COMMENTS

Explaining Environmental and Tax Policy Incongruity Twenty-Five Years Later: Treatment of Environmental Remediation Costs Imposed by CERCLA Under the Internal Revenue Code

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I. INTRODUCTION

As the twenty-fifth anniversary of the enactment of the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) approaches, the Internal Revenue Code's (Tax Code) treatment of remediation expenses imposed by CERCLA as deductible or subject to capitalization remains uncertain. The Internal Revenue Service (Service) has not been silent on the issue, however. Over the past two decades, the Service has intermittently issued Technical Advice Memoranda, Private Letter Rulings,[1] and Revenue Rulings, most notably in the mid-1990s and most recently in 2004. The various tests applied by the Service to determine whether deduction or capitalization is appropriate, coupled with its periodic pronouncements, have resulted in incongruent treatment of cleanup costs. The tests reflect the conflict between the environmental policy—to promote voluntary environmental cleanup, and the tax policies—to raise revenue and match income to related expenses. The need to reconcile the environmental and tax policies to achieve uniform treatment under the Tax Code is especially significant in light of the broad liability imposed by CERCLA.

It is worth noting that, as part of the Taxpayer Relief Act of 1997, Congress enacted section 198 to "encourage the cleanup of contaminated sites, as well as to eliminate uncertainty regarding the appropriate treatment of environmental remediation expenditures for Federal tax law purposes."[2] An elective provision, section 198 authorizes a taxpayer to currently deduct *qualified environmental remediation costs*.[3] Qualified environmental remediation costs are expenditures "otherwise chargeable

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1. Internal Revenue Service (IRS) Technical Advice Memoranda and Private Letter Rulings may not be cited as precedent; rather, they constitute mere advice from the Service relating only to the particular instance and particular facts at hand. However, they are helpful as planning devices. *See* 26 I.R.C. § 6110(k)(3) (2000).
2. JOINT COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997 135 (Comm. Print 1997).
3. 26 I.R.C. § 198 (emphasis added).

to a capital account" and "paid or incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site."[4] Although hazardous substances are defined with reference to CERCLA,[5] section 198 specifically excludes remediation costs imposed by CERCLA,[6] thereby limiting the scope of section 198 to brownfields.[7]

Congress has failed to enact a similar provision relating to cleanup costs imposed by CERCLA. Moreover, the express exclusion of CERCLA sites from section 198 and the conference report concerning the Taxpayer Relief Act of 1997 make it difficult to analogize section 198 to environmental remediation costs imposed by CERCLA. According to the conference report, "providing current deductions for certain environmental remediation expenditures . . . creates no inference as to the proper treatment of other remediation expenditures not described in the agreement."[8]

This Comment examines the treatment and tax consequences of CERCLA cleanup costs in the context of both environmental and tax policy objectives. Part II explains the environmental considerations and liability involved in CERCLA. Part III discusses deduction and capitalization as well as the corresponding tax policy. Part IV considers the potential tax consequences of environmental remediation costs under the Tax Code according to prior pronouncements by the Service. The Comment concludes, in Part V, by proposing a solution to the current dilemma that harmonizes the environmental and tax policies.

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4. *Id.* § 198(b)(1).

5. Hazardous substance is defined as "any substance which is a hazardous substance as defined in section 101(14) [of CERCLA] and any substance which is designated as a hazardous substance under section 102 of [CERCLA]." *Id.* § 198(d)(1). Section 198(d)(2) of the Internal Revenue Code (I.R.C.) specifically excepts from the definition "any substance with respect to which a removal or remedial action is not permitted under section 104 of [CERCLA] by reason of subsection (a)(3) thereof." *Id.* § 198(d)(2).

6. Pursuant to section 198(c)(2), "any site which is on, or proposed for, the national priorities list under section 105(a)(8)(B)" of CERCLA cannot attain qualified contaminated site status. *Id.* § 198(c)(2).

7. Brownfields are certified to be located within a targeted area by a state environmental agency and actually or potentially contain a hazardous substance. *See* Small Business Liability Relief and Brownfields Restoration Act, Pub. L. No. 107-118, 115 Stat. 2356 (codified at 42 U.S.C. §§ 9601-9675 (2000)).

8. H.R. CONF. REP. NO. 105-220, at 488 (1997).

II. ENVIRONMENTAL POLICY CONCERNS UNDER CERCLA AND SARA[9]

A. CERCLA

True to its name, CERCLA is a comprehensive environmental measure. Congress enacted CERCLA "to reduce and eliminate threats to human health and the environment posed by hazardous waste."[10] To carry out this purpose, CERCLA created a response program to identify, assess, and clean up hazardous waste sites[11] as well as a trust fund (Superfund) to enable the government to pay for costs incurred in the aforementioned actions.[12] CERCLA's far-reaching objectives are most readily apparent from its scope.

CERCLA imposes liability on any person for costs associated with the cleanup of a site where there has been an actual release or a threat of release of a hazardous substance from a facility.[13] Person is broadly defined and includes "an individual, firm, corporation, association, partnership, consortium, joint venture, commercial entity, United States Government, State, municipality, commission, political subdivision of a State, or any interstate body."[14] A release is "any spilling, leaking, pumping, pouring, emitting, emptying, discharging, injecting, escaping, leaching, dumping or disposing."[15]

CERCLA defines hazardous substance with reference to an express list of substances in section 102 as well as substances provided for in other environmental statutes.[16] Typically the release or threat of release of a hazardous substance consists of "wastes or mixtures that contain a hazardous substance and not only the pure hazardous substance itself."[17]

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9. The Superfund Amendments and Reauthorization Act of 1986 (SARA) was passed in October 1986. LYNN BULAN & CAROLE STEM SWITZER, COMPREHENSIVE ENVIRONMENTAL RESPONSE, COMPENSATION, AND LIABILITY ACT (SUPERFUND), 19 Section of Environment, Energy, and Resources 2001-2002. SARA expanded CERCLA by establishing new mandatory cleanup standards, settlement provisions, and mandating state and public participation. *Id.*

10. Elliott Milhollin, Note, *Taxation of Superfund Cleanup Costs: How the IRS Continues to Frustrate CERCLA's Twin Policy Goals*, 5 WIS. ENVTL. L.J. 213 (1998) (citing CERCLA § 101, 42 U.S.C. § 9601 (1994).

11. CERCLA § 102, 42 U.S.C. § 9602 (2000).

12. CERCLA § 111, 42 U.S.C. § 9611.

13. CERCLA § 107(a), 42 U.S.C. § 9607(a).

14. CERCLA § 101(21), 42 U.S.C. § 9601(21).

15. CERCLA § 101(22), 42 U.S.C. § 9601(22).

16. The statutes include sections 307(a) and 311 of the Clean Water Act, section 3001 of Resource Conservation and Recovery Act, section 112 of the Clean Air Act, and section 7 of the Toxic Substance Control Act. *Id.* § 101(14), 42 U.S.C. § 9601(14).

