitalized).

E. Repair v. Permanent Improvement

Next the Service argued that a repair is not a permanent cure, but only a remedy for immediate consequences, while section 263 requires the capitalization of any costs associated with permanent improvements or betterments.
1. In support of this argument, the Service cited American Bembera Corp. v. Commissioner, 10 T.C. 361 (1946), nonacq., 1948-2 C.B. 5, aff'd per curiam, 177 F.2d 200 (6th Cir. 1949).

2. The Service noted that in American Bembera the Tax Court had, in allowing a deduction for costs incurred to prevent cave-ins due to a geological fault, stressed that the original geological defect had not been cured, and rather that its immediate consequences had been dealt with.

F. INDOPCO

Finally, the Service cited INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039 (1992), for the proposition that capitalization was required because the removal of the asbestos-containing insulation would create benefits extending beyond the taxable year in which the costs were incurred.

III. TAM 9315004 - PCB CLEANUP

A. In TAM 9315004, the taxpayer had, prior to 1972, used PCB-containing lubricants in its machinery. At the time of such use, PCBs were not viewed as posing any risk to health or the environment.

1. As part of its maintenance routine the taxpayer removed lubricants from its machinery and disposed of them in earthen pits and trenches on its property. Because of the prior use of the PCB-containing lubricants in the machinery, this resulted in PCBs being introduced into the soil on the taxpayer’s property.

2. The EPA became aware of the presence of PCBs in the soil on the taxpayer’s property and commenced actions against the taxpayer. The taxpayer entered into an agreement with the EPA whereby it agreed to

a. Test the levels of PCBs at specific sites on its property,

b. Conduct an environmental cleanup of sites where the levels of PCBs exceeded permissible levels, and

c. Perform periodic environmental "audits" to examine and evaluate that status of its compliance with the agreement.
B. From the start, the Service took a slightly different posture in TAM 9315004 than it did in TAM 9240004, stating early on that the distinctions between current expenses and capital expenditures "are those of degree and not of kind" (quoting Welch v. Helvering, 290 U.S. 111, 114 (1933)).

C. Treas. Reg. § 1.162-4

The Service also focused more closely on the language of the regulations authorizing a deduction for repair expenses.

1. Treas. Reg. § 1.162-4 allows a deduction for "the cost of incidental repairs which neither add materially to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition."

2. From this language, the Service distilled four separate requirements, all of which must be met if the repair cost is to be deducted.

a. The repair must be incidental,

b. The cost of the repair must not materially add to the value of the property,

c. The repair must not appreciably prolong the useful life of the property, and

d. The purpose of the expenditure must be to keep the property in ordinarily efficient operating condition.

D. The "Incidental" Requirement

Although setting forth as a requirement of deductibility that repairs must be "incidental," the Service acknowledged that the cost of work performed is not dispositive. In addition, the Service stated, one must look to the nature of the work in relation to the taxpayer's operations. The Service never squarely resolved this issue in TAM 9315004, but because removal of PCBs was clearly not a core part of the taxpayer's business, and because the Service's analysis quickly moved on to other factors, it may be assumed that the Service conceded that the environmental cleanup costs were "incidental" to the taxpayer's business.
E. Addition of Material Value - The Wolfsen Case

The Service's found that the costs of cleaning up PCB contamination added material value to the taxpayer's property and hence must be capitalized. The analysis supporting this conclusion rested in large part upon its analysis of Wolfsen Land & Cattle Co. v. Commissioner, 72 T.C. 1 (1979).

1. In Wolfsen, the taxpayer undertook a systematic draglining of the ditches which constituted the irrigation system for its cattle ranch. The purpose of the draglining was to restore to original capacity ditches which had become clogged with sediment and other materials.

2. Draglining was required approximately every 10 years, but could have been avoided if the taxpayer instead had adopted a plan of annual maintenance.

3. Although acknowledging that the purpose of the draglining, i.e., restoring the property to its original operating state, was "a maintenance-type expense," the Tax Court required capitalization because "[t]o permit a current deduction of such a large expenditure with a beneficial effect lasting on the average of 10 years would surely distort that year's income." 72 T.C. at 13.

4. Instead, the Tax Court held that the expenditures created "a free-standing intangible asset with an amortizable 10-year life." Id.

5. The Tax Court's argument included a certain measure of circularity. In finally concluding that the expenses for draglining were not deductible, the court stated that "[w]e also believe that to the extent that the expenditures have the effect of replacing the previously wasted intangible created by the last draglining of the subject ditch or levee, they have a substantial impact on the value of the system, as well as producing a separate item of value." 72 T.C. at 17.

a. The Tax Court created the amortizable intangible asset to ameliorate the effect of its refusal to allow a current deduction for the draglining expenses, but it then used the existence of this asset as support for its decision to disallow the deduction in the first place.
b. Part of the problem in Wolfsen arises from the fact that there was apparently no attempt to amortize any portion of the acquisition costs of the ranch attributable to the irrigation system. Instead, it seems to have been conceded by all parties that the irrigation system had an indeterminate or infinite useful life.

c. If the irrigation system had been depreciated all along, then the Tax Court’s finding that draglining expenses restore the value previously claimed through amortization would have had support from the facts of the case. Instead, the reasoning fails, because it treats the costs as incurred to restore value, the loss of which was never claimed through any amortization allowance or other means. If, in contrast, the decline in value of the irrigation system had been claimed through depreciation deductions, it would have been more appropriate to deny a deduction for the repairs. See Treas. Reg. § 1.263(a)-1 (capitalization required for any amounts expended to restore property for which depreciation has been allowed).

