The Tax Lawyer

VOL. 52
NO. 1
FALL 1998

Published by
Section of Taxation, American Bar Association
With the Assistance of
Georgetown University Law Center

59 Years of Public Service

TAX TREATMENT OF ENVIRONMENTAL TRANSACTIONS

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I. INTRODUCTION

Businesses in the United States incur significant economic costs when complying with the vast array of governmental regulations enacted since the 1960s and 1970s.[1] Among the most expensive of the new "social regulations" are those implementing federal and state environmental policy.[2] Pervasive environmental regulation is now a recognized, although not necessarily welcome, fact of doing business in the United States. For many sectors of the economy — particularly, the chemical and petroleum industries — state and federal environmental regulation reaches virtually every level of business activity. While not all businesses so directly confront the plethora of rules and regulations enacted to protect the environment, for those that do, the cost of compliance can be staggering. Even for those industries not directly subject to the environmental statutes, this form of regulation imposes "hidden" or indirect outlays as the cost of compliance is built into the price of chemical and petroleum products used generally by American industry. In this way, the costs of environmental compliance and remedial programs constitute a significant financial cost for virtually every sector of domestic industry.

In those sectors of the economy where environmental regulation is a direct and visible cost of doing business, most decision makers have integrated this cost into the overall scope of their financial planning and into the price structure of their products. However, even those familiar with the nature and magnitude of the costs of environmental regulation need to understand better the income tax consequences of such expenditures. The tax considerations should be considered within the context of the current and long-term tax planning of the business entity as a whole. Yet remarkably, it is common for businesses to enter into consent agreements with the Environmental Protection Agency ("EPA") or settlements with other parties in environmental litigation involving millions of dollars

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[1] An excellent analysis of the new "social regulation" that characterized federal activity during the 1960s and 1970s (as contrasted with the regulatory agencies created during the New Deal) is presented by Richard Harris and Sidney Milkis: "Whereas the New Deal focused on economic issues, major initiatives during the 1970s involved the federal government directly in so-called quality of life issues such as safety in the workplace, affirmative action, pollution control, and consumer protection." RICHARD A. HARRIS & SIDNEY M. MILKIS, THE POLITICS OF REGULATORY CHANGE: A TALE OF TWO AGENCIES vii (2d ed. 1996).

[2] *See id.* at 225: "Of all the new social regulation, that dealing with environmental regulation imposed the highest compliance costs on business firms."

without adequately considering or anticipating the tax consequences of their actions.

This Article focuses on the major federal income tax issues related to the costs imposed on American businesses by federal environmental regulation.[3] Manufacturing concerns, real estate developers, and even passive investors in real estate syndications may find themselves facing potential liabilities and ultimately may be required to expend significant sums to comply with environmental statutes. This Article will evaluate the tax implications flowing from the most common and important "environmental transactions" — by which is meant those transactions required or mandated under the federal environmental statutes.[4]

Broadly speaking, an environmental agency and a particular business interact through two distinct forms of regulation. First, the environmental statutes have a substantial impact upon ongoing business operations (for example, the establishment of emission controls, permitting, development of waste management requirements, expenditures on new technology to reduce emissions, etc.). This form of regulation imposes its own very particular type of "environmental compliance" cost on businesses. Second, "environmental remediation" costs are incurred where there are unpermitted discharges of contaminants into the environment (*e.g.*, hazardous waste cleanups, soil and water remediation, wetlands restoration, etc.). These costs include those required for cleanup operations where hazardous materials have been "dumped" illegally — or in certain cases, before the dumping became illegal. Together, expenditures for environmental compliance and remediation are the direct and indirect costs that result from environmental transactions.

For the most common environmental transactions imposed by statute or regulation, this Article identifies the relevant tax issues, considers the appropriate tax treatment, and discusses various planning opportunities frequently overlooked. It is important that tax professionals and legal advisers representing businesses in environmental transactions (as well as in litigation arising out of such transactions) be aware of the various tax issues and the potential impact on their clients. In addition, those responsible for preparing a business's financial statements — particularly where the company is publicly traded — need to be involved in the analysis from the outset.[5] Only when all these professionals are working together

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[3] The central concern here is federal environmental law. State environmental regulation, which generally follows and implements standards set by the federal government, imposes additional costs on business.