17. BULAN & SWITZER, *supra* note 9, at 13. According to Bulan, this is the result of the failure of CERCLA's section 101(14) to specify a threshold for release to impose liability. *Id.*

Hazardous substance specifically excludes petroleum, including various forms of natural gas or synthetic gas used for fuel.[18]

A facility is "any building, structure, installation, equipment, pipe or pipeline . . . , well, pit, pond, lagoon, impoundment, ditch, landfill, storage container, motor vehicle, rolling stock, or aircraft, or . . . any site or area where a hazardous substance has been deposited, stored, disposed of, or placed, or otherwise come to be located."[19] As a result of the broad definition of facility "the reach of the government to impose liability is virtually unlimited."[20] It is worth noting that the definition of environment is also broad, "ensur[ing] that the reach of CERCLA, and the imposition of liability, applies not only to contamination of navigable waters . . . but to any release of hazardous substances outside of a structure and into the environment."[21]

Liability is costly for potentially responsible parties (PRPs) charged with the cleanup of a site under CERCLA. Identified PRPs are required to pay "response costs," comprised of

> (A) all costs of removal or remedial action incurred by the [Environmental Protection Agency (EPA)] or a State . . . (B) any other necessary costs of response incurred by any other person . . . (C) damages for injury to, destruction of, or loss of natural resources, including the reasonable costs of assessing such injury, destruction, or loss resulting from such a release[,] and (D) the costs of any health assessment or health effects study carried out under section 9604(i).[22]

Identified PRPs are liable under section 107(a)(4) for interest accrued on the aforementioned items.[23] Finally, section 107(c)(3) authorizes punitive damages to be assessed against PRPs "in an amount at least equal to, and not more than three times, the amount of any costs incurred by [Superfund] as a result of [the PRPs'] failure to take proper action."[24] Recovered punitive damages are to be deposited in Superfund.[25]

Section 107 clearly exemplifies CERCLA's stated purpose. CERCLA imposes a strict liability scheme[26] including both retroactive[27]

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18. CERCLA § 101(14), 42 U.S.C. § 9601(14) (2000).
19. CERCLA § 101(9), 42 U.S.C. § 9601(9).
20. BULAN & SWITZER, *supra* note 9, at 13.
21. *Id.*; *see* CERCLA § 101(8), 42 U.S.C. § 9601(8).
22. CERCLA § 107(a)(4), 42 U.S.C. § 9607(a)(4).
23. *Id.*
24. CERCLA § 107(c)(3), 42 U.S.C. § 9607(c)(3).
25. *Id.* Because of the nature of punitive damages, these are specifically excluded from deductibility under I.R.C. § 263 irrespective of the treatment of cleanup costs. *See* I.R.C. § 162(f).
26. BULAN & SWITZER, *supra* note 9, at 25.

and joint and several liability.[28] Though CERCLA provides statutory defenses, they are of limited import. PRPs may avoid liability if they prove by a preponderance of the evidence that the release or threat of release was a result of an act of God, an act of war, the act or omission of an independent third party, or any combination thereof.[29] There are four categories of PRPs: past owners or operators of the facility,[30] generators,[31] transporters,[32] and current owners or operators of the facility.[33]

CERCLA confers a great deal of discretion on the EPA.[34] Section 104 authorizes the EPA to act "to remove or arrange for the removal of, and provide for remedial action relating to such hazardous substance, pollutant, or contaminant at any time . . . or take any other response measure . . . the [EPA] deems necessary to protect the public health or welfare or the environment," unless it determines that the owner or operator of the offending facility, or any other responsible party, will undertake such activity properly.[35] More specifically, the EPA may use the Superfund money to clean up the site immediately and later seek reimbursement from the identified PRPs[36] or order the PRPs to clean up the hazardous site themselves.[37]

If the EPA cleans up the site, the agency files a cost recovery action against the PRPs.[38] Frequently, the parties reach a settlement agreement in which the PRPs pay a percentage of the costs in exchange for a limited release from liability.[39] It is also common for the PRPs and the EPA to

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27. Milhollin, *supra* note 10, at 214 (citing United States v. Shell Oil Co., 214 F. Supp. 962, 974 (C.D. Cal. 1993) (holding CERCLA's liability scheme is retroactive)).

28. *See id.*; *see also* United States v. Monsanto Co., 858 F.2d 160, 171 (4th Cir. 1988) (holding CERCLA's liability scheme is joint and several).

29. CERCLA § 107(b), 42 U.S.C. § 9607(b) (2000).

30. This includes any person who owned or operated the facility at the time of hazardous substance disposal. *Id.* § 107(a)(2), 42 U.S.C. § 9607(a)(2).

31. Generators include any person who arranges for the disposal, treatment, or transport of the hazardous substance at or to any facility owned or operated by another party if such facility contained hazardous substances. *Id.* § 107(a)(3), 42 U.S.C. § 9607(a)(3).

32. Transporter means any person who accepted hazardous substances for transport to the treatment or disposal facility, or other site, if that person selected that facility or site. *Id.* § 107(a)(4), 42 U.S.C. § 9607(a)(4).

33. *Id.* § 107(a)(1), 42 U.S.C. § 9607(a)(1).

34. CERCLA § 115, 42 U.S.C. § 9615. Under section 115, the President has the authority "to delegate and assign any duties or powers imposed upon or assigned to him." These powers have been conferred on the EPA. *Id.*

35. CERCLA § 104(a)(1), 42 U.S.C. § 9604(a)(1) (2000).

36. CERCLA § 104(a), 42 U.S.C. § 9604(a).

37. CERCLA § 106, 42 U.S.C. § 9606.

38. CERCLA § 107(a)(4)(A), 42 U.S.C. § 9607(a)(4)(A).

39. Jeffrey M. Gaba, *Tax Deduction of Hazardous Waste Cleanup Costs: Harmonizing Federal Tax and Environmental Policies*, 20 HARV. ENVTL. L. REV. 61, 66 (citing Ridgway M. Hall,

enter into settlement agreements when the EPA has ordered the PRPs to remediate the site.[40] The PRPs agree to take the necessary steps to clean up the site in exchange for limited protection from future suits by other PRPs and the EPA.[41] A final alternative is for a private party that incurs cleanup costs to seek reimbursement from other PRPs through a cost recovery action[42] or a contribution action.[43] To recover cleanup costs, the government and private parties are required to take actions "consistent with the national contingency plan."[44] According to the regulations, parties who comply with section 106 or enter into an approved settlement agreement meet the consistency requirement for purposes of recovering remediation costs.[45]

B. Environmental Policy

The broad discretion granted to the EPA under CERCLA is evidence of Congress's goal to target hazardous waste sites and ensure they are cleaned up in a prompt and efficient manner. According to EPA regulations PRPs are liable for all response costs incurred by the federal government or a state government as well as costs incurred by any other person who conducts a cleanup under CERCLA.[46] Additionally, the EPA has declared it will "require the potentially responsible parties identified by the EPA to conduct the site cleanup themselves whenever possible rather than spending [S]uperfund money."[47]

The overriding environmental policy concern of CERCLA is the prompt cleanup of environmental contamination. The breadth of liability under the stature illustrates this objective. Of equal importance, once contamination has occurred, is the voluntary cleanup of hazardous waste

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Jr. et al., *Superfund Response Cost Allocations: The Law, the Science and the Practice*, 49 BUS. LAW. 1489 (1994)); *see also* 40 C.F.R. 300.700(g) (2004).

40. Section 122 establishes the requirements for settlements with the government. CERCLA § 122, 42 U.S.C. § 9622.

41. Gaba, *supra* note 39, at 65-66. The author notes that "[m]ost parties ultimately agree to settle since penalties for noncompliance with the order include daily penalties of up to $25,000 per day and treble the final amount of the cleanup." *Id.* at 66 n.23; *see also* 40 C.F.R. 300.700(g) (2004).