F. Application of Wolfsen in TAM 9315004

1. The Service’s position

The Service likened the taxpayer’s environmental cleanup costs to the costs in Wolfsen in several respects.

a. The taxpayer failed to perform ongoing maintenance with the result that a large-scale operation was later required. In this regard, the Service was unmoved by the taxpayer’s argument that because it was unaware of the health and environmental risks posed by PCBs it could not have been expected to use an alternative means of disposal.

b. The expenditures were part of a systematic plan involving extensive remediation activities throughout the property.

c. The value of the taxpayer’s property was increased as a result of the remediation activities.
2. The taxpayer's position

The taxpayer attempted to distinguish its situation from *Wolfsen* on the grounds that in TAM 9315004 the taxpayer's equipment was operational at the time the costs were incurred, while in *Wolfsen* the costs were incurred in order to restore the irrigation system to a functioning condition.

a. The Service rejected this argument as irrelevant, citing *Blue Creek Coal, Inc. v. Commissioner*, 48 T.C.M. 1504 (1984), where a taxpayer was required to capitalize the cost of installing enclosed cabs bulldozers in order to comply with an order of the federal Mine, Health and Safety Administration.

b. In *Blue Creek Coal*, the operational state of the bulldozers was a fact relied on as support for the capitalization of the costs, the court reasoning that the work could not be a repair if the bulldozers were already fully operational before the costs were incurred.

G. Prolonging Life

The examining agent had not asserted that the cleanup costs prolonged the life of any asset, hence the TAM did not address this issue. Presumably, where cleanup costs relate to land, which is treated for purposes of the tax laws as if it has an infinite life, the Service will never assert that cleanup costs are incurred to prolong the life of the land.

H. Ordinary Operating Condition

The TAM never directly addressed the issue of whether the cleanup costs were incurred to maintain the taxpayer's property in an ordinary operating condition or for some other purpose. This issue was, however, tangentially addressed in the discussion of *Blue Creek Coal* (see above). This prong of the regulations is difficult to apply in circumstances like the PCB-cleanup involved in TAM 9315004, because the taxpayer’s property is in operating condition before the cleanup, except for restrictions imposed by governmental regulations or potential tort liability.
I. **Effect of Government Regulations**

In TAM 9315004, like in TAM 9240004, the Service also relied on the fact that the costs were incurred in order to comply with governmental regulations. In TAM 9315004, however, the Service went further, denying the taxpayer's assertion that the cited cases stood for the proposition that otherwise capitalizable expenditures do not become deductible merely because incurred as a result of governmental regulation.

J. **The Service Explicitly Rejects Plainfield Union**

The Service also signalled that it will reject any argument based on Plainfield Union, stating that "if the Plainfield Union 'increase in value' test was the only factor used in determining whether an expenditure should be categorized as a deductible repair or capital expenditure, then any replacement of a capital asset would also be deductible. We do not believe, especially in light of the Tax Court's more recent decision in Wolfseen, that the court intended such a narrow application of the inquiry into value."

K. **Plan of Rehabilitation**

Having already determined that it did not consider the taxpayer's expenditures in TAM 9315004 to constitute deductible repairs, the Service went further and buttressed its conclusion through its analysis of the "plan of rehabilitation" doctrine.

1. Stated simply, the "plan of rehabilitation" doctrine, a judicially created rule, provides that costs otherwise deductible as repairs must be capitalized if they are undertaken as part of a general plan of rehabilitation. The doctrine has its genesis in Cowell v. Commissioner, 18 B.T.A. 997, where costs incurred in the rehabilitation of a hotel, including rewiring, replumbing, replacing a roof and windows, and painting were held to be capital expenditures. Although any of the costs, if incurred alone, may have been deductible, the court held that the determination of deductible repair vs. capital expenditure depends on "whether it is part of the entire capital investment in the improved property." 18 B.T.A. at 1002.

2. Whether a systematic series of repairs constitutes a plan of rehabilitation generally depends upon the facts and circumstances of each case. Wehrli v. United States, 400 U.S. 686 (10th Cir. 1968).
a. Many of the cases finding that repairs are undertaken pursuant to a plan of rehabilitation and thus must be capitalized involve plans to rehabilitate run-down buildings. See e.g., Jones v. Commissioner, 24 T.C. 563 (1955), aff'd, 242 F.2d 616 (5th Cir. 1957); Home News Publishing Co. v. Commissioner, 18 B.T.A. 1008 (1930).

b. Furthermore, many of these cases involved buildings which were acquired in their dilapidated state, and thus the repair costs could be viewed as a form of additional acquisition cost and hence more clearly capital in nature. Id.

c. In general, prior to a finding that the plan of rehabilitation doctrine applies to require the capitalization of the costs of repairs, courts also find that the overall improvement to the taxpayer's property is of a kind which would otherwise meet the requirements of capitalization under section 263. See e.g., Mountain Fuel Supply Co. v. United States, 449 F.2d 816 (10th Cir. 1971) (expenses incurred in reconditioning pipeline must be capitalized where they "substantially prolonged the life" of the affected pipe); Jones v. Commissioner, supra (the results of the plan were "tantamount to new construction 'more like the reconstruction of a building gutted by fire than ordinary repairs to old apartments.'").

d. In this context, the distinction between repairs and a plan of rehabilitation requiring capitalization has been described as the difference between "keeping" an asset in good condition and "putting" it in good condition. Moss v. Commissioner, 87-2 U.S.T.C. ¶ 9590 (10th Cir. 1987); Mountain Fuel Supply Co. v. United States, supra.

