MEMORANDUM
Tax Issues with Environmental Expenditures

by Robert W. Wood, Esq.[*]
Robert W. Wood, P.C.
San Francisco, CA

Major References:

I.R.C. §§162, 198; *United Diary Farmers, Inc. v. U.S.*, 267 F.3d 510 (6th Cir. 2001); *Dominion Res., Inc. v. U.S.*, 219 F.3d 359 (4th Cir. 2000); *Cinergy Corp. v. U.S.*, 55 Fed. Cl. 489 (2003); *S&B Restaurant, Inc. v. Comr.*, 73 T.C. 1226 (1980); *Plainfield-Union Water Co. v. Comr*, 39 T.C. 333 (1962); *Allied Signal, Inc. v. Comr.*, T.C. Memo 1992-204; Rev. Rul. 2005-42, 2005-28 I.R.B. 1; Rev. Rul. 2004-18, 2004-8 I.R.B. 509; Rev. Rul. 98-25, 1998-1 C.B. 998; Rev. Proc. 98-17, 1998-1 C.B. 405; Rev. Rul. 94-38, 1994-1 C.B. 35.

INTRODUCTION

Real property owners are charged with the responsibility and cost of environmental clean-up expenditures. Indeed, a number of pieces of legislation enacted over several decades impose these obligations. The granddaddy of this clean-up legislation remains the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) of 1980. The owner of real property may incur costs to governmental entities or private parties as a fee, penalty, or damage payment, or simply as a function of remediating the land. Unfortunately, with the cost comes uncertainty over the proper tax treatment of such costs. When coupled with unfavorable tax consequences, real property owners suffer a double economic loss.

Real property owners typically face one of two general issues with respect to the tax treatment of environmental costs. By far the more prevalent issue is whether the costs are deductible in the year incurred or whether instead they must be capitalized. A second issue is whether certain fines and penalties paid to government entities (or in some cases, even non-government entities) can be expensed at all.

Much of the tax law here has not changed. Issues of deductibility often turn on rather subtle factual distinctions. This is an age-old exercise. Yet, there is one change. Last year the IRS released Rev. Rul. 2004-18,[1] adding an extra hurdle for the deduction of certain environmental remediation costs.

TO DEDUCT OR CAPITALIZE?

Historically, taxpayers attempting to deduct costs associated with environmental remediation have done so under the general business expense provisions of §162.[2] There is, of course, no separate environmental remediation deduction so denominated. The regulations provide that the cost of incidental repairs that neither materially add to the value of the property nor prolong its life may be deducted as an expense.[3] Many taxpayers have successfully deducted environmental repair or clean-up costs under this authority.

Not surprisingly, the IRS often disallows such deductions under §263(a), which generally prohibits deductions for capital expenditures paid or incurred to add to the value or substantially prolong the useful life of property, or to adapt the property to a new or different use.[4] This classic battle between deducting and capitalizing is nearly as old as the income tax. Even in the environmental arena, this battle between taxpayers and the IRS has rather clean battle lines and has been going on for many years.[5]

Case law and administrative rulings have helped shape what environmental remediation costs are deductible and what costs must be capitalized. The seminal case in the "deduct-versus-capitalize" match between taxpayers and the IRS remains *Plainfield-Union Water Co. v. Comr.*[6] Plainfield-Union was a privately owned water company in operation since 1890. In 1950, it added an additional water source to its water system. The new system drew from filtered river water, which was more acidic and resulted in tuberculation, reducing the carrying capacity of its pipes. The tuberculation also caused iron oxide to be transported in the water system when it reached the consumer.

The reduced carrying capacity occurred only after introduction of the new water source. The taxpayer cleaned out the pipes and lined them with cement to prevent transporting the iron oxide. The cement lining was not a permanent solution, but it eliminated the tuberculation and the need for constant cleaning of the pipes for as long as the cement lining actually lasted. Plainfield-Union deducted the costs as ordinary and necessary business expenses, and the IRS challenged the deduction.

The Tax Court concluded that the cleaning and cement lining amounted to a repair that merely restored the original carrying capacity of the pipes. Cleaning and lining the pipes did not materially enhance the

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[*] Robert W. Wood practices law with Robert W. Wood, P.C., in San Francisco (www.rwwpc.com). He is the author of *Taxation of Damage Awards and Settlement Payments* (3d ed. 2005), published by Tax Institute and available at www.damageawards.org.

[1] 2004-8 I.R.B. 509.

[2] Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

[3] Regs. §1.162-4.

[4] *See* Regs. §1.263(a)-1(b).

[5] *See Jones v. Comr.*, 242 F.2d 616 (5th Cir. 1957).

[6] 39 T.C. 333 (1962).

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value, use, life expectancy, strength, or capacity of the pipes, compared with the pipes prior to the condition that necessitated their repair. The cement lining also did not render the pipes suitable for any additional use.

All of this made perfect sense, of course. So, this *Plainfield-Union* test became the standard for determining whether environmental clean-up costs were deductible. In its decision, the Tax Court emphasized a comparison of the status of the improved asset with the prior status of the asset. This simple before-and-after analysis sought to determine whether the value, life, or integrity of the asset was enhanced beyond its otherwise normal life. Where an asset is enhanced in any of these ways, or where the enhancement creates a substantial new or additional use for the property, the taxpayer would have to capitalize the costs of the environmental correction. Conversely, where the repair or correction did *not* substantially create or add to the use of the property, or did not extend its life, value, or integrity, the taxpayer could deduct the related costs.