42. CERCLA § 107(a)(4)(B), 42 U.S.C. § 9607(a)(4)(B) (2000).

43. CERCLA § 113(f), 42 U.S.C. § 9613(f).

44. Section 107(a)(4)(A) declares that government actions must not be "inconsistent with the national contingency plan," and § 107(a)(4)(B) requires private party actions to be "consistent with the national contingency plan." CERCLA §§ 107(a)(4)(A)-(B), 42 U.S.C. §§ 9607(a)(4)(A)-(B).

45. 40 C.F.R. § 300.700(c)(3)(ii).

46. *See id.* §§ 300.700(c)(1)-(2).

47. Milhollin, *supra* note 10, at 214 (citing United States v. Shell Oil. Co., 605 F. Supp. 1064 (D.C. Colo. 1985); 40 C.F.R. § 300.400(c)(3)).

sites. The EPA reported it spent $367 million for construction and post-construction CERCLA-related activities in its 2004 fiscal year.[48] In contrast, it only spent $109 million from PRP settlements on the same construction work.[49] The EPA spent an additional $140 million for emergency response and removal actions and $228 million to conduct and oversee various other site activities.[50]

Neither CERCLA nor the EPA provides the resources necessary to remediate all of the sites on the national priority list, nor do they account for future sites. In 2004, nine long-term sites accounted for fifty-two percent of the Superfund obligations.[51] As a result, nineteen sites that were ready for construction were unfunded.[52] Thus, from an environmental standpoint, the preferred federal tax treatment of environmental remediation expenses is one that provides an incentive for PRPs to voluntarily remediate the site. A related, but secondary, objective is to deter behavior that is inconsistent with environmental policy.

III. DEDUCTION, CAPITALIZATION AND TAX POLICY

A. *Section 162 Deduction versus Sections 263 and 263A Capitalization*

From a tax perspective, a current year deduction under section 162(a) is more desirable than capitalizing pursuant to section 263 or 263A because of the time value of money. A section 162(a) deduction permits the taxpayer to recover the full cost of the expense in the current year in tax savings (using before-tax dollars). Taxpayers not entitled to an allowable deduction are faced with two alternatives: capitalize and depreciate,[53] or, with property that cannot be depreciated, capitalize and add the cost of the expenditure to the basis of the property.[54] Depreciation results in cost recovery in smaller increments over a period of years (39 years for nonresidential real property).[55] Property not subject to depreciation, such as land, defers cost recovery until the sale or other disposition of the property (in after-tax dollars).[56]

48. EPA, *Superfund National Accomplishments Summary Fiscal Year 2004*, *at* http://www.epa.gov/superfund/action/process/numbers04.htm (last updated Nov. 22, 2004).
49. *Id.*
50. *Id.*
51. *Id.*
52. *Id.*
53. *See* I.R.C. §§ 167, 168 (2002).
54. *See id.* §§ 263, 263A.
55. *Id.* §§ 167(a)(1), 168(c).
56. *See id.* §§ 1016, 1001(a).

Section 161 of the Tax Code subjects the deductions allowed in part VI (including section 162) to certain exceptions set forth in part IX (including sections 263 and 263A).[57] Accordingly, section 162 and the accompanying regulations are defined with respect to section 263 and its corresponding regulations. In interpreting section 161, the Supreme Court has declared that "an income tax deduction is a matter of legislative grace" and therefore "deductions are the exceptions to the norm of capitalization."[58] The burden of proof rests with the taxpayer to point with specific authority to a provision of the Tax Code allowing a deduction.[59] Thus, unless the taxpayer establishes that an expenditure qualifies for a section 162(a) deduction, the taxpayer is required to capitalize the expense under section 263 or 263A.

Section 162(a) permits a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."[60] While each of these requirements must be met, whether the cost constitutes a deductible *expense*, rather than a capital expenditure, is dispositive of its character.[61] The prevailing distinction in the regulations is between a repair (which is deductible) and a permanent improvement (which must be capitalized).

Section 263 forbids a deduction for "any amount for permanent improvements or betterments made to increase the value of any property or estate"[62] and "any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made."[63] The regulations characterize capital expenditures as those expenses which (1) add to the value of the property, (2) substantially prolong the useful life of the property, or (3) adapt the property to a new or different use.[64] Specifically included is the cost of acquisition, construction, or erection of buildings, machinery and equipment,

57. *Id.* § 161.

58. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992); *cf.* Treas. Reg. § 1.263(a)-4 (2004) (declaring deductibility as the norm and capitalization as the exception for intangibles). Treas. Reg. § 1.263(a)-4 was adopted in 2004 and specifically lists the twelve intangibles that are subject to capitalization; all others are deductible. *Id.*

59. *INDOPCO, Inc.*, 503 U.S. at 84.

60. I.R.C. § 162(a) (2002).

61. Section 162(a) imposes six conditions on the taxpayer. The taxpayer must prove the cost is (1) an expense (2) that is reasonable and (3) necessary and (4) is paid or incurred during the taxable year (5) in carrying on (6) any trade or business. I.R.C. § 162(a).

62. I.R.C. § 263(a)(1). Although the Tax Code excludes from capitalization, inter alia, expenditures related to soil and water conservation and tangible, depreciable property for use in the active conduct of a trade or business up to $25,000, environmental remediation expenses are not specifically excluded by this section. I.R.C. § 263(a)(1)(C), (G).

63. I.R.C. § 263(a)(2).

64. Treas. Reg. § 1.263(a)-1(b)(1)-(2) (2004).

furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.[65]

Section 263A requires a taxpayer to capitalize any costs[66] incurred relating to real or tangible personal property produced by the taxpayer for use in its business.[67] In the case of real or tangible personal property that is inventory in the hands of the taxpayer, the taxpayer must include such costs in its inventory costs.[68] The Tax Code requires capitalization irrespective of whether the cost was incurred before, during, or after production.[69] Production is defined as constructing, building, installing, manufacturing, developing, or improving.[70] The taxpayer may actually perform the production activity or be deemed to produce the property if it is produced for the taxpayer under a contract.[71]

The greatest challenge in ascertaining the proper tax treatment of environmental cleanup costs is in distinguishing between deductible and capital expenditures.[72] According to the Supreme Court, the differences between deductible expenses and capital expenditures "are those of degree and not of kind."[73]

Courts apply various tests and evaluate several factors to determine the proper treatment of environmental expenses. While some tests attempt to distinguish between incidental repairs and long-term improvements pursuant to the regulations, others involve analyzing whether the taxpayer incurred any "significant future benefits" or whether the expenses were part of a "general plan of rehabilitation."[74] More often than not, courts address several of the tests but rely on one in particular in reaching a holding.

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65. Treas. Reg. § 1.263(a)-2(a).

66. Under section 263A(a)(2)(B), the taxpayer must include the direct costs and the property's proper share of the indirect costs that are allocable in part or in whole to the property. I.R.C. § 263A(a)(2)(B) (2002). Indirect costs are those which "directly benefit, or are incurred by reason of, the performance of production activities." Treas. Reg. § 1.263A-1(e)(3)(i).

67. I.R.C. §§ 263A(a), (b)(1), (c)(1) (limiting the definition to § 263A).

68. I.R.C. § 263A(a)(1)(A).

69. Treas. Reg. § 1.263A-2(a)(3)(i).

70. I.R.C. § 263A(g)(1).

71. *See* I.R.C. § 263A(g)(2); Treas. Reg. § 1.263A-2(a)(1)(ii)(B) (2004).

72. The fact that the EPA orders a PRP to comply with CERCLA does not necessarily require capitalization. According to the Supreme Court, the decision whether to deduct or capitalize is not influenced by legal or economic compulsion. *See* Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 358-59 (1971).