(1) Although cited by a number of commentators in support of the current deductibility of cleanup costs, it seems this formulation of the test may often point in favor of capitalization.

(2) In the case of cleanup costs, as opposed to waste treatment costs or other preventive measures, it seems that the costs are indeed incurred to "put" the taxpayer's property in good condition.
3. Because of the long-term nature and broad scope of the taxpayer's cleanup in TAM 9315004, and because of the benefits which would flow from the cleanup, the Service concluded that the cleanup project constituted a general plan of rehabilitation, the costs of which must be capitalized.

L. Legal Fees and Other Costs

TAM 9315004 also considered the treatment of legal fees and the costs of the "environmental audit" incurred in connection with the cleanup of the taxpayer's PCB contaminated land.

1. With regard to legal fees, the Service concluded that the costs were not incurred to create or enhance an asset or to produce a long-term benefit, but rather to protect the taxpayer's business by defending it against claims, and securing its contractual rights with insurers. Hence, the legal fees were currently deductible.

2. The taxpayer also incurred "oversight costs" in connection with its cleanup operations. These costs were not clearly described in the TAM, but because they were described as "incurred pursuant to the plan of rehabilitation" the Service concluded that the costs must be capitalized.

3. Finally, the taxpayer incurred "environmental audit" costs in connection with the identification of contaminated sites and the monitoring of such sites once they were identified. The TAM concluded that the proper tax treatment of such costs required further factual development.

M. Treatment of Capitalized Costs

Despite the fact that the costs incurred by the taxpayer in TAM 9315004 related primarily to soil remediation and thus might be expected to be capitalized into the cost of the taxpayer's land, the Service allowed the taxpayer to add such costs to the depreciable basis of its equipment. This result has been criticized by at least one Treasury Department official who described it as the Service trying to be "nice." See 60 Tax Notes 926 (Aug. 16, 1993) (Robert Kilinskis speaking at an August 6, 1993 meeting of Regulated Public Utilities Committee the ABA Tax Section).
IV. AFTERMATH OF THE TWO TAMs

A. The Service's Study and the Five Factors

1. Following the issuance of the two TAMs, the Service announced plans to study the tax treatment of environmental cleanup costs in greater depth. At that time, the Service identified five factors which it considered to be of relevance in determining whether cleanup costs should be deducted or capitalized. See 59 Tax Notes 1408 (Mar. 15, 1993) (Stuart R. Brown speaking at a March 9 meeting of the Federal Bar Association Tax Section).

   a. Whether the costs relate to the creation of new property or to the cleaning up of existing property;

   b. Whether the property on which the cleanup is performed is owned by the taxpayer;

   c. Whether the property on which the cleanup is performed will produce future income;

   d. Whether the problem necessitating the cleanup was present when the property was acquired by the taxpayer or if it arose in the course of the taxpayer’s business; and

   e. Whether the expenditure is voluntary or is involuntarily imposed by a governmental order.

2. More recently, Service officials have indicated that this list was merely preliminary and that any final guidance would likely include additional factors and might not include all the factors listed above.

B. Private Sector Reaction

1. In early March of 1993, at the time it announced the five factors that it considered to be of relevance in determining whether cleanup costs should be deducted or capitalized, the Service asked practitioners for responses to its proposed factors and comments as to whether the factors should be developed in the form of guidance (such as a published ruling) or whether the Service should decide the issue on a case by case basis (through technical advice and private rulings).
2. Not surprisingly, the comments received have generally requested published guidance which would provide that cleanup costs are currently deductible in most circumstances.  

a. In particular, it has been suggested that the Service adopt a bright-line test under which a taxpayer would always be permitted to deduct costs incurred in connection with a cleanup of property not owned by the taxpayer (e.g., cleanup costs incurred as a PRP in connection with a Superfund site).

b. Many commentators have argued strongly that deductibility results in a more appropriate matching of income and expense than does capitalization. This is particularly the case, the commentators argue, where the environmental problem arose from the taxpayer's operations and thus can clearly be linked to previously earned income (see above).

c. A number of commentators have suggested as an exception to a general rule of deductibility, however, the case where costs are incurred to remediate recently purchased property where the necessity of cleanup activities was known and taken into account in the negotiation of the purchase price.

d. Commentators have, in general, rejected as irrelevant the Service's suggestion that the voluntary or involuntary nature of the cleanup costs be considered in determining if the costs should be capitalized or deducted.

(1) The commentators note that case law generally states that whether a particular cost is incurred pursuant to governmental regulation does not determine if the cost should be deducted or capitalized. See, e.g., Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345 (1971).

