New Authorities on Deducting Environmental Costs

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The tax treatment of environmental liabilities and expenditures has become of increasing significance over the past decade. Far from being an isolated incident or line item buried on a financial statement, environmental costs now can consume millions of dollars and can cripple companies. The tax treatment of such costs has therefore become correspondingly important.

In 1993 the Service issued a Letter Ruling (PLR 9343011) addressing the treatment of the assumption of contingent liabilities (specifically environmental and other post-employment benefit expenses) in a Section 351 exchange. (See "IRS Rules Favorably on Contingent Liabilities," *The M&A Tax Report*, Vol. 2, No. 6, January 1994).

Now, the IRS has formalized its position concerning the assumption of contingent environmental liabilities in a published ruling. In Revenue Ruling 95-74, the Service ruled that contingent environmental liabilities that have not been deducted or capitalized, and that are assumed by a newly-formed subsidiary in a Section 351 exchange, will not be treated as "liabilities" for purposes of Sections 357(c)(1) and 358(d). While this is a significant conclusion by itself, Revenue Ruling 95-74 goes on to conclude that the liabilities assumed by the new subsidiary in the Section 351 exchange are deductible by it as business expenses under Section 162, or will be treated as capital expenditures under Section 263, as appropriate, under the subsidiary's method of accounting.

Structure of Transaction

The facts of Revenue Ruling 95-74 do not seem far-fetched. The Parent (P) was an accrual basis, calendar year corporation that engaged in various businesses. One of these businesses included the operation of a manufacturing plant. The plant was located on land purchased by P many years ago. The land was not contaminated by hazardous wastes when P purchased it. As the result of plant operations, though, certain environmental liabilities such as the potential need for soil and groundwater remediation, were now apparent.

In a Section 351 exchange, P transferred substantially all of the assets associated with the manufacturing business (including the plant and the land on which it was located) to a newly-formed corporation (S), in exchange for all of S' stock and S' assumption of the manufacturing business' liabilities. The liabilities assumed by the newly-

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created subsidiary S included the environmental liabilities that were associated with the land surrounding the plant. The ruling indicates that P has no plan or intention to dispose of any of the S stock, nor to have S issue any additional stock apart from the stock transferred to P in the Section 351 exchange.

Before this Section 351 exchange occurred, P never undertook any remediation of the environmental problems. Likewise, P never deducted or capitalized any amount with respect to the contingent environmental liabilities that were associated with the transferred land. After the exchange, S undertook soil and groundwater remediation efforts relating to the land it received.

Consequently, S incurred costs as a result of those remediation efforts. Of the total amount of costs incurred, a portion would have constituted ordinary and necessary business expenses deductible under Section 162. The remainder of the costs would have been capital expenditures under Section 263, had there not been a Section 351 exchange. In other words, if P had incurred the costs, a portion would have been deductible and a portion would have been required to be capitalized. The question was what treatment S should receive for these expenditures.

Same Treatment to Sub

In considering the treatment of these environmental expenditures by S, the IRS noted that the contingent environmental liabilities that were assumed by S had not yet been taken into account by P before the transfer. Such amounts had neither given rise to deductions for P nor resulted in the creation of (or any increase to) basis in any property owned by P. Consequently, these contingent environmental liabilities were not to be included in determining whether the amount of the liabilities assumed by S exceeded the adjusted basis of the property transferred by P under Section 357(c)(1). Obviously, that turns out to be an extremely important determination, given that more than a few taxpayers have been stung by the excess liability tax hit imposed by Section 357(c).

Furthermore, due to the parallel constructions and interrelated function and mechanics of Sections 357 and 358, the Service went on to point out in the ruling that liabilities not included in the determination under Section 357(c)(1), are also not included in the determination of the transferor's basis in the stock received in the Section 351 exchange. (These rules are in Section 358.) Thus, the ruling concludes that the contingent environmental liabilities that were assumed by S are not treated as money received by P under Section 358 for purposes of determining P's basis in the stock of S it received in the exchange.

Drawing support for this conclusion from a prior ruling (Revenue Ruling 80-198, 1980-2 C.B. 113), the Revenue Service noted that here there were business reasons for P's transfer in a Section 351 exchange of substantially all of the assets and liabilities associated with its manufacturing business to a new subsidiary in exchange for the subsidiary's stock. P would retain control of S. Had P continued the manufacturing business and incurred the remediation costs itself, then the costs P incurred would be deductible in part and capitalized in part. The ruling concludes that it would frustrate the intent of Congress in allowing "necessary business readjustments" if S in this transaction were not afforded the same ability as P to deduct or capitalize expenses of an ongoing business.