73. Welch v. Helvering, 290 U.S. 111, 114 (1933).

74. *See, e.g.*, INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992); Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333 (1962).

1. Judicial Interpretation of Treasury Regulations §§ 1.263(a)-1(b) and 1.162-4

Treasury Regulation section 1.263(a)-1(b) excludes as capital expenditures any amounts paid or incurred for incidental repairs and maintenance of property. Treasury Regulation section 1.162-4 establishes a four-part test to determine the deductibility of repairs. Ordinary and necessary business expenses are deductible as repairs if they: (1) are "incidental," (2) do not "materially add to the value of the property," (3) do not appreciably prolong the useful life of the property[75] and (4) keep the property in an "ordinarily efficient operating condition."[76]

a. Add to the Value of the Property

In *Plainfield-Union Water Co. v. Commissioner*, the Tax Court established a "restoration principle" for purposes of characterizing an expense.[77] The court held that "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."[78] Because properly performed repairs should increase the value of the property, limiting the analysis to the value of the property immediately before the expense (in the contaminated state) and the value immediately after (in an uncontaminated state) is not a meaningful distinction.[79] An expense that merely restores the property to its prior condition and does not add to the property's value, usefulness, or life expectancy qualifies for a deduction.[80]

b. Substantially Prolong the Useful Life of the Property

The Tax Code is silent as to what time period constitutes substantially prolonging the useful life of an asset. The relevant time period for purposes of determining whether an expense substantially prolongs the useful life of an asset is the anticipated period of use, measured in accordance with the taxable year in which the expense was

75. Though the specific language of Treasury Regulation section 1.162-4 forbids deducting the costs of a repair that "appreciably prolong[s]" the property's life, because section 162 is defined with respect to section 263, the appropriate measure is to prolong its *useful* life appreciably as provided in section 1.263(a)-1(b)(1) (emphasis added).

76. Treas. Reg. § 1.263(a)-4.

77. This test is also referred to as the "added value" or "before-after" test.

78. Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333, 338 (1962).

79. *Id.*

80. *Id.* at 339.

incurred.[81] The asset depreciation period is irrelevant for the determination.[82] Courts have adopted a twelve-month rule to provide a definite time period.[83]

In *Woolrich Woolen Mills v. United States*, operation of the taxpayer's manufacturing plant caused water containing dyes and woolen fibers to discharge into a public stream.[84] The Pennsylvania Sanitary Water Board ordered Woolrich to cease all further discharges of water and to eliminate the pollution elements in the water.[85] Woolrich constructed a water filtration plant and deducted the allocable costs.[86] The Third Circuit denied the deduction, reasoning that the useful life of the filtration plant extended beyond one year.[87]

c. New or Different Use of the Property

Some courts are "more willing to allow the deduction of expenses used to remedy latent, pre-existing conditions if that remedy allows the property to be used for its original intended purposes."[88] In *Midland Empire Packing Co. v. Commissioner*, the Tax Court held that Midland Empire, a meat processing plant, was permitted to deduct expenses incurred in oil-proofing its basement.[89] The court concluded that the basement was not put to a new or additional use; rather, the cost to oil-proof maintained the plant in an "ordinarily efficient operating condition" by continuing its use for meat processing.[90] Accordingly, expenditures associated with continuing the "ordinarily efficient operating condition"—where the property has been continuously used for its original purpose—may be deducted.

The Fourth and Sixth Circuits have recently applied the new use test to environmental cleanup costs. In *Dominion Resources, Inc. v. United*

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81. Kim M. Kalishek, *Tax Treatment of Post-Purchase Soil Remediation of Pre-Purchase Contamination—A Policy Perspective:* United Dairy Farmers, Inc. v. U.S., 9 U. BALT. J. ENVTL. L. 87, 92 (2002) (citing Treas. Reg. § 1.167(a)-11(g)(1)(ii)(b)).

82. *Id.*

83. *See* United States Freightways Corp. v. Commissioner, 270 F.3d 1137, 1142-43 (7th Cir. 2001) (declaring that for administrative feasibility the taxpayer was entitled to a deduction when the benefit did not extend beyond one calendar year); *see also* Treas. Reg. § 1.263(a)-4(f) (creating a twelve-month rule for purposes of determining substantiality for deduction or capitalization of intangible assets); *cf.* United States v. Wehrli, 400 F.2d 686, 689 (10th Cir. 1968) (characterizing the one-year time period as merely a "guidepost").

84. Woolrich Woolen Mills v. United States, 289 F.2d 444, 445 (3d Cir. 1961).

85. *Id.*

86. *Id.* at 446.

87. *Id.* at 449.

88. Gaba, *supra* note 39, at 80.

89. Midland Empire Packing Co. v. Commissioner, 14 T.C. 635, 641 (1950).

90. *Id.* at 642-43.

States, the Fourth Circuit held that the taxpayer was required to capitalize its cleanup costs because the remediation enabled the property to become income-producing.[91] Relying on the reasoning of *Dominion Resources*, the Sixth Circuit in *United Dairy Farmers, Inc. v. United States* determined that remediation work done to property acquired in a contaminated state constituted a new use of the property.[92]

A corollary to the new or different use test is the "put versus keep" test, stemming from the language in Treasury Regulation section 1.162-4, which allows a taxpayer to deduct costs that keep the property in an ordinarily efficient operating condition. Instead of examining whether an expense adds to the value of the property, the test focuses on the nature of the improvement.[93] The "put versus keep" test requires capitalization of expenses that "put" an asset in an efficient operating condition but permits a taxpayer to deduct expenses that "keep" an asset in an efficient operating condition.[94] The test is, however, of limited import and has been infrequently applied by courts.

2. Significant Future Benefits

Similar to the substantially prolong the useful life requirement of Treasury Regulation section 1.263(a)-1(b), the Supreme Court created the significant future benefit test in *INDOPCO, Inc. v. Commissioner*.[95] The Court reasoned:

> Although the mere presence of an incidental future benefit—*some* future aspect—may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably

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91. Dominion Res., Inc. v. United States, 219 F.3d 359, 370 (4th Cir. 2000). Dominion Resources, Inc. owned property which it unsuccessfully tried to sell. *Id.* In 1991, it spent over two million dollars to remediate the property, removing asbestos-containing materials, sludge, and various other contaminants and claimed the expenses as deductible. *Id.*

92. United Dairy Farmers, Inc. v. United States, 267 F.3d 510, 518-19 (6th Cir. 2001). United Dairy Farmers, a manufacturer of milk and ice cream products, knowingly purchased property with surface and underground soil contamination. *Id.* at 512-13. It later discovered underground gasoline storage tanks that caused additional contamination. United Dairy Farmers remediated the property and deducted the costs. *Id.* at 513. In dicta, the Sixth Circuit stated that the combined effect of *Plainfield-Union*, Revenue Ruling 94-38, 1994-1 C.B. 35, and *Dominion Resources* was to permit a deduction under section 162 of the I.R.C. when "(1) the taxpayer contaminated the property in its ordinary course of business, (2) the taxpayer cleaned up the contamination to restore the property to its pre-contamination state, and (3) the clean-up did not allow the taxpayer to put the property to a new use." *Id.* at 519.

93. *Dominion Res., Inc.*, 219 F.3d at 371.

94. Estate of Walling v. Commissioner, 373 F.2d 190, 192-93 (3d Cir. 1967).

95. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 87 (1992).

> important in determining whether the appropriate tax treatment is immediate deduction or capitalization.[96]

An *INDOPCO* analysis will mirror that of the regulation in ascertaining whether an expenditure is a permanent improvement or a repair.