(2) Furthermore, it may be argued, the adoption of a rule providing that voluntary payments are more likely to be capitalized would discourage taxpayers from voluntary compliance with cleanup laws, while a rule that involuntary payments are more likely to be capitalized would penalize taxpayers for attempting to assert their rights in court. Neither of
the results would be desirable from an environmental policy standpoint.

V. TAM 9411002 - ASBESTOS ABATEMENT

A. In TAM 9411002 (Nov. 19, 1993), the taxpayer owned (i) a boiler house with asbestos-laden equipment and (ii) a warehouse with exposed or damaged asbestos-containing pipe insulation. The boiler house equipment had originally heated the warehouse, but the equipment was no longer in use. In order to secure a bank loan, the taxpayer (i) removed all asbestos-containing materials located within the boiler house and (ii) encapsulated the exposed or damaged asbestos-containing pipe insulation in the warehouse (which involved less than 25% of the warehouse's pipes). The taxpayer subsequently converted the boiler house into garage and office space.

B. The Service required capitalization of equipment removal costs, but it allowed a deduction for the pipe encapsulation costs.

C. Equipment Removal Costs - Capitalization Required

1. Added Value

The Service applied the test of Plainfield Union Water Co. v. Commissioner, 39 T.C. 333 (1962), nonacq., 1964-2 C.B. 8. The Service found that, in contrast to the facts in Plainfield Union, the costs incurred by the taxpayer to remove the asbestos-containing materials "increased the value, use, and capacity of the taxpayer's property as compared to the status of its property in its original asbestos-containing condition."

a. The expenditures added value in three respects:

(1) The expenditures permanently eliminated the health risks created by the presence of asbestos in the boiler house, thereby improving operating conditions and preventing future contamination of employees or lessees.

(2) The expenditures made the property "significantly more attractive to potential buyers, investors, lenders, and customers."
(3) The expenditures enabled the taxpayer to convert the boiler house into office space and a garage, thereby "adapt[ing the] property to a new or different use." Treas. Reg. § 1.263(a)-1(b)(2).

b. In distinguishing the situation from Plainfield Union, the Service noted that in its original condition, the taxpayer's property contained the asbestos-laden equipment: "the costs incurred to remove asbestos from the taxpayer's boiler house did not return the property to the state that it was in before the condition necessitating the expenditures arose." By contrast, in Plainfield Union, the tuberculation of the pipes' lining (which necessitated the deductible expenditures) developed after the taxpayer had installed the pipes.

2. Intermediate vs. Permanent Consequences

In TAM 9411002, the Service also emphasized the permanent nature of the remediation.

a. By removing the asbestos-laden equipment, the taxpayer physically altered the property, thereby permanently eliminating the defect in the boiler house.

b. The Service relied on American Bemberg Corp. v. Commissioner, 10 T.C. 361, 377 (1946), nonacq., 1948-2 C.B. 5, aff'd per curiam, 177 F.2d 200 (6th Cir. 1949) (allowing the taxpayer to deduct costs incurred to prevent cave-ins due to a geological fault and stressing that the taxpayer had not cured the original geological defect, but had dealt with the intermediate consequences) and Plainfield Union, 39 T.C. 333, 338 (allowing the taxpayer to deduct the costs of cleaning and re-lining its pipes and emphasizing that the new lining temporarily eliminated a maintenance problem, but that it "was not a permanent addition to the pipe").

D. Encapsulation Costs - Deduction Allowed

1. Incidental Repair Costs

The Service found that the costs incurred to encapsulate the damaged pipe insulation were incidental repair costs that neither increased the value nor prolonged the useful life of the
taxpayer's property beyond what it was before the asbestos-containing pipe insulation became damaged.

a. In support of this conclusion, the Service cited Midland Empire Packing Co. v. Commissioner, 14 T.C. 635 (1950), acq., 1950-2 C.B. 3 (allowing the taxpayer to deduct as a repair expense the cost of concrete lining designed to prevent oil seepage).

b. The Service noted that in Midland Empire, the Tax Court had specifically noted that the expenditure "merely served to keep the property in an operating condition over its probable useful life for the purpose for which it was" intended. Midland Empire, 14 T.C. at 641.

c. The Service explained that the encapsulation reduced, but did not eliminate, the threat of exposure to asbestos, and that because of the continued presence of asbestos, the property was not adaptable to a new or different use.

2. Intermediate Consequences

Citing American Bemberg, 10 T.C. at 377, the Service found that because the asbestos was not permanently removed from the warehouse, the encapsulation had only temporary effect and thus dealt with "intermediate consequences."

a. The taxpayer will have to monitor asbestos levels and to re-encapsulate or remove insulation that becomes worn or damaged. See American Bemberg, 10 T.C. at id. (noting the required continuance of the inspection program).

b. The continued existence of asbestos in the warehouse poses the same threat to the efficient operation of the warehouse (caused by potential exposure to asbestos) that existed before the taxpayer undertook the encapsulation project. See id. (noting that the original defect still exists).