It is not surprising that *Plainfield-Union* has stood the test of time. However, the tax treatment of environmental clean-up costs was tested again in 1994 with a slightly different (and somewhat more troubling) result. In Rev. Rul. 94-38,[7] the IRS determined that costs incurred to clean up land and to treat groundwater contamination due to hazardous waste from the taxpayer's business were deductible as ordinary and necessary business expenses. However, in the same ruling the IRS determined that costs allocable to constructing groundwater treatment facilities were capital expenditures under §263(a). This parsing can be a painstaking process. Rev. Rul. 94-38 asks taxpayers to examine each environmental clean-up activity individually to determine whether the associated costs were deductible.

The facts in Rev. Rul. 94-38 involve a taxpayer who built a manufacturing plant on land it purchased in 1970. The land was not contaminated by hazardous waste at the time the taxpayer purchased it. In fact, it only later became contaminated as a result of the taxpayer's manufacturing process. The taxpayer buried the hazardous waste on its land, ultimately damaging both the soil and groundwater.

Like many buried problems, this one eventually surfaced. In 1993, the taxpayer was ordered to comply with federal, state, and local environmental requirements to remediate the contaminated soil and groundwater. The taxpayer excavated the contaminated soil, transported the waste to disposal facilities, and backfilled excavated areas with uncontaminated soil. The taxpayer also established a system for the continued monitoring of the groundwater to ensure that all hazardous waste was removed by the remediation. Plus, the taxpayer constructed groundwater treatment facilities, including wells, pipes, pumps, and other equipment to extract, treat, and monitor contaminated groundwater.

These measures eventually restored the taxpayer's land to the same physical condition that existed prior to the contamination. That kind of "put it back like it was" approach would seem to generate immediate deductions under *Plainfield-Union*. In determining whether the costs expended by the taxpayer in the remediation activities should be deducted or capitalized, the IRS ultimately bifurcated the costs associated with these activities, treating some as deductible and others as capital expenditures. Some of these line-drawing exercises are not easy and may be subject to varying interpretations.

For example, the IRS determined that the groundwater facilities constructed by the taxpayer had a useful life beyond the taxable year in which they were constructed. The costs of such facilities were therefore ruled to be capital in nature. On the other hand, the soil remediation and groundwater treatment expenditures did not produce permanent improvements to the taxpayer's land. Those costs would therefore be deducted.

The difference is meaningful. The IRS found that these latter expenditures merely restored the taxpayer's soil and groundwater to their approximate condition before they were contaminated by the taxpayer's manufacturing operations. Such expenditures did not prolong the useful life of the land, and they did not adapt the land to a new or different use. Just as the court had done in *Plainfield-Union*, the IRS compared the status of the affected asset after the expenditure with the status of that same asset before the condition arose which necessitated the expenditure. Thus, the before-and-after test had acquired new sophistication.

Rev. Rul. 98-25[8] brought a further requirement. There, distinguishing the conclusion of Rev. Rul. 94-38, the IRS allowed the taxpayer to deduct the full costs of replacing underground storage tanks containing waste by-products. The taxpayer placed waste from its manufacturing activities in steel tanks which it buried on its land. In compliance with federal, state, and local environmental laws, the taxpayer removed the old storage tanks and replaced them with new steel-fiberglass-reinforced plastic composite tanks. This process involved excavating the old tanks, draining the waste from those tanks, disposing of the old tanks at an appropriate disposal facility, transferring the waste by-products to the new tanks, placing the new tanks in the old hole, and filling the hole with soil.

In determining that all of the substantial costs associated with the process were deductible in the year incurred, the IRS did not rely upon *Plainfield-Union*. Rather, the IRS focused on §§162 and 263 and the accompanying regulations. The IRS analyzed whether the storage tanks had a useful life substantially beyond the tax year the costs were incurred. The IRS distinguished this situation from that in Rev. Rul. 94-38. In Rev. Rul. 94-38, the groundwater treatment facility had a useful life beyond the year in which the costs were incurred. That meant the value of the land

[7] 1994-1 C.B. 35.

[8] 1998-1 C.B. 998.

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increased when compared to the value of the land prior to the condition that required the expenditure. Replacing the old storage tanks with the new ones did not increase the useful life of the property. The new tanks could only be filled once, had no salvage value, and therefore had no useful life to the taxpayer beyond the year in which the costs were incurred.

Interestingly, Rev. Rul. 98-25 does not discuss whether the value of the land was enhanced, nor whether the new storage tanks created a new use for the property. The IRS seemed to stop short of the indices of the *Plainfield-Union* test, focusing on the storage tanks rather than on the land itself. In Rev. Rul. 94-38, the IRS had focused on the groundwater facilities, noting that the taxpayer actually used the asset substantially beyond the taxable year the costs were incurred. After all, the taxpayer used the facilities to monitor the groundwater on a continual basis. That monitoring encompassed examinations of the groundwater and the land, so the costs of implementing the facilities had to be linked to the land and the groundwater.

Shortly after issuing Rev. Rul. 98-25, the IRS issued Rev. Proc. 98-17,[9] announcing that the IRS would issue private letter rulings on the tax treatment of costs incurred in environmental clean-up projects that spanned multiple years, including both future and past years. While it was helpful in providing definite answers regarding the tax treatment in specific instances, this development has proven to be of limited value. Indeed, the revenue procedure itself says that under its terms, the IRS would only issue this written advice during the two-year period ending on February 2, 2000.