3. Plan of Rehabilitation

The Service issued Revenue Ruling 2001-4 to clarify the distinction between deductibility and capitalization. After reviewing various tests used by the courts, the Service concluded that the outcome depends on the context in which the cost is incurred.[97] Citing *United States v. Wehrli*, the Service observed that "where an expenditure is made as part of a general plan of rehabilitation, modernization, and improvement of the property, the expenditure must be capitalized, even though, standing alone, the item may be classified as one of repair or maintenance" and would therefore be deductible.[98] Application of the doctrine is fact-intensive and requires an analysis of, inter alia, the "purpose, nature, extent, and value of the work done."[99]

As part of its building renovation, a subsidiary of the taxpayer in *Norwest Corp. v. Commissioner* removed asbestos-containing materials.[100] Norwest characterized the expenses as deductible repairs incidental to renovation.[101] The Service contended the costs to remove asbestos from the building were capital because, inter alia, the removal was part of a general plan of restoration.[102] The Tax Court agreed with the Service, reasoning that "but for the remodeling, the asbestos removal would not have occurred."[103]

B. Tax Policy

Tax objectives inherent in the treatment of environmental remediation expenses include raising revenue, matching income with tax liability, and the public policy limitation which disallows the deduction of expenses that violate government policy. Whereas permitting the

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96. *Id.*
97. Rev. Rul. 2001-4, 2001-3 I.R.B. 295.
98. *Id.* at 298 (citing United States v. Wehrli, 400 F.2d 686, 689 (10th Cir. 1968)).
99. *Wehrli*, 400 F.2d at 689.
100. Norwest Corp. v. Commissioner, 108 T.C. 265, 273-76 (1997).
101. *Id.* at 278.
102. *Id.* at 282. The Service also argued that asbestos removal was a permanent improvement that increased the value of the building by eliminating a hazard and reducing the risk of damage claims and increased insurance premiums. *Id.* The Tax Court rejected this argument. *Id.* at 284.
103. *Id.* at 285.

deduction of environmental cleanup costs results in significant tax advantages to the taxpayer, it runs counter to the goal of raising government revenue. As mentioned previously, the EPA spent over $500 million on CERCLA-related activities in its 2004 fiscal year.[104] If PRPs spent the same amount and were permitted to deduct the expenses, it would represent a significant amount of foregone income to the government.[105] In contrast, taxpayers that capitalize cleanup costs would either deduct a small portion of the amount expended in the current year through depreciation, deducting the rest over a period of several years, or take no deduction but include the expense in the basis of the property. This would have the effect of decreasing any potentially foregone income.

The Tax Code is designed to tax the taxpayer's net income—that is, to tax earnings and profits less expenses and losses.[106] To carry out this objective, the Tax Code requires the taxpayer to adopt a method of accounting that "clearly reflects income."[107] A fundamental principle underlying the capitalization sections of the Tax Code is the matching of income with related expenses.[108] The idea is that the taxpayer should match expenses to the corresponding income that such expenses generated in the same taxable period. With respect to environmental remediation costs, no hard-and-fast rule exists. On the one hand, one can argue that environmental cleanup costs are directly related to current or previous income and are therefore deductible. On the other hand, cleanup costs may relate to income that will be earned in the future and so should be capitalized. The appropriate treatment of remediation expenses as deductible or capitalized will be based on the facts and circumstances of each case.

Prior to 1969, courts assessed the character of expenditures as deductible or subject to capitalization based on a "public policy" limitation, in which taxpayers were not authorized to deduct expenses that were contrary to government policy.[109] Congress subsequently

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104. *See infra* Part II.B.

105. Typically, government increases taxes to offset foregone income.

106. *See* Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30, 33 (1958) (noting Congress's objective of only taxing net income in enacting income tax laws); McDonald v. Commissioner, 323 U.S. 57, 66 (1944) (Black, J., dissenting) (observing "[t]axation on net, not on gross, income has always been the broad basic policy of our income tax laws").

107. *See* I.R.C. § 446(b) (2002).

108. *See id.*; Commissioner v. Idaho Power Co., 418 U.S. 1, 16 (1974); INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 86 (1992).

109. *See* Commissioner v. Heininger, 320 U.S. 46, 467, 472-73 (1943); *Tank Truck Rentals*, 356 U.S. at 30; Hoover Motor Express Co. v. United States, 356 U.S. 38, 40 (1958); Commissioner v. Tellier, 383 U.S. 687, 1122-23 (1966).

codified the limitation in the Tax Code by denying deductions for illegal bribes, kickbacks and other illegal payments, certain lobbying and political expenditures, any fines or penalties paid to a government for the violation of any law, and treble damage payments under antitrust laws.[110] Similarly, some argue that granting a deduction for cleanup costs results in the government subsidizing behavior that is against public policy.[111] Instead of bearing any part of the cost, they argue, the government should deny a deduction and thus discourage such behavior.[112] A response to that argument is that environmental remediation expenses are not expressly excluded from deduction in the Tax Code. Rather, the Tax Code clearly authorizes the deduction of certain environmental costs under section 198. If Congress believed environmental contamination was against public policy, it could have enacted similar legislation mandating the capitalization of cleanup costs.

There are other common arguments against using the Tax Code (i.e., capitalization) as a means of punishment. First, the purpose of the income tax is not to punish PRPs.[113] Congress sought only to tax "net income" and should not make selective exceptions.[114] Further, the actual financial effect of prohibiting a deduction does not punish PRPs appropriately because the "punishment" would relate to the marginal tax rate of the PRPs instead of their relative culpability.[115]

IV. TREATMENT OF CLEANUP COSTS UNDER THE TAX CODE

The idea that "deductions are the exception" and not the rule has had a checkered past in the context of environmental remediation costs. The Service issued three pronouncements, in the form of Technical Advice Memoranda, before it released its first official interpretation concerning the treatment of environmental cleanup costs for federal tax purposes. Initially the Service took the position that cleanup costs must be capitalized. In Technical Advice Memoranda issued in 1992 and 1993, the Service characterized the complete removal and replacement of asbestos as a permanent improvement necessitating capitalization.[116] Additionally, in 1992, the Service required the taxpayer to capitalize

110. I.R.C. §§ 162(c), (e)-(g).

111. *See* Jacob L. Todres, *Internal Revenue Code Section 162(f): An Analysis and Its Application to Restitution Payments and Environmental Fines*, 99 DICK. L. REV. 645, 650 (1995).

112. *Id.*

113. *Id.*

114. *Id.*

115. *Id.* at 651.

116. Tech. Adv. Mem. 92-4-004 (Oct. 2, 1992); Tech. Adv. Mem. 94-11-002 (Nov. 9, 1993).

costs associated with soil remediation.[117] In 1994, the Service issued Revenue Ruling 94-38, adopting a more pro-taxpayer position.[118] Until 2001, the Service frequently permitted taxpayers to deduct cleanup costs under the logic of Revenue Ruling 94-38. Current owners that incurred costs associated with property they purchased and subsequently contaminated were allowed to deduct the expenses. Current owners that purchased contaminated property were required to capitalize the expenses. The Service's most recent pronouncement addressing cleanup costs imposed by CERCLA was issued in 2004.[119] While the Service acknowledged the continued validity of Revenue Rulings 94-38 and 98-25, it limited their application and required the taxpayer to capitalize its cleanup costs for federal tax purposes.