3. No Plan of Rehabilitation

In TAM 9411002, the Service recognized that while some courts have denied deductions for "incidental repairs" where the repairs were actually part of a significant improvement program, the encapsulation
expenditures were truly incidental repairs. The Service cited Mountain Fuel Supply Co. v. United States, 449 F.2d 816, 822 (10th Cir. 1971), Wolfsen Land & Cattle Co. v. Commissioner, 72 T.C. 1, 17 (1979), and Niagara Mohawk Power Corp. v. United States, 558 F.2d 1379 (Ct. Cl. 1979).

a. In Niagara Mohawk, the Tax Court allowed a deduction for the costs of clamping joints that were leaking even though, at the same time, the taxpayer also clamped non-leaking joints as a form of preventive maintenance. The Tax Court explained that it was more cost effective to clamp all the joints once the taxpayer had excavated down to the pipeline that contained leaking joints. Niagara Mohawk, 558 F.2d at 1383.

b. The Tax Court in Niagara Mohawk found that the number of joints clamped constituted a small percentage of the system's total joints. Id. at 1389.

c. Similarly, in TAM 9411002, the Service found that the encapsulation activities were "incidental in relation to the taxpayer's overall operations" because the encapsulation only involved damaged areas of pipe insulation, and a significant number of pipes containing asbestos insulation remained unencapsulated.

E. Depreciation Period

The Service also determined that the applicable depreciation period for the capitalization of costs associated with the asbestos removal from the boiler house was 31.5 years.

1. The Service stated that the expenditures should be considered "nonresidential real property" for the purpose of ascertaining the applicable recovery period under § 168(c)(1).

2. As nonresidential real property, the expenditures had a depreciable life of 31.5 years. (As a result of the enactment of the Omnibus Budget Reconciliation Act of 1993, the depreciation period for nonresidential real property is 39 years).
F. Criticism of TAM 9411002

From a tax policy perspective, commentators have criticized TAM 9411002 as encouraging taxpayers to create temporary fixes to environmental hazards instead of permanently solving the problem. See, e.g., Lester Drucker, Special Report: IRS Continues Flawed Analysis of Treatment of Environmental Cleanup Costs: TAM 9411002, 63 Tax Notes 5 (1994).

VI. REVENUE RULING 94-38 - SOIL REMEDIATION AND GROUNDWATER TREATMENT

A. The facts of Rev. Rul. 94-38, 1994-25 I.R.B. 4, are as follows: A taxpayer owned a manufacturing plant that discharged hazardous waste. The taxpayer had buried this waste on its land, which had not been contaminated when the taxpayer purchased it in 1970. In response to environmental requirements, the taxpayer began to remediate the soil and groundwater, and to construct groundwater treatment facilities.

B. The Service reversed its position in TAM 9315004, and allowed the deduction of costs incurred to remediate the contaminated soil and groundwater (other than the costs to construct the groundwater treatment facilities). The Service required capitalization of the costs of constructing groundwater treatment facilities.

C. Soil and Groundwater Remediation - Deduction

1. Plainfield Union Test

   a. The Service stated that the appropriate test for determining whether these particular expenditures added value to the property was stated in Plainfield Union, 39 T.C. at 338 (comparing the status of the asset after the expenditure to the status of the asset "prior to the condition necessitating the expenditure").

   b. Applying this test, the Service found that these expenditures did not increase the property's value because the taxpayer "merely restored its soil and groundwater to their approximate condition before they were contaminated" by the hazardous waste from the manufacturing operations.
2. **Section 263 and Treasury Regulation Section 1.263(a)-(1)**

In allowing the deduction, the Service stated that neither § 263 nor Treas. Reg. § 1.263(a)-1 would deny the deduction.

a. Treas. Reg. § 1.263(a)-1 disallows deductions for "permanent improvements or betterments made to increase the value of any property." This includes amounts paid "to add to the value, or substantially prolong the useful life, of property owned by the taxpayer . . . or to adapt the property to a new or different use."

b. Echoing the language of this regulation, the Service found that the expenditures at issue

   (1) do not produce permanent improvements;

   (2) do not prolong the useful life of the land; and

   (3) do not adapt the land to a new or different use.

c. In a remark perhaps suggesting that the Service will approach expenditures to clean up contaminated land differently than expenditures to solve other environmental problems, the Service additionally recognized that "since the land is not subject to an allowance for depreciation, amortization, or depletion, the amounts expended to restore the land to its original condition are not subject to capitalization under § 263(a)-2."

3. **INDOPCO**

The Service also referred to the future benefits test articulated in **INDOPCO, Inc. v. Commissioner, 112 S.Ct. 1039, 1044-45 (1992)**, and found that the expenditures do not provide significant future benefits.

4. The Service stated that the outcome would be the same regardless of whether the taxpayer continued manufacturing operations that discharge hazardous waste, or discontinued those operations and held the land in an idle state.
D. **Groundwater Treatment Facilities - Capitalization**

Both the direct construction costs and an allocable portion of the indirect construction costs of the groundwater treatment facilities must be capitalized.

1. Because these facilities were designed to extract, treat, and monitor contaminated groundwater, they have a useful life substantially beyond the taxable year in which they are constructed. Treas. Reg. § 1.263(a)-2(a).

2. The construction of the facilities constitutes "production" under § 263A(g)(1).

E. **Modification of Revenue Ruling 88-57**

The Service also modified Rev. Rul. 88-57 to the extent that the earlier ruling implied that the increase in value test of Plainfield Union can only be used when there is sudden and unanticipated damage to an asset.