However, notwithstanding its limited and self-closing window, Rev. Proc. 98-17 still provided some enduring value. It defines both "environmental clean-up costs" and "environmental clean-up project," both key terms in this genre. These definitions help to frame what activities will be considered in drawing the deduct-versus-capitalize Maginot line. Under these definitions, environmental clean-up costs included any costs associated with the "assessment, mitigation, removal, or remediation of environmental hazards, whether latent or imminent, on the taxpayer's property or on the property of another."

The definition of an "environmental clean-up project" is even more detailed, including projects that consist of one or more of the following related environmental clean-up activities: (1) the study, remediation, and monitoring of soil and groundwater at a former manufacturing site, (2) the removal and replacement of asbestos in manufacturing equipment located at several of the taxpayer's operating plants, or (3) the removal of underground storage tanks, treatment of contaminated soil and groundwater, and removal of asbestos from a retail facility where the taxpayer intends to begin operations.

In the years since 1998, the courts have continued to use and refine the *Plainfield-Union* test. There are at least two cases (both holding that costs incurred by the taxpayers in environmental remediation should be capitalized) that actually modify the *Plainfield-Union* test. The Fourth Circuit's foray into this field came in *Dominion Resources, Inc. v. U.S.*,[10] an asbestos removal case. The Sixth Circuit weighed in with its own reading of *Plainfield-Union* in *United Diary Farmers, Inc., et. al. v. U.S.*,[11] a soil remediation case.

In *Dominion Resources*, the taxpayer (Dominion) owned all the stock of a regulated public utility. Dominion incurred approximately $2.2 million in the environmental clean-up of a property it had previously used as a power plant. Dominion deducted these costs as ordinary and necessary business expenses. The IRS disallowed the deduction.

Dominion had cleaned the property by removing asbestos-containing materials, sludge, and assorted contaminants to avoid liability to trespassers and third parties. The IRS contended that the taxpayer incurred these costs primarily to adapt the property for use in the company's real estate development business, constituting a new and different use from the previous use of the property as an electric generating facility. The Fourth Circuit looked to the *Plainfield-Union* test, which would suggest that a new and different use would mandate capitalization. Yet, the Fourth Circuit took a slight detour from the *Plainfield-Union* paradigms, stating that the focus should be not on the amount of value added to the property by the improvements, but rather on the *nature* of the improvements themselves.

If an improvement merely restored the value to property that existed prior to the deterioration, the improvement was properly deductible. In contrast, if the improvement permitted the property be utilized in a different way, the improvement should be capitalized. The court concluded that Dominion's environmental clean-up made the property fit for human habitation, a condition which did not previously exist. Because the environmental clean-up substantially altered the *character* of the property, the clean-up costs permanently improved the property and had to be capitalized.

Interestingly, the Fourth Circuit in *Dominion* noted that distinctions between capital expenditures and ordinary and necessary business expenses are complicated. That seems the pinnacle of understatement. Indeed, the court recognized that certain individual expenditures could be properly deductible if made in isolation, but would become capital in nature when incurred as part of a larger project of property improvement. The character of single expenses suggests that isolationism is preferred. Indeed, this transmutation of expenses, a kind of guilt-by-association, seems unfair, but is a built-in feature of *Plainfield-Union* analysis.

The Sixth Circuit case, *United Dairy Farmers v. U.S.*,[12] added another fillip to the traditional *Plainfield-Union* analysis. The court there determined that the costs incurred in cleaning up environmental

[9] 1998-1 C.B. 405.

[10] 219 F.3d 359 (4th Cir. 2000).

[11] 267 F.3d 510 (6th Cir. 2001).

[12] 267 F.3d 510 (6th Cir. 2001).

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contaminants were not ordinary because such contamination existed at the time the taxpayer purchased the property. United Dairy Farmers had purchased two pieces of property intending to use them as convenience stores. Both properties contained underground gasoline storage tanks left by previous occupants that caused soil contamination, and the taxpayer was aware of this at the time of purchase. Predictably, the taxpayer incurred costs in remediating the soil, and attempted to deduct them as ordinary and necessary business expenses.

One would assume this would involve a before-and-after analysis with the traditional focus on the dreaded new or different use distinction, which might be good from the standpoint of business flexibility, but would be bad from a tax perspective because it would inevitably spell capitalization. Yet, the court was a bit more sophisticated, finding there to be two key determinations: (1) whether the environmental clean-up costs allowed the property to be used in a different way, and (2) whether the property conditions should be evaluated as of the time prior to the contamination of the soil.

The taxpayer relied on *Plainfield-Union* and Rev. Rul. 94-38, both of which had blessed evaluating the property conditions prior to the condition necessitating the expenditure. The court, however, found a key factual difference, reasoning that the taxpayer could not rely on those authorities, since this taxpayer bought property that was *already* contaminated at the time of purchase. Plus, the taxpayer *knew* of the contamination. In contrast, *Plainfield-Union* and Rev. Rul. 94-38 both involved "clean" property.

Because the taxpayer purchased the property in a contaminated state, the court considered that cleaning up the property crated a new and different use for the property. The court distinguished "restoration" cases by stating that at the time the taxpayer acquired the property, there was no relationship between the improvements and the defects. If a taxpayer improves defects that were already present when the taxpayer acquired the property, the costs to remedy those defects are capital in nature. Where a taxpayer remedies defects that were present when the taxpayer acquired the property, *Plainfield-Union* does not apply.

The *United Dairy Farmers* court enumerated three elements which must exist for a taxpayer to deduct environmental clean-up costs as ordinary and necessary business expense deductions: (1) the taxpayer must have contaminated the property in the ordinary course of its business, (2) the taxpayer must have cleaned up the contamination to restore the property to its pre-contamination state, and (3) the clean-up must not have allowed the taxpayer to put the property to a new use. It is this third requirement, of course, that erects a new non-*Plainfield-Union* hurdle.