Finally, Revenue Ruling 95-74 specifically notes that the Revenue Service will not follow the decision in *Holdcroft Transportation Co. v. Commissioner*, 153 F.2d 323 (8th Cir. 1946), on these facts. In *Holdcroft*, a corporate taxpayer

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acquired the business assets of a partnership in exchange for the corporation's stock and an assumption of partnership liabilities under the predecessor to Section 351 of the Code. One of the liabilities assumed was a bodily injury claim that arose from the partnership's operation of the business. Much like the situation presented in Revenue Ruling 95-74, the corporation then paid amounts in settlement of the claim against the partnership.

The Eighth Circuit Court of Appeals in *Holdcroft* held that amounts paid in settlement of such claims were payments in satisfaction of assumed liabilities, and could not be deducted. According to the court, the fact that this corporate taxpayer acquired the assets of a partnership in a tax-free transfer did not place the corporation in the same position with respect to expense and loss deductions as its predecessor would have been in had there been no transfer. In *Holdcroft*, this conclusion was pertinent both for purposes of the income tax as well as for the then applicable excess profits tax. Revenue Ruling 95-74 now says that it will not follow *Holdcroft* with respect to the assumption of contingent environmental liabilities.

Revenue Ruling 95-74 addresses only contingent environmental liabilities. It is silent as to other types of contingent liabilities (*e.g.*, other post-employment benefits). Presumably the analysis that supports the holding for environmental liabilities would also apply to all types of contingent liabilities.

Revenue Ruling 94-38, Too

Despite the favorable conclusion in Revenue Ruling 95-74, which will help insure that Section 351 (and Section 357) will not be a bar to certain restructurings where environmental liabilities are a concern, the ruling does not address the distinction between deductible and capital environmental expenditures. The Service's holding in Letter Ruling 9541005 limits a taxpayer's ability to deduct expenditures. However, this particular story begins with Revenue Ruling 94-38, 1994-1 C.B. 685.

In Revenue Ruling 94-38, a taxpayer was allowed to deduct expenses it incurred in soil and groundwater remediation. The soil and groundwater had been contaminated through a discharge of hazardous wastes generated by the taxpayer's manufacturing operations. These expenses were not held to be capital in nature because they were not permanent improvements made to increase the value of the property.

The value of the property would not be increased, the ruling reasoned, where the expenditures would merely restore the property to the condition it occupied prior to the contamination events which required the expenditures in the first place. This kind of "does it improve" analysis is obviously beneficial to taxpayers seeking to deduct the often substantial costs of remediation. The alternative of capitalizing such costs is almost never attractive.

Unfortunately, a recent letter ruling, No. 9541005, suggests that Revenue Ruling 94-38 may be interpreted narrowly. In that letter ruling, a taxpayer acquired property that was already contaminated. In fact, the property had been designated as a Superfund site. The taxpayer entered into a consent order with the Environmental Protection Agency in order to complete a remedial investigation and feasibility study.

Not surprisingly, the taxpayer incurred consulting fees in order to prepare the hazardous waste study, as well as legal fees in order to negotiate and draft the consent order. The question was what tax treatment these fairly substantial consulting and legal fees should receive.

Narrow Reading

Did Revenue Ruling 94-38 apply? The IRS in Letter Ruling 9541005 said no. According to the Letter Ruling, Revenue Ruling 94-38 will apply only to expenditures that *restore* contaminated property to its uncontaminated condition at the time it was acquired.

Under the facts involved in Letter Ruling 9541005, the property had been contaminated already, and was contaminated at the time it was acquired. Consequently, said the ruling, the actual clean-up costs would have to be capitalized improvements. Likewise, any and all costs that were associated with those improvements would also have to be capitalized. Here, the consulting and legal fees were precisely such associated costs. Letter Ruling

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9541005 therefore requires these costs to be capitalized rather than deducted.

Conclusion

It will be a long time before authorities concerning environmental liabilities become irrelevant. Given the enormous tax difference in this area between deducting and capitalizing, litigation on many of these fine points seems almost a foregone conclusion. In the meantime, Revenue Ruling 95-74 comes as welcome authority where a parent drops a business into a subsidiary and environmental liabilities are present. On the other hand, Letter Ruling 9541005 suggests a narrow view of one facet of the all-important deduction issue. ■