VII. **AFTERMATH OF THE REVENUE RULING**

A. **Reversal of Service Position in TAM 9315004**

By allowing the deduction of soil remediation expenditures, Rev. Rul. 94-38 effectively reverses the Service's position in TAM 9315004 (requiring the capitalization of expenditures to remove PCBs introduced into the soil by the taxpayer's operations).

B. **Remarks by the Service**

1. **Rev. Rul. 94-38 Limited to the Facts**

   According to at least one government official involved in the drafting of Rev. Rul. 94-38, the ruling is limited to land remediation expenditures in situations where the taxpayer caused the damage. See remarks of Merrill D. Feldstein at an August 6, 1994, meeting of the American Bar Association Tax Section (published in Tax Analysts' Highlights & Documents, Aug. 9, 1994; available electronically at 94 TNT 155-6).

   a. The ruling does not apply to several situations still under study, including the following:
(1) asbestos abatement;
(2) removal of storage tanks;
(3) cleanup of preacquisition contamination; and
(4) costs incurred in cleaning up property before selling it.

b. For other issues, the Service is taking a "wait and see" approach, postponing further guidance until Rev. Rul. 94-38 prompts some well-defined reactions.

2. Rev. Rul. 94-38 Applies Broadly To Contaminated Land Situations

a. Shortly after the ruling was released, Treasury stated that it expected the ruling to have "broad applicability" for situations involving contaminated land. See Environmental Cleanup Revenue Has 'Broad Applicability,' Official Says, BNA Daily Tax Report for Executives, no. 109, at G-7 (June 9, 1994) (remarks of Robert Kilinskis).

(1) The ruling applies to contaminated land that the taxpayer both owns and does not own.

(2) The ruling applies across a wide variety of industries, including public utilities and retailers.

b. The future breadth of the application of Plainfield Union will determine whether the ruling will apply to the cleanup of a combination of preacquisition and postacquisition contamination.

C. Private Sector Reaction

1. The private sector has generally applauded the outcome of the revenue ruling. The ruling is sound from a tax policy perspective because it encourages voluntary environmental cleanup -- at least with respect to contaminated soil -- by reversing the Service's position in TAM 9315004 (expenditures to remediate soil contaminated with PCBs must be capitalized).

2. Extension to Asbestos

Commentators have requested guidance indicating that the ruling extends to asbestos remediation costs. However, the Service has stated that
asbestos remediation is still under study and thus is not covered by the ruling.

3. **Certain Factors May No Longer Be Dispositive**

a. While there has been disagreement among the commentators, some have suggested that the Service also overruled TAMs 9240004 and 9411002 by applying the increase in value test of *Plainfield Union*, which the Service had rejected in the two TAMs. At a minimum, the Service may have implicitly abandoned certain factors that were significant in the two TAMs.

(1) Rev. Rul. 94-38 does not acknowledge that cleanup activities add value to the property because they decrease health risks and thus reduce the taxpayer's potential liability for hazardous working conditions. See TAMs 9411002, 9240004.

(2) The ruling does not mention that soil remediation will make the property more attractive to potential buyers, investors, and lenders. See TAM 9411002.

(3) The ruling does not employ a "general plan of rehabilitation" analysis. See TAM 9411002.

(4) The ruling does not address the significance of compliance with government regulations, as opposed to voluntary environmental cleanup. See TAM 9240004.

4. **Land vs. Other Property**

a. Commentators have suggested that Rev. Rul. 94-38 should be interpreted as applying only to land remediation because the *Plainfield Union* increase in value test cannot be extended to property such as asbestos.

(1) In *Plainfield Union*, 39 T.C. at 338, the Tax Court compared the value of the asset after the remediation with the "status of the asset prior to the condition necessitating the expenditure."
(2) Because property containing asbestos is originally constructed with the asbestos, it is arguably impossible to determine the value of the property before "the condition necessitating the expenditure." See 64 Tax Notes 338 (July 18, 1994).

b. Other commentators have stated that Plainfield Union can apply to asbestos remediation by treating the "status of the asset prior to the condition necessitating the expenditure" as the value of the asset before the discovery that asbestos is hazardous.

c. A factor that may cut in favor of current deductions for land remediation, but not for other property, is that the taxpayer cannot take advantage of any amount capitalized until the property is sold. In TAM 9315004, the Service may have taken into account this hardship when it allowed the taxpayer to add the costs of the PCB cleanup to the depreciable basis of its equipment.

5. Commentators have suggested that Rev. Rul. 94-38 was as much a result of political pressure to allow the current deduction of environmental expenditures as a reasoned analysis of the law.

D. Questions That Remain Open

In addition to the subjects still under study, see supra, Rev. Rul. 94-38 leaves other questions open.

1. A Treasury official has stated that the ruling does not apply to lead paint removal. See Environmental Cleanup Revenue Has 'Broad Applicability,' Official Says, BNA Daily Tax Report for Executives, no. 109, at G-7 (June 9, 1994) (remarks of Robert Kilinskis).