Interestingly, in putting the costs of restoring property that the taxpayer acquired in an already contaminated state in a separate category, the court does not point out or apparently rely upon the whipsaw that would occur to the fisc if a taxpayer could buy an already contaminated property and deduct remediation costs. That would be more preferable from a tax standpoint to buying a property that had just been cleaned up, where the purchase price (all capitalized) would of necessity clearly reflect the clean-up costs.

The courts have continued to massage the *Plainfield-Union* test. In so doing, they have limited the situations in which taxpayers may successfully deduct environmental remediation costs. Like the courts, Congress has also attempted to frame the situations in which a taxpayer may successfully deduct environmental remediation costs by enacting §198. Congress' offering may be too little too late, but it is at least some small crumb of relief during its pre-ordained short life.

SECTION 198 LIMITATIONS

Enacted in 1997, §198 allows taxpayers to elect to treat certain qualified environmental remediation costs that would otherwise have to be capitalized as deductible in the year paid or incurred. This provision appears to be of little value to taxpayers contemplating new remedial activities, as it is currently only effective for expenditures incurred before December 31, 2005.[13] In order for a taxpayer to make this election and receive a deduction for environmental remediation costs, the expenditure must be paid or incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site.[14]

The term "qualified contaminated site" generally means any property that is (1) held for use in a trade or business, (2) certified by the appropriate state agency, and (3) contains a hazardous substance.[15] It is worth noting that deductions for qualified environmental remediation expenditures (which otherwise would have been capitalized but for §198) are subject to recapture as ordinary income upon a sale or other disposition of the property for which the expenditures were made.[16] The deduction is not only limited for taxpayers who incur such costs prior to December 31, 2005, but also to taxpayers who do not permanently retain their property.

While the *Dominion* and *United Dairy Farmers* decisions were unfavorable to taxpayers, and §198 seems to offer only a limited avenue of deductibility for certain environmental remediation costs, not all authority in this area in recent years has been adverse. For example, in *Cinergy Corp. v. U.S.*,[17] a public utility removed and disposed of asbestos containing materials from a portion of its building. It replaced some of the removed materials with non-asbestos containing materials, and encapsulated some existing fireproofing material so as not to flake or spread potentially fibrous materials.

In delineating the deduct-versus-capitalize authority, the court commented on several points that all pointed towards a deduction. First, the taxpayer had

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[13] §198(h).

[14] §198(b).

[15] §198(c).

[16] §198(e).

[17] 55 Fed. Cl. 489 (2003).

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no intention of selling the building. Second, the work performed was not part of a larger project to refurbish the entire building. Third, the work did not extend the useful life of the building. Finally, the taxpayer internally characterized the asbestos removal and encapsulation as "maintenance," rather than as a capital project.

I find this last point particularly momentous. On this latter point, the court found that this semantic nicety was reflected in work order authorization forms, internal memoranda, minutes of office meetings, and recorded communications with the contractor who was performing the work. That means this "maintenance" moniker was spread liberally throughout the project, and like many an oft repeated shortcut, it stuck. I suspect many have read the *Cinergy Corp.* case to underscore the relevance of word choice. Indeed, sometimes something simply is what you call it.

Regardless of how important the "maintenance" moniker may be to the holding, the *Cinergy* decision is a happy one. In holding that the environmental remediation costs were deductible, the court distinguished *Dominion* and *United Dairy Farmers*. The removal and clean up of asbestos materials in *Dominion* had provided the property with a new use (real estate development), which substantially altered the character of the property. No such shift occurred with *Cinergy*. *Cinergy*'s facts were also different from *United Dairy Farmers*, since the asbestos issue did not exist at the time Cinergy built its building. In *United Dairy Farmers*, of course, the soil was already contaminated at the time the taxpayer acquired the property.

Cinergy involved a classic problem developing over time. The asbestos damage was not an issue at the time the building was constructed. Instead, the asbestos became friable over time, all while in the taxpayer's possession. Cinergy's correction was a remedial measure that had the effect of restoring that portion of the building to its original state. This remedial operation did not add value to the building, prolong its life, or add a new use to the property.

All of that seemed like *Plainfield-Union*, where deduction was the order of the day. *Cinergy* represents a recent example that despite the judicial and legislative restrictions, environmental remediation costs can be successfully deducted. Clearly, having the right elements is important. If you must have contamination, you want contamination arising over time, *not* pre-purchase contamination. Furthermore, you want the right use of the property post-"clean-up" (that is, no new use for the property, but rather merely a refurbishment that facilitates the same use). Semantics may also be important, with the "maintenance" moniker being preferred.

INVENTORY AND OTHER RED HERRINGS

The inventory rules doubtless seem out of place in this memorandum. Unfortunately, read on. Rev. Rul. 2004-18[18] takes a new approach, adding another hurdle for real property owners who attempt to deduct the cost of environmental remediation expenditures. There, the IRS determined that amounts incurred in cleaning up land the taxpayer contaminated with hazardous waste through operation of a manufacturing plant must be included in inventory costs under §263A.

The facts are not unlike those in Rev. Rul. 94-38. The taxpayer owned and operated a manufacturing plant that discharged hazardous waste onto portions of the taxpayer's land. The land was not contaminated with the hazardous waste when purchased by the taxpayer. The property produced by the manufacturing plant was inventory in the hands of the taxpayer.