A. Capitalization: Initial Pronouncements

1. Technical Advice Memorandum 92-40-004

In Technical Advice Memorandum 92-40-004 the Service held that the removal and replacement of asbestos insulation constituted a permanent improvement.[120] The Service reasoned that it was "impossible to value the [property] prior to the existence of the asbestos, or . . . prior to the condition necessitating the expenditure," and that the asbestos insulation did not result in a decrease in efficiency.[121] It concluded that removal increased the value of the property based on "subjective factors that [were] not compatible with the objective measurement articulated in *Plainfield-Union*."[122]

2. Technical Advice Memorandum 94-11-002

The Service distinguished between the costs allocable to complete removal of asbestos installation and those allocable to the temporary abatement of damaged and punctured asbestos installation in Technical Advice Memorandum 94-11-002.[123] Characterizing the encapsulation of asbestos installation as a deductible repair, the Service emphasized that

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117. Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992).
118. Rev. Rul. 94-38, 1994-1 C.B. 35.
119. Rev. Rul. 2004-18, 2004-8 I.R.B. 509.
120. Tech. Adv. Mem. 92-4-004 (Oct. 2, 1992).
121. *Id.*
122. *Id.* (citing as factors: long-term benefits from reduced monitoring and maintenance costs, safer working conditions, a reduced risk of liability for owners and/or investors, increase in marketability, permanence of the improvement and compliance with local requirements permitting the business to continue its operation).
123. Tech. Adv. Mem. 94-11-002 (Nov. 9, 1993).

the expenditures did not permanently solve the asbestos problem and therefore did not materially enhance the property's value, substantially prolong its useful life, or adapt the property to a new or different use.[124]

The Service ordered the taxpayer to capitalize the expenses attributable to the complete removal of asbestos insulation.[125] It reasoned that complete removal "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."[126] The Service cited, as evidence of the long-term benefits, the fact that the removal permanently increased working conditions, increased the marketability of the property, expanded the usable area available to the taxpayer, and adapted the property to a new and different use (by converting the property into garage and office space).[127]

3. Technical Advice Memorandum 93-15-004

In Technical Advice Memorandum 93-15-004, the Service held that costs associated with soil remediation were not incidental repairs, relying on *Wolfson Land & Cattle Co. v. Commissioner*.[128] The Service distinguished *Plainfield-Union*, noting that the before-and-after test used to determine whether an expense added to the value of the property was merely one factor in the "full consideration of the 'entire factual context.'"[129] Furthermore, the repair in *Plainfield-Union* was "a very minor part of the petitioner's operation"[130] as compared to the significant increase in value of the taxpayer's remediated property.[131]

Under *Wolfson*, the work being performed was crucial to the treatment of cleanup costs.[132] The Service found the facts in the Technical Advice Memorandum similar to those in *Wolfson* in that both taxpayers "made the expenditures as part of a systematic plan involving extensive identification and/or remediation activities throughout its property," and received an increase in the value of the property after the cleanup activities.[133] Similarly, the Service determined the taxpayer's cleanup costs were part of a general plan of rehabilitation because the

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124. *Id.*
125. *Id.*
126. *Id.*
127. *Id.*
128. Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992).
129. *Id.* (citing Plainfield-Union Water Co. v. Commissioner, 39 T.C. 338, 341 (1962)).
130. *Id.* (citing *Plainfield-Union*, 39 T.C. at 339).
131. *Id.*
132. *Id.*
133. *Id.*

total effect of the soil remediation was to make permanent improvements to the taxpayer's properties.[134] The Service listed the following items as improvements:

> transforming sections of contaminated land into land that is no longer contaminated, avoiding further government penalties by bringing the properties into compliance with government regulations, providing a safe environment for workers and adjoining property owners, and increasing the marketability of the properties once the level of [polychlorinated biphenyls (PCBs)] is brought within the safety range permitted under the environmental regulations.[135]

Accordingly, the Service required the taxpayer to capitalize all expenditures allocable to the soil remediation activities.[136]

B. Deductibility: Revenue Ruling 94-38 and Its Progeny

1. Revenue Ruling 94-38

In 1994, the Service issued Revenue Ruling 94-38, allowing the taxpayer, a corporation that owned and operated a manufacturing plant, to deduct costs incurred in cleaning up soil and groundwater contamination on its property.[137] The taxpayer purchased land in 1970 and subsequently built a manufacturing plant.[138] Operation of the plant created hazardous waste, which the taxpayer buried on its land.[139] In 1993, the taxpayer began remediation efforts, as required by existing and anticipated environmental requirements.[140] From 1993 until 1995, the taxpayer undertook a series of soil remediation actions.[141] Also in 1993, the taxpayer began constructing groundwater treatment facilities to monitor the groundwater and ensure removal of the hazardous waste until 2005.[142]

The Service found that the soil remediation and groundwater treatment had no effect beyond restoring the land to its physical condition before the contamination.[143] The taxpayer was merely "continu[ing] to use the land and operate the plant in the same manner as it did prior to

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134. *Id.*
135. *Id.*
136. *Id.*
137. Rev. Rul. 94-38, 1994-1 C.B. 35.
138. *Id.*
139. *Id.*
140. *Id.*
141. *Id.*
142. *Id.*
143. *Id.*

the cleanup," except for the added disposal of hazardous waste.[144] Before analyzing the treatment of the expenses, the Service acknowledged that "the expense may qualify as ordinary and necessary if it is appropriate and helpful in carrying on that business, is commonly and frequently incurred in the type of business conducted by the taxpayer, and is not a capital expenditure."[145]

In ascertaining whether the costs were deductible or capital expenditures, the Service adopted the restoration principle in *Plainfield-Union*. The Service declared that "the appropriate test for determining whether the expenditures increase the value of the property is to compare the status of the asset after the expenditure with the status of that asset before the condition arose that necessitated the expenditure."[146]

The Service authorized the deduction of costs incurred to "evaluate and remediate" the soil and groundwater contamination as ordinary business expenses under section 162(a).[147] The Service held that the expenditures did not constitute permanent improvements or otherwise provide significant future benefits.[148] Under the Service's reasoning, "soil remediation and ongoing groundwater treatment expenditures do not result in improvements that increase the value of [the taxpayer's] property because [the taxpayer] had merely restored its soil and groundwater to their approximate condition before they were contaminated by [the taxpayer's] manufacturing operations."[149] The Service quickly dispelled application of any other provision under section 263 as there was no indication that the expenditures prolonged the useful life of the property nor adapted the land to a new or different use.[150] Because the land was not subject to depreciation, amortization, or depletion, the Service found that the capitalization principles of section 263(a)(2) did not apply either.[151]

In accordance with capitalization principles, the Service required the taxpayer to capitalize the costs to construct groundwater treatment facilities.[152] The Service indicated that the taxpayer was entitled to depreciation, though.[153] Finally, the Service observed that the outcome

144. *Id.*
145. *Id.* (citing Commissioner v. Tellier, 383 U.S. 687 (1966); Deputy v. du Pont, 308 U.S. 488 (1940); Welch v. Helvering, 290 U.S. 111 (1933)).
146. *Id.* at 36.
147. *Id.*
148. *Id.*
149. *Id.*
150. *Id.*
151. *Id.*
152. *Id.*
153. *Id.*

(i.e., deduction of soil and groundwater cleanup costs and capitalization of construction expenses) would be the same regardless of whether the taxpayer continued operation of its manufacturing plant or held the land in an "idle state."[154] This statement has been interpreted to suggest the Service would permit deduction of remediation expenses in other circumstances as well.[155]