2. The ruling does not address whether the taxpayer must own the land being remediated.

3. The ruling does not address whether the cleanup must be voluntary.

4. Commentators have raised the example of monitoring wells to suggest that in certain situations, Rev. Rul. 94-38 might produce two conflicting results. Monitoring wells are less elaborate structures than groundwater treatment facilities. Arguably,
the purpose of installing monitoring wells is to facilitate groundwater testing, not to improve the property. However, the Service could treat the costs either like the soil remediation expenditures or like the costs of constructing the water treatment facility.

VIII. THE COURTS' TREATMENT OF EXPENDITURES THAT RELATE TO LAND OR THE ENVIRONMENT

A. Environmental Cases

1. Woolrich Woolen Mills

In Woolrich Woolen Mills v. United States, 289 F.2d 444 (3rd Cir. 1961), the taxpayer was engaged in a manufacturing process which resulted in the discharge, directly into a public stream, of a large quantity of water containing dyes and woolen fibers.

a. Following tightening of Pennsylvania's environmental laws, the Sanitary Water Board directed the taxpayer to discontinue all discharge of water or to submit satisfactory plans for the treatment of the water so as to eliminate the pollution elements from the water.

b. In order to satisfy the Sanitary Water Board, the taxpayer planned and constructed a water filtration plant.

c. The taxpayer claimed that the cost of constructing the filtration plant was deductible because it was necessary to save the life of the business.

d. The government argued, and the court agreed, that because the filtration plant had a useful life in excess of one year the cost of construction must be a non-deductible capital expenditure.

e. Finally, the court rejected the taxpayer's assertion that the expenditures did not add any value to the taxpayer's property.

2. Midland Empire Packing

a. In Midland Empire Packing Co. v. Commissioner, 14 T.C. 635 (1950), the taxpayer was a meat packing company whose base-
ment was used for the curing of hams and bacon and the storage of meat and hides.

b. The basement rooms were not sealed against water, and had historically been subject to seepage which did not interfere with the use of the rooms for their intended purpose.

c. In 1943, the taxpayer found that oil was seeping into the groundwater in its area from an oil refinery located 300 yards upgrade from the taxpayer's plant. When this water seeped into the basement storage rooms it created a fire hazard and made the rooms unusable; federal meat inspectors directed the taxpayer to oilproof the basement or to shut down its plant.

d. In order to preserve its operations, the taxpayer hired a contractor to add concrete linings to the basement in order to seal it against oil.

e. In finding the costs of oilproofing to be deductible, the court focused on the fact that the expenses "did not add to the value or prolong the expected life of the property over what they were before the event occurred which made the repairs necessary." 14 T.C. at 641. In this regard, the court laid the groundwork for its later decision in Plainfield Union.

B. Cases relating to land but not directly to the environment

Additional insight into the factors which should control the tax treatment of environmental cleanup costs may be found from an analysis of a variety of cases dealing with costs incurred with respect to land used by the taxpayer in its trade or business.

1. American Bemberg

In American Bemberg, supra, the taxpayer incurred sizable costs to prevent future cave-ins after it was discovered that its factory had been built on a geological fault.

a. At the time the plant was built the taxpayer did not know of, nor did it have reason to know of, the existence of the fault.
b. After a number of cave-ins, additional geological testing revealed the existence of the fault, and the taxpayer was informed that it must undertake a large-scale program of drilling and grouting to prevent future cave-ins or else abandon its plant. Having received this advice, the taxpayer chose to undertake the program necessary to preserve its plant.

c. The court found that "the purpose [of the program] was not to improve, better, extend or increase the original plant, nor to prolong its original useful life. . . . the purpose of the expenditures was to enable petitioner to continue the plant in operation not on any new or better scale, but on the same scale and, so far as possibly, as efficiently as it had operated before." 10 T.C. at 376.

d. Furthermore, the court noted that "[i]n connection with the physical nature of the work, the drilling and grouting was not a work of construction, nor the creating of anything new." Id.

e. The court also quoted with approval from Buckland v. United States, 66 F. Supp. 681 (D. Conn. 1946), where it was stated that "[t]he government’s contention appears to be that repairs are only those mendings of the fabric which recur year by year. This is not consistent with the meaning given ‘ordinary and necessary’ in Welch v. Helvering, 290 U.S. 11."

2. Collingwood

In Collingwood v. Commissioner, 20 T.C. 937 (1953), the taxpayer incurred costs in terracing his farms to prevent the loss of topsoil from water erosion. The tax court found that the terracing "did not increase the value of the land or its products"; was undertaken "for the purpose of maintaining the farms in an ordinarily efficient condition for carrying on the kind of farming which had been followed before the terracing was done; and was for preserving the normal productivity of the farm lands." The court concluded that "[e]xpenditures for such purposes are not capital in nature." 20 T.C. at 942-43.
3. **Mt. Morris Drive-In**

In contrast to Collingwood, the Tax Court required the taxpayer in Mt. Morris Drive-In Theatre v. Commissioner to capitalize costs incurred in constructing a drainage system for its land. Crucial to the court's decision was its finding that "it was obvious at the time when the drive-in theater was constructed that a drainage system would be required . . . until this was accomplished, petitioner's capital investment was incomplete." 25 T.C. 272, 275 (1955), aff'd, 238 F.2d 85 (6th Cir. 1956).