To comply with federal, state, and local environmental requirements, the taxpayer incurred costs in remediating the soil and groundwater, and established an appropriate system for the continued monitoring of the groundwater to ensure that the remediation removed all of the hazardous waste. The remediation procedures restored the taxpayer's land to essentially the same physical condition it had prior to contamination. During this process, the taxpayer continued to use the land and operate the plant in the same manner as it did prior to the clean-up, except that the taxpayer disposed of all hazardous waste in compliance with environmental requirements.

Rev. Rul. 94-38 does not address the treatment of costs to clean up the land and treat groundwater as inventory costs under §263A. Similarly, Rev. Rul. 98-25 does not address whether amounts paid or incurred to replace the underground storage tanks must be included as inventory costs. In both rulings, the hazardous waste produced on the taxpayer's land was a byproduct of the taxpayer's manufacturing activity. Because the cost incurred in this ruling was viewed as a cost related to the production of inventory, capitalization was required.

The IRS states that even where a repair cost is deductible under §162, a taxpayer that causes environmental damage during the production of its inventory must *still* apply the rules of §263A to determine whether the repair costs must be included in inventory. In other words, the inventory rules of §263A trump the environmental rules, or to put it perhaps more cynically, capitalization always trumps deduction.

In Rev. Rul. 2004-18, the taxpayer incurred environmental remediation costs to clean up land that was contaminated as part of the ordinary business operations of the taxpayer's manufacturing of inventory. Under Regs. §1.263A-1(e)(3)(i), the costs are properly allocable to the property produced by the taxpayer that is inventory in its hands. As such, the tax-

[18] 2004-8 I.R.B. 509.

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payer had to capitalize the *otherwise deductible* environmental remediation costs, including these costs in inventory costs in accordance with Regs. §1.263A-1(c)(3).

The inventory rule caused some shock waves. Fortunately however, the IRS provided a transition rule within Rev. Rul. 2004-18. The IRS stated that it would not challenge any taxpayer who deducted environmental remediation or clean-up costs stemming from the manufacture of inventory prior to any taxable year ending February 6, 2004. However, where a taxpayer deducts those costs for any tax year ending *after* February 6, 2004, the IRS presumably will require these costs to be capitalized.

This development adds a new layer to the complexity of environmental remediation costs. First, the taxpayer should clear the *Plainfield-Union* hurdle by showing that the costs expended in remediating the property do not: (1) add value to the property; (2) prolong the property's useful life; or (3) adapt it to a different purpose. Next, the taxpayer must show that the clean-up activities are not related to the taxpayer's inventory manufacturing or production process. If the costs of clean-up are not a result of environmental damages stemming from the real property owner's inventory manufacturing activity, but are a result of some other activity in its ordinary course of business, the costs should be deductible.

However, if the environmental damage is caused by the taxpayer's inventory manufacturing process, then the costs expended in the related environmental clean-up must be capitalized as an indirect cost under Rev. Rul. 2004-18 and Regs. §1.263A-1(a)(3)(ii). This suggests the inventory versus non-inventory question is a lynchpin. Unfortunately, I do not think such issues are usually very easy to resolve. Or, to put it another way, given the sometimes difficult factual issues about who did what to the property when it seems like appropriate pragmatism to structure the payments as related to general operations (or something else that does not smack of inventory) when one can. This once again may invite the taxpayer to pay lip service to something that is deductible. Although such actions are to be decried where they do not fit the facts, ultimately, it often simply may be unclear who did what, when, and how. Environmental disputes often are difficult to resolve.

Rev. Rul. 2004-18 actually may have a chilling effect on voluntary clean-up efforts. Indeed, the ability to deduct such costs provides an added incentive to real property owners, somewhat mitigating the cost of such expenditures. Conversely, taking away those deductions has a deleterious effect. Although §198 still provides some taxpayers with relief, it does so only for a limited time period. Plus, it requires taxpayers to recapture the deductions as ordinary income upon disposition of the environmentally corrected property.

THE LATEST ON CAPITALIZATION

As if Rev. Rul. 2004-18 did not send a strong enough message to taxpayers wanting to deduct environmental remediation costs, the IRS issued Rev. Rul. 2005-42[19] in June 2005. Rev. Rul. 2005-42 emphasizes the IRS's intent on disallowing deductions for environmental remediation costs in any case where the source of the hazard requiring remediation is related to the taxpayer's manufacturing activity. This most recent ruling provides four alternative fact patterns stemming off of the one set forth in Rev. Rul. 2004-18.

In each of those fact patterns, the taxpayer contaminates land as a result of manufacturing its inventory. The taxpayer incurs environmental remediation costs in cleaning up the land, which are properly allocable under §263A to the inventory produced during the same taxable year. Just as in Rev. Rul. 2004-18, the soil and groundwater discussed in each fact pattern in Rev. Rul. 2005-42 are restored to the same physical condition that existed prior to the contamination as a result of the remediation. The remediation does not materially add to the value of the land, prolong the life of the land, nor adapt the land to a new or different use.

Essentially, capitalization of environmental remediation costs are required regardless of whether or not the taxpayer continues to manufacture the same type of inventory, utilizes the same land in its manufacturing process, or halts its manufacturing activities at the contaminated site either temporarily or permanently. The IRS determined that capitalization under the rules of §263A is proper in all of the following situations:

1. Where the taxpayer changes the type of product (i.e. from stoves to clothes washers) it manufactures after the hazardous waste is discharged and the land remediated;
2. Where the taxpayer temporarily ceases its manufacturing activities during the course of the clean-up process;
3. Where the taxpayer permanently ceased manufacturing operations on the remediated land and moves those activities to another site; and
4. Where the taxpayer buries hazardous waste from its manufacturing activities on a remote dump site instead of its own land and after restoring the dump site to its original uncontaminated condition, stopped using the dump site to bury waste.