2. Private Letter Ruling 96-27-002

The Service took an even broader position in Private Letter Ruling 96-27-002, holding that pre-remediation costs, including cleanup costs, legal fees, and consulting fees, were currently deductible.[156] The taxpayer's contaminated land was designated a Superfund site, and the taxpayer requested advice on how to treat the projected expenses.[157] Because the expenses were not actually incurred, the added-value argument of section 263 failed.[158] The Service concluded that the costs would not create or enhance the asset nor produce a long-term benefit that would require capital treatment under Revenue Ruling 94-38.[159] Therefore, the taxpayer was entitled to deduct the expenses in the year incurred.[160]

3. Revenue Ruling 98-25

The Service continued its pro-taxpayer treatment in Revenue Ruling 98-25.[161] The taxpayer, a corporation, incurred costs to remove and replace underground storage tanks and to monitor the newly installed underground storage tanks in compliance with environmental requirements.[162] Allowing the taxpayer to deduct the costs of removing, cleaning, and disposing of the old underground storage tanks and the filling and monitoring of the new underground storage tanks, the Service focused on the nature of the new underground storage tanks. The Service noted that "[t]he useful life of an asset for [section] 263 purposes

154. *Id.*
155. *See* Glenn R. Carrington et al., *Tax Treatment of Environmental Remediation Costs*, *in* FIFTH ANNUAL REAL ESTATE TAX FORUM 2003, at 232 (PLI Tax Law & Estate Planning Course, Handbook Series No. J0-006M, 2003); Gaba, *supra* note 39, at 88.
156. Priv. Ltr. Rul. 96-27-002 (Jan. 17, 1996).
157. *Id.*
158. *Id.*
159. *Id.*
160. *Id.*
161. Rev. Rul. 98-25, 1998-1 C.B. 998.
162. *Id.*

is its useful life to the taxpayer, not its inherent useful life."[163] The new underground storage tanks had no remaining useful life to the taxpayer after they were filled with waste and indefinitely sealed.[164] The Service distinguished the construction of the groundwater treatment facilities in Revenue Ruling 94-38 because the facilities would be used substantially beyond the taxable year (into 2005).[165]

4. Technical Advice Memorandum 1999-52-075

Technical Advice Memorandum 1999-52-075 offered the most comprehensive treatment of environmental cleanup costs to date.[166] Prior to the taxpayer's purchase of the property, two separate previous owners had operated a manufactured gas plant and electrical power plant and disposed of hazardous waste on the property in unlined pits.[167] The taxpayer continued to operate the manufactured gas plant but subsequently switched to supplying natural gas.[168] After two years, the taxpayer "intended to relocate many of the functions and decommission the buildings" because of their deteriorated condition.[169]

Before relocating any of the facilities, the EPA ordered a site reconnaissance.[170] No contamination was found, but the EPA placed the property on the Comprehensive Response, Compensation, and Liability Information Systems list, indicating it may be investigated further.[171] The taxpayer undertook its own investigation and discovered contamination on its property in succeeding years.[172] The taxpayer continued developing its corporate facilities plan and constructed the new operations building contemporaneously with its cleanup efforts.[173] The taxpayer deducted the cleanup costs, including amounts for site investigation and reports, preparation and implementation of remediation action plans, actual remediation, and legal fees.[174]

The Service concluded that the taxpayer was entitled to deduct remediation expenses allocable to contamination that occurred during the

163. *Id.* (citing Silverton v. Commissioner, T.C.M. 1977-198; Massey Motors, Inc. v. United States, 364 U.S. 92 (1960)).
164. *Id.*
165. *Id.*
166. Tech. Adv. Mem. 1999-52-075 (Aug. 28, 1999).
167. *Id.*
168. *Id.*
169. *Id.*
170. *Id.*
171. *Id.*
172. *Id.*
173. *Id.*
174. *Id.*

taxpayer's ownership of the property; however, the taxpayer was required to capitalize any costs allocable to contamination that occurred prior to the taxpayer's acquisition of the property.[175] Relying on Revenue Ruling 94-38 and *Plainfield-Union*, the Service analogized the facts and restoration purpose of the cleanup activities to those of the prior Revenue Ruling.[176]

The examining agent asserted three separate arguments to support the treatment of cleanup costs as capital expenditures. The Service expressly rejected the argument that the remediation enabled the taxpayer to adapt the property to a new and different use by facilitating construction of a new building.[177] The Service contended that "because these remediation costs merely [were] restorative in nature, they [did] not adapt the property to a new or different use."[178] Next, the Service cited Revenue Ruling 94-38 to discredit the examining agent's contention that the cleanup costs should be capitalized as land preparation costs in accordance with construction of the new building.[179] Because land preparation costs improve and add to the value of the land, the Service held that the argument failed because such a designation would be contrary to the holding in Revenue Ruling 94-38 that mere restoration constitutes neither an improvement nor an increase in value.[180]

The examining agent's final argument was that the cleanup costs were required to be capitalized as a part of a general plan of rehabilitation, citing *Norwest Corp. v. Commissioner*.[181] In distinguishing *Norwest Corp.* from the facts of Technical Advice Memorandum 1999-52-075, the Service reasoned:

> [The] [t]axpayer's environmental cleanup costs were not directly related to the construction of the building. Rather . . . these costs relate to the restoration of the land, an asset separate and apart from the building. In general, courts and the Service have been reluctant to apply the plan of restoration doctrine to require capitalization of otherwise deductible expenses where they relate to an asset different from the asset that is being rehabilitated or improved.[182]

Thus, the Service bifurcated the analysis of the treatment of cleanup costs into the land and the incidental new building. It concluded that

175. *Id.*
176. *See id.*
177. *Id.*
178. *Id.*
179. *Id.*
180. *Id.*
181. *Id.* (citing Norwest Corp. v. Commissioner, 108 T.C. 265 (1997)).
182. *Id.*

although the property required cleanup before construction of the new building, the cleanup costs related to the restoration of the land and not to an overall plan of rehabilitation or improvements of its building.[183]

C. Recent Pronouncements: Capitalize

1. Private Letter Ruling 2001-07-029

The Service required the taxpayers to capitalize cleanup costs associated with property purchased in a contaminated condition in Private Letter Ruling 2001-07-029.[184] The taxpayers initially deducted expenses relating to consultation, testing, supplies and equipment, labor, and legal fees in remediation ordered by the State Department of Environmental Conservation.[185] Subsequently, the taxpayers sought to capitalize the costs and future expenses and requested a determination by the Service.[186]

The Service noted the holding in Revenue Ruling 94-38 and adopted the *Plainfield-Union* restoration principle.[187] Thereafter, the Service distinguished Revenue Ruling 94-38 as allowing a deduction for cleanup costs relating to the purchase of uncontaminated property. In instances where the taxpayers maintained that they purchased contaminated property, "the expenditures for the remediation operations increased the value of the land, by improving the land from a contaminated state to a remediated state."[188] Taxpayers who remediate property that was purchased in a contaminated state are therefore required to capitalize cleanup costs.