**IX. MATCHING OF INCOME AND OTHER CONSIDERATIONS**

A. As a general matter, proper tax accounting requires a matching of items of income with associated items of expense. The purpose of the capitalization rules is, in large part, to ensure this result. See INGPOCO, Inc. v. Commissioner, 112 S. Ct. 1039, 1043 (1992).

1. Two of the factors under consideration by the Service appear to relate, at least in part, to this principle.

   a. Whether the property on which the cleanup is performed will produce future income; and

   b. Whether the problem necessitating the cleanup was present when the property was acquired by the taxpayer or if it arose in the course of the taxpayer's business.

2. In a great number of cases, these factors will likely point in opposite directions; i.e., the property will produce future income (militating in favor of capitalization) but the problem will have arisen in the course of the taxpayer's business (militating in favor of deductibility).

B. **Financial Accounting**

Abstract No. 90-8 of Emerging Issues Task Force of the Financial Accounting Standards Board addresses the treatment of environmental cleanup costs for financial accounting purposes, and finds in general such costs should be treated as current expenses.

1. An exception to the general rule of expensing is provided where
28

a. The costs incurred extend the life, increase the capacity, or improve the safety or efficiency of property owned, when compared to the condition of the property when originally constructed or acquired;

b. The costs are incurred to prevent or mitigate environmental contamination from future operations and activities; or

c. The costs are incurred in preparing for sale property that is currently held for sale.

2. Treas. Reg. § 1.446-1(a)(2) provides that "a method of accounting which reflects the consistent application of generally accepted accounting principles . . . will ordinarily be regarded as clearly reflecting income." This is because GAAP, like the rules for income tax accounting is, in general, concerned with the proper matching of items income with the associated items of expense.

a. Where the condition necessitating an environmental cleanup is the result of the taxpayer's past business activities, the costs of the cleanup are most properly attributable to previously earned income. This is especially true where the condition could have been prevented through additional expenses in the past. In such a situation, it can be argued, the taxpayer's past income was artificially inflated because the costs associated with its business activities were not taken into account at the time the associated income was recognized. However, under a system of annual accounting it is not possible to go back and change the taxpayer's income for those prior years. In the absence of such treatment, the best matching is achieved through allowing a current deduction for environmental cleanup costs.

b. This reasoning, obviously, does not apply where the condition necessitating the cleanup is not a result of the taxpayer's past business activities.

c. **Uniform Capitalization Rules**

The uniform capitalization rules of section 263A require the capitalization of any costs incurred with respect to real or tangible personal property produced by the taxpayer. Treas. Reg. § 1.263A-1T(a). These rules may prevent a formidable barrier to the deduction
of cleanup costs where the creation of tangible property is part of the plan of remediation.

D. Relevance of Prior Depreciation

Regulations under section 263 provide that capitalization is required for any amount expended in restoring property for which an allowance has been made in the form of depreciation. Treas. Reg. § 1.263(a)-1.

1. Although this provision will generally not be directly applicable to environmental cleanup costs (because such costs are not generally incurred to "restore" losses which have previously been accounted for through depreciation), it serves as an additional indication that the concept of "matching" is of paramount importance in determining the correct treatment of cleanup costs.

2. Where a taxpayer has already claimed the benefit of a tax deduction for depreciation (or from a loss deduction upon the retirement of an asset), it is clearly correct to deny a deduction for expenditures incurred in restoring or replacing the asset in question.

3. Where in contrast, no such benefit has been realized, deductibility is a much more reasonable result. In this regard, cleanup costs incurred to restore the value of nondepreciable land are qualitatively different from costs that are incurred to restore or replace depreciated equipment.

4. Taxpayers may be able use this argument to rebut the Service's assertion in TAM 9315004 that "if the Plainfield Union 'increase in value' test was the only factor used in determining whether an expenditure should be categorized as a deductible repair or capital expenditure, then any replacement of a capital asset would also be deductible."

E. Reclamation Costs

The tax treatment of reclamation expenses incurred to restore strip-mined land to its original condition are somewhat analogous to environmental cleanup costs and can be used to support current deductibility.

1. Like environmental remediation costs, reclamation expenses are often incurred pursuant to state or federal laws, the purpose of which are to ensure that land is not permanently damaged by industrial or commercial use.
2. The Service and taxpayers have frequently clashed over the timing of deductions for reclamation expenses -- taxpayers claiming that deductions may be claimed at the time that the mining occurs by setting up a reserve, and the Service arguing that no deduction is allowable prior to actually incurring the cleanup costs. See e.g., Denise Coal Co. v. Commissioner, 271 F.2d 930 (3rd Cir. 1959); Harrold v. Commissioner, 192 F.2d 1002 (4th Cir. 1951); Ohio River Collieries Co. v. Commissioner, 77 T.C. 1369 (1981).

3. However, it has apparently never been challenged that the costs need not be capitalized into the basis of the land.

F. Environmental Policy

Sound environmental policy indicates that the tax treatment of environmental cleanup costs should not provide taxpayers with a disincentive to undertaking environmental remediation. In general, allowing a deduction for cleanup costs will encourage more voluntary compliance with environmental laws. In particular, as noted in IV.B.2.d, above, it would be particularly bad environmental policy to adopt a rule that ties the deductibility of cleanup costs to whether the costs are incurred voluntarily or involuntarily.