In each of these four situations, the cost of the environmental remediation is allocable to the inventory produced by the taxpayer in the year the costs were incurred.

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[19] 2005-28 I.R.B. 1.

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The issuance of Rev. Rul. 2005-42 is consistent with the IRS's recent trend in disallowing deductions associated with environmental remediation costs. It effectively closes the door on taxpayers who restore their land from damages occurring as a result of their manufacturing activities. While this ruling appears not to have any effect on certain asbestos related cases like *Cinergy*, one can only imagine what type of environmental remediation costs the IRS will attack next.

FINES AND PENALTIES

Although capitalizing the expenses of environmental remediation is rarely an ideal scenario, it is certainly not the worst position an owner can face in the wake of making environmental payments. An even more unpalatable situation occurs when the taxpayer cannot recover any portion of its costs-ever. Fines or penalties paid or incurred as a result of environmental remediation violations may never be deducted. For that matter, they cannot be capitalized either. Section 162(f) prohibits any deduction for any fine or similar penalty paid to a government for the violation of any law.

Here, though, we need to distinguish between deductible penalties and non-deductible ones. Given §162(f), a deductible penalty may seem like an oxymoron. Fortunately, it is not, as there is a good deal of characterization that must go on within this deduction prohibition Code section. The term "similar penalty" is central to determining whether the unlikely payor of a penalty is entitled to a deduction. While all "fines" are included within the reach of §162(f), only "penalties" that are *similar* to fines are included and therefore nondeductible. This does invite quite a lot of hair-splitting.

A statute frequently will have many purposes, some of which are punitive in nature and some of which are remedial in nature. Determining the purpose of a provision can involve some investigatory work. Where statutes have dual purposes, and the legislative histories behind those statutes are silent or unclear, the courts must determine the intent of the penalty.

The stakes can be quite large. The tax treatment to the payor hinges on this determination. If the penalty is determined to be punitive in nature, the taxpayer will be unable to deduct it. If the penalty is determined to be remedial in nature, the taxpayer can deduct it. Here again, semantics can be quite important.

Several significant cases discuss the deductibility of monetary environmental sanctions. The best known and perhaps most ominous case is *Allied Signal, Inc. v. Comr.*,[20] which the taxpayer lost, admittedly on rather bad facts. Like *True v. U.S.*,[21] and *Colt Industries, Inc. v. U.S.*,[22] the court in Allied Signal took a dim view of attempts to deduct environmental sanctions.

The taxpayer faired much better in *S&B Restaurant, Inc. v. Comr.*[23] The taxpayer operated a motel and restaurant, and discharged sewage waste from its premises into an underground waterway. The taxpayer entered into an agreement with the Commonwealth of Pennsylvania to settle the violation. Under the settlement, the taxpayer made monthly payments up until the time that a central municipal sewer system became available. At that point, the taxpayer was to be able to connect to that system to discharge waste. In return, the taxpayer would not be prosecuted for any violations of the applicable statutes.

It is important to note that at the time of this violation, a central municipal sewage system was under construction, and the government wanted the taxpayer to connect to that system rather than to build its own treatment facility. Moreover, the payments to be made by the taxpayer totaled approximately the amount that would have been required had the municipality's central sewage system been operational at that time. The court also found that no practical environmental harm was being caused by the taxpayer's discharge of sewage waste.

In arguing that the monthly payments were fully deductible, the taxpayer emphasized that: (1) the payments were for permission to continue discharging raw sewage and (2) they were designed to further public policy such that they could not constitute a "fine" or "penalty." In the alternative, the taxpayer argued that the payments did not fall within the ambit of §162(f) since no legal proceeding was instituted against the taxpayer, and no conviction or other disposition of any such proceeding was involved. The IRS argued that the payments fell squarely within the prohibition of §162(f). Moreover, under Regs. §1.162-21(b)(1)(iii), an amount paid in settlement of the taxpayer's actual or *potential* liability for a fine or penalty can be characterized as a fine or penalty.

The court ultimately held for the taxpayer. In analyzing the Clean Streams Law (the environmental statute at issue) the court concluded that the statute had a dual purpose: (1) to control pollution, and (2) to fine or penalize those who did not comply with the statute. The court determined that these payments were in furtherance of controlling pollution. The court also concluded that these payments were made by the taxpayer in consideration of being allowed to continue to discharge its sewage waste, rather than as a fine or similar penalty imposed by the law or settlement of the taxpayer's actual or potential liability.

The court reached this conclusion based on several factors. The court determined that the taxpayer was obligated to connect into the municipal sewer system when it became available, and these payments were to continue only until that time. The court found that the indefiniteness of the total amount of the payments distinguished them from a fine or penalty, which is usually a fixed amount. The state had also determined that no practical environmental harm would be caused by the taxpayer's continued discharge of the sewage waste.

[20] T.C. Memo 1992-204, *aff'd without opinion*, 54 F.3d 767 (3d Cir. 1995).

[21] 894 F.2d 1197 (10th Cir. 1990).

[22] 880 F.2d 1311 (Fed. Cir. 1989).

[23] 73 T.C. 1226 (1980).