2. Revenue Ruling 2004-18

The facts of the Service's most recent decision, Revenue Ruling 2004-18, are strikingly similar to those of Revenue Ruling 94-38; in this instance, however, the Service reached a different result.[189] The taxpayer was a corporation that purchased uncontaminated land and built a manufacturing plant that it owned and operated.[190] The plant's operation resulted in the discharge of hazardous substances onto the land, which the taxpayer sought to clean up in accordance with environmental

183. *Id.*
184. Priv. Ltr. Rul. 2001-08-029 (Feb. 23, 2001).
185. *Id.*
186. *Id.*
187. *Id.*
188. *Id.*
189. Rev. Rul. 2004-18, 2004-8 I.R.B. 509.
190. *Id.*

requirements.[191] The taxpayer incurred soil remediation and groundwater treatment expenses as well as costs to construct a monitoring system to ensure hazardous substance removal.[192] The only factual difference between the Revenue Rulings was that the operation of the manufacturing plant produced property that was inventory in the hands of the taxpayer.[193]

The Service maintained the same position it had in Revenue Ruling 94-38: the remediation had the effect of "restor[ing] [the taxpayer's] land to essentially the same physical condition that existed prior to the contamination."[194] The Service again reasoned that the taxpayer was merely continuing the use and operation of the plant in the same manner as before the remediation, the only change being the disposal of hazardous substances.[195] Notwithstanding Revenue Rulings 94-38 and 98-25, the Service concluded that "[e]nvironmental remediation costs are subject to capitalization under [section] 263A."[196] Further, "costs incurred . . . to clean up land that a taxpayer contaminated with hazardous waste by the operation of the taxpayer's manufacturing plant must be included in inventory costs under [section] 263A."[197]

In its analysis, the Service included a brief summary of Revenue Rulings 94-38 and 98-25. Thereafter, the Service immediately discounted the application of the Revenue Rulings to the present facts because they failed to address inventory costs under section 263A.[198] The analysis did not end after characterizing an expense as deductible under section 162(a) or subject to capitalization under sections 263 and 263A; rather, an additional inquiry was necessary. "[A] taxpayer with inventories must apply the rules of [section] 263A to determine whether the repair costs [or depreciation expense] must be included in inventory."[199] Under the facts of Revenue Ruling 2004-18, the Service concluded that, because the remediation expenses were incurred as a result of the taxpayer's production activities, the costs were attributable to

191. *Id.*
192. *Id.*
193. *Id.* While Revenue Ruling 94-38 made no mention of production of property that was inventory in the hands of taxpayer, one can reasonably assume that such facts did exist due to the similarity between Revenue Rulings 2004-18 and 94-38.
194. *Id.* at 509.
195. *Id.*
196. *Id.* at 510.
197. *Id.*
198. *Id.*
199. *Id.* (citing Treas. Reg. § 1.263A-1(e)(3) (2004) (deductible repair costs); *id.* § 1.263A-1(e)(3)(ii)(I) (capitalized and depreciated expenses)).

property that was produced by the taxpayer and was inventory in the taxpayer's hands.[200]

Rather than ending with the facts at issue, the Service applied the same rationale to the situation presented in Revenue Ruling 98-25. It declared that "costs incurred to replace underground storage tanks and depreciation cost recoveries of the groundwater treatment facility must be included in inventory costs to the extent properly allocable to inventory."[201]

In addition to the characterization of environmental remediation costs as subject to capitalization and the ancillary inquiry into whether the expense, after being characterized as deductible or capitalized must be included in inventory under section 263A (and therefore capitalized), Revenue Ruling 2004-18 is significant for its prospective application. The Service indicated it would not "challenge the treatment of environmental remediation costs [of a type that are the subject of Revenue Ruling 2004-18] as deductible expenses rather than as costs properly capitalized to inventory under [section] 263A in any taxable year ending on or before February 6, 2004."[202] Further, the Service declared it would not pursue any such issue that had been raised before the Courts of Appeals or the Tax Court before February 6, 2004.[203] Finally, the Service would not impose penalties in instances where taxpayers or preparers characterized such expenses as deductible in a taxable year ending on or before February 6, 2004.[204]

The practical effect of Revenue Ruling 2004-18 is that most expenses incurred in environmental remediation efforts after February 6, 2004, will be required to be capitalized under section 263A of the Tax Code by a taxpayer that produces real or tangible personal property. The section 263A auxiliary test operates like a recapture provision. Arguably, most real or tangible personal property produced by the taxpayer in a trade or business (or acquired by the taxpayer for resale) will likely constitute inventory in the hands of the taxpayer, thereby placing the taxpayer within the bounds of Revenue Ruling 2004-18 and requiring capitalization of the direct and indirect costs incurred in connection with such property. Thus, remediation expenses that previously could be reasonably characterized as deductible under section 162(a) of the Tax

200. *Id.* (citing Treas. Reg. § 1.263A-1(e)(3)(i)).
201. *Id.*
202. *Id.*
203. *Id.*
204. *Id.*

Code are subject to an additional analysis and will be brought back into the capitalization realm by section 263A.

V. PROPOSED SOLUTION AND CONCLUSION

Allowing PRPs to deduct costs expended in environmental remediation may encourage polluters to clean up hazardous waste voluntarily by providing an incentive to act. In the tax realm, however, a current deduction would have the effect of decreasing tax revenues and increasing government spending. In contrast, capitalization would provide a disincentive for PRPs to complete voluntary cleanups because of the time and financial burden placed on them. However, capitalization could serve as a deterrent to blatant disregard for environmental law compliance. These conflicting policies need to be reconciled to provide uniform treatment of environmental remediation costs for federal tax purposes.

Considering the prevalent environmental and tax policies involved, the tax treatment of cleanup costs should be deducted to the extent income is generated by the activities causing the contamination and necessitating remediation in the taxable year and only to the extent assignable to the current owner. That current owners are permitted to deduct environmental remediation costs is not inconsistent with environmental policies. Obviously the preferential tax treatment will encourage current owners to remediate the land and comply with environmental laws. In addition, while capitalization might be a more appropriate way to achieve deterrence, arguably the current number of CERCLA sites, along with the costs expended by the EPA dictates that the incentive to clean up CERCLA sites outweighs the deterrent effect.

Moreover, limiting deductions to current owners coincides with the structure of liability under CERCLA—subjecting a variety of parties to potential liability. Either the government or identified PRPs will seek contribution from other PRPs. Only the current owner will receive a current deduction. This may affect deterrence, as property owners will not want to face the uncertainty of liability in the future. Instead, property owners will undertake necessary actions to prevent contamination or ensure adequate cleanup of contaminated property.

Allowing only current owners to take the deduction provides the most sensible solution with respect to tax policy as well. Notwithstanding Revenue Ruling 2004-18, it is consistent with past pronouncements by the Service. Presumably the prior owner already accounted for the contamination by factoring it in the selling price of the property. The prior owner therefore should not be permitted to circumvent the Tax Code by deducting cleanup costs it already recovered.

Although limiting a deduction to current owners would not solve the problem of decreasing government revenue, it would lessen the amount of forgone income. The deduction available to the current owner—the amount for expenses generated by the remediation costs—constitutes forgone income. The government would not forgo, however, any revenue from (1) prior owners adjudged liable for contamination that contributes to remediation costs or (2) current owners with expenses that exceed the corresponding income for the taxable year. As such, limiting the deduction to income generated by the remediation expenses is in accord with the income matching doctrine. Finally, the limitations satisfy public policy concerns by preventing a taxpayer who violates environmental laws from receiving the benefits of a current deduction.

It is worth noting that, notwithstanding Revenue Ruling 2004-18, treatment of environmental remediation expenses remains unclear. The recent issuance of the Revenue Ruling combined with the Service's checkered record regarding environmental cleanup costs and the fact that Congress has not codified the Revenue Ruling in any provision of the Tax Code counter the breadth of Revenue Ruling 2004-18. Nevertheless, it is advisable to adhere to the principles of Revenue Ruling 2004-18 due to the specificity of the Revenue Ruling and the deference accorded to such pronouncements by various courts.