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One of the lessons of *S&B Restaurant* is that a payment can be characterized as something other than a "penalty that is similar to a fine" when the statute imposing that payment has a dual purpose, one of which is *not* a fine or similar penalty. The nature of the payment, the policy of the statute, and the facts may yield a deductible result.

In *Colt Industries*,[24] the taxpayer challenged the disallowance of deductions for penalties assessed under the Clean Water Act and the Clean Air Act. The taxpayer's subsidiary violated federal environmental protection statutes and remitted $1.6 million in civil penalties in satisfaction of its violations. On its consolidated return, the taxpayer deducted the $1.6 million, and the IRS disagreed.

The taxpayer did not contest the payment's characterization as a "civil penalty,"[25] but rather argued that §162(f) only barred the deduction of civil penalties that serve a punitive or criminal purpose. The $1.6 million in civil penalties it paid, it argued, did not serve such a purpose.

The legislative history to §162(f) suggested that a deduction for "late filing charges or interest charges" imposed "to encourage prompt compliance with filing or other requirements" is not barred by §162(f). Noting this, the court recognized that the legislative history actually clarified that civil penalties are within the ambit of §162(f). The taxpayer attempted to use this legislative history to distinguish between deductible and nondeductible civil penalties, which were not the purpose of the legislation.[26] The court in *Colt* determined that the taxpayer's payment did not meet the legislative exception of "late filing charges" for encouraging prompt compliance with filing or other requirements.

In *True v. U.S.*,[27] the court held that a civil penalty paid by the taxpayer for an oil leak in violation of the Federal Water Pollution Control Act was nondeductible. The court determined that the Federal Water Pollution Control Act had a deterrent and retributive function similar to a fine. Furthermore, the statute included an additional provision allowing the government to recover clean-up costs, which was intended to be the primary mechanism for compensatory or remedial payments. As such, the court reasoned that the penalties paid by the taxpayer served the function of punishment.

[24] 880 F.2d 1311 (Fed. Cir. 1989).

[25] The court referred to Regs. §1.162-21(b)(1)(ii) and (iii) in noting that a fine or similar penalty includes an amount paid as a civil penalty imposed by federal, state, or local law or paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal).

[26] *See* S. Rep. No. 437, 92d Cong., 1st Sess. 73-74 (1971).

[27] 894 F.2d 1197 (10th Cir. 1990).

WHEN IS VOLUNTARY VOLUNTARY?

This brings us to *Allied-Signal v. Comr.*,[28] a case that continues to spawn interest. The taxpayer manufactured and sold a highly toxic chemical pesticide that ultimately polluted several populated bodies of water harming employees, fisherman, and other individuals. Approximately 10,500 persons claimed to have been harmed by the chemical either physically or economically and sought to recover damages in excess of $25 billion. In its efforts to clean up the affected land, Allied-Signal incurred large remedial costs.

In addition, Allied-Signal initially was liable for a total fine of $13.24 million. In anticipation of the impact of this fine, the taxpayer established a "voluntary" endowment fund. The fund called for a portion ($8 million) of the monies otherwise treated as a penalty to be paid to the fund for the benefit of the injured parties. The taxpayer had informal assurances from the presiding judge that the amount of the penalty would be reduced by the amount contributed to the endowment fund.

The taxpayer argued that the $8 million payment to the endowment fund was not a fine or similar penalty. After all, it was voluntary, and it did not punish or deter the taxpayer. The Third Circuit agreed that a voluntary payment is not a fine or similar penalty within the meaning of §162(f), but was clear in stating that the $8 million payment made by Allied-Signal was not voluntary. The facts and semantics both need to be examined. The court defined a "voluntary" payment as made without expectation of a *quid pro quo*. The Third Circuit concluded that Allied-Signal made the $8 million payment to the endowment fund with the virtual guarantee that the sentencing judge would reduce the criminal fine by at least the amount so contributed.

This was a crushing blow, but Allied-Signal had an alternative argument. It argued that compensatory damages paid to a non-government third party do not constitute a fine or penalty, as they serve remedial purposes.[29] The court recognized that civil penalties could have multiple purposes. They can help to enforce the law by punishing violators, as well as encourage prompt compliance with a requirement of the law. They can act as a remedial measure to compensate another party. In the case of a dual-purpose civil penalty, it is the court's task to determine which purpose the payment was designed to serve.

In *Allied-Signal*, the court determined that the payment served a law enforcement purpose rather than a compensatory purpose. It was in substance, a criminal fine, not a voluntary payment to an endowment fund. The Third Circuit noted that the primary reason the taxpayer agreed to contribute to the fund was to obtain a deduction for the payment, thereby mitigating the cost of the penalty. Significantly, the court con-

[28] T.C. Memo 1992-204, *aff'd without opinion*, 54 F.3d 767 (3d Cir. 1995).

[29] *See* Regs. §1.162-21(b)(2).

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cluded that it was not necessary for the government to actually "pocket the fine or penalty to satisfy the paid to a government requirement of [§]162(f)."[30]

In an interesting ancillary issue, the court determined that legal fees and related expenses associated with the penalty were not actually part of the penalty. As such, those ancillary costs were deductible. Those expenses were incurred to defend civil actions arising from the violation of the law and defense costs incurred in the prosecution. Not being a payment to the government, they fell outside the scope of §162(f).

Taxpayers who pay penalties for violating federal, state, or local environmental statutes, and who seek to deduct them must be able to show that the payments more closely resemble either a late filing fee or compensatory payment than a penalty. Each situation appears to turn on its facts as well as the language and legislative history of the statute involved.

Plus, in light of Rev. Rul. 2004-18, it is worth questioning whether an otherwise deductible compensatory penalty would be subject to the capitalization requirements of §263A where the violation giving rise to the penalty was in connection with the taxpayer's inventory manufacturing process. If so, it would be another step in the wrong direction for real property owners who are responsible for environmental remediation and other costs.

PROPERTY TAXES: TEMPORARY ABATEMENT

Property taxes do not represent a significant part of the environmental tax literature, but perhaps they should. Where environmental defects are discovered on a property, a local property assessor may reduce the assessed property value by the amount of the environmental defect for the period until the defect is fully remediated, thereby decreasing the amount of property taxes due on the property. Assessors are unlikely to take this step without some prompting.

In seeking an abatement or reduction of property taxes, the taxpayers should consider potential statute of limitations issues. The timing and degree of contamination may be too attenuated to merit such abatement, especially in situations where the property has already been remediated. Where the defect is already cleaned up, the real property owner may seek a refund attributable to the period of time the property was burdened. Obviously, like remedial assessments, refunds do not happen automatically.

Some of the case law in this area is interesting. For example, in *Columbus City School District Board of Education v. Wilkins*,[31] the tax commissioner granted a 10-year property tax exemption on the increase in value attributable to the voluntary remediation of hazardous waste (but not for the increase in value from any cause or construction). The tax exemption applied to the increase in the assessed value of land, improvements, buildings, fixtures, and structures situated on that land at that time.

In *Town of Jay v. Androscoggin Energy LLC et. al.*,[32] the Department of Environmental Protection and Board of Environmental Protection granted Androscoggin Energy a property tax exemption for retrofitting turbines to minimize pollution output. The taxpayer owned and operated a gas-fired cogeneration plant that produced and sold steam and electricity to the regional market. In an attempt to comply with a local law mandating that new energy generation facilities comply with the best available control technology, the taxpayer retrofitted turbines with a low nitrogen oxide combustion system.

The town of Jay had an interest in this, since it would have received the property taxes on this plant but for the exemption. The town sued, alleging that the Department of Environmental Protection erred in granting the property tax exemption. The town stated that the primary purpose for the retrofitted turbines was to produce energy, and the secondary purpose was pollution control. The court concluded that the Department of Environmental Protection did not err in finding that reducing industrial air pollutants was Androscoggin Energy's primary motivation in retrofitting the turbines. The court's analysis hinged on determining the taxpayer's primary purpose, as the statute allowing the tax exemption called for pollution control as the necessary primary purpose.

A third recent example of property tax abatement due to environmental concerns can be seen in *Appeal of Town of Newington*,[33] where the taxpayers received several property tax exemptions in constructing and operating a cycle electric generation facility. The New Hampshire Department of Environmental Services granted Newington Energy, LLC and Hawkeye Funding, LP (collectively NEL) full exemptions for several pollution control systems, including its water injection system, smoke stacks system, temporary construction devices, storm and water management system, and denied an exemption for a portion of its demineralization system.

The New Hampshire statute allowed any person who built, constructed, installed, or placed in use any treatment facility, device, appliance, or installation wholly or partly for the purpose of reducing, controlling, or eliminating any source of air or water pollution a whole or partial property tax exemption on the value of such facility or device, and any real estate necessary for such facility or device. It further mandated that the Department of Environmental Services determine a partial tax exemption based on the allocation of the taxpayer's investment in the facility's pollution control purpose.

The court examined each project and determined whether the Department of Environmental Services' basis for granting or denying a property tax exemption was in error. In most cases, the court determined that the exemption was justified, as these projects had

[30] *Allied-Signal v. Comr.*, T.C. Memo 1992-204, *aff'd without opinion*, 54 F.3d 767 (3d Cir. 1995).

[31] 802 N.E.2d 637 (Ohio 2004).

[32] 822 A.2d 1114 (Me. 2003).

[33] 821 A.2d 1100 (N.H. 2003).

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a pollution control purpose. Where this was not the primary purpose, the taxpayer was granted a partial property tax exemption based upon the percentage of pollution control intent allocated to each project, in compliance with the statute.

Needless to say, divining a taxpayer's intent is not easy. Perhaps this is particularly true where one seeks to determine which percentage of intent is attributable to one goal and which percentage of intent is attributable to another. Ultimately, recordkeeping and window dressing can be important. This is not mere cynicism, but rather can be attributed to the realities of showing just what a particular effort is all about. Recall for that as we saw in some of the deduct versus capitalize authorities under federal law, sometimes calling something "maintenance" will help to make it so.

CONCLUSION

Taxpayers will continue to incur significant costs in remediating land damaged by hazardous waste or other environmental debilitating conditions. In fact, these costs seem likely to increase rather than diminish. The economic impact of these costs can be mitigated if the taxpayer can immediately deduct them. Taxpayers will encounter resistance to deducting these costs where they relate to pre-acquisition contamination, where the costs are related to cleaning up land which the taxpayer polluted in the course of its manufacturing process, and where the costs are considered a fine or similar penalty imposed by a federal, state, or local statute.

Whether environmental remediation is voluntary or compelled by an appropriate authority, the taxpayer often will be required to capitalize its costs. In some cases, it will not be able to recover those costs at all.

Regardless of the treatment of these costs for purposes of U.S. federal income tax, the taxpayer should attempt to secure a state or local property tax exemption for the time period attributable to the contamination and the remediation. More than a handful of states appear to have such statutes in effect, although the extent of exemption may differ. Property tax relief may not provide complete tax relief to a taxpayer that expends these costs, but it can help soften the impact of a less desirable federal income tax result.

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