[4] The term "environmental transaction" was coined by Professor Timothy Malloy of UCLA Law School to convey the notion that costs incurred in complying with federal and state environmental statutes should be viewed as one more cost of doing business. Timothy F. Malloy, *Bridging the Gap: Integrating Tax, Environmental Considerations*, THE LEGAL INTELLIGENCER, June 19, 1997, at 7.

[5] The standards for reporting contingent environmental liabilities for financial purposes are enunciated by the Securities and Exchange Commission ("SEC") and the Financial Accounting Standards Board ("FASB"). For a summary of these accounting standards, *see Official Releases: FASB No. 126...SOP 96...Auditing Interpretations*, J.ACCT., Mar. 1997, at 96.

can a company entering into an environmental transaction obtain the most favorable tax results. Rather than an after-thought, tax issues should be a driving factor from the very first stage of the environmental transaction — just as for any other complex, expensive business transaction.

II. ENVIRONMENTAL TRANSACTIONS

A. *Liability Under the Environmental Statutes*

During the 1970s, Congress enacted a host of statutes designed to protect the environment and reduce or eliminate risks to human health. These statutes include the Clean Air Act of 1970,[6] the Clean Water Act of 1972,[7] the Safe Drinking Water Act of 1974,[8] the Resource Conservation and Recovery Act of 1976 ("RCRA"),[9] the Toxic Substances Control Act of 1976 ("TSCA"),[10] and the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA").[11] Collectively, these statutes create a web of regulatory restrictions on the interaction between businesses and the environment, and thereby, impose significant costs on doing business in the United States.

The most prominent and expensive of environmental transactions are those incurred in cleaning up sites contaminated by "hazardous waste." Cases involving contamination from hazardous waste are highly dramatic and hence are commonly publicized by the popular media. The infamous Love Canal site near Niagara Falls, New York, attracted considerable media attention in 1968.[12] However, cleaning up sites contaminated by hazardous waste is only one aspect of environmental regulation. The generation, handling, storage, and disposal of hazardous waste are all heavily regulated under the "cradle to grave" regulatory scheme of RCRA. This statute, as well as those rules and regulations promulgated by the EPA, impose significant compliance costs on businesses dealing with any form of hazardous waste.

Hazardous waste has been defined by Congress in general terms, allowing for broad regulatory control over a significant portion of U.S. industry. Hazardous

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[6] 42 U.S.C. §7401 (1994).

[7] 33 U.S.C. § 1251 (1994).

[8] 21 U.S.C. § 349; 42 U.S.C §§ 201, 300f to 300j-9 (1994).

[9] 42 U.S.C. § 6901 (1994). In 1984, RCRA was substantially amended under the Hazardous and Solid Waste Amendments ("HSWA").

[10] 15 U.S.C. § 2601 (1998).

[11] 42 U.S.C. § 9601 (1998). CERCLA is also commonly known as "Superfund." CERCLA was subsequently revised by the Superfund Amendments and Reauthorization Act of 1986 ("SARA").

[12] Remarkably, final settlement of legal claims arising out of the Love Canal contamination was reached only recently, in March 1998, some twenty years later. At that time, Occidental Petroleum — successor to the Hooker Chemical Company, which generated and dumped the hazardous waste at the site — paid compensation to the last 900 families for medical claims. In addition, Occidental paid the federal government an estimated $300 million, and New York State some $78 million, for cleaning up the site and relocating families at the site. *See Coda for Love Canal: Last Suits Are Resolved,* NAT'L L.J., May 11, 1998, at B2.

waste is defined in RCRA as any "solid waste"[13] that "cause[s], or significantly contribute[s] to an increase in mortality or an increase in serious irreversible, or incapacitating reversible, illness . . . or pose[s] a substantial present or potential hazard to human health or the environment when improperly treated, stored, transported, or disposed of, or otherwise managed."[14] This broad concept has been given substance by the EPA in its regulations, wherein hazardous waste is defined as any solid waste that the agency deems hazardous by virtue of displaying one of four hazardous waste characteristics: ignitability, corrosivity, reactivity, or toxicity.[15] The EPA estimates that as much as fifteen percent of all solid wastes produced as by-products of the manufacturing process constitute hazardous waste.[16] The Congressional Budget Office (CBO) estimates are that as much as sixty percent of this hazardous waste is produced by the chemical and petroleum industries alone.[17] (Toxic waste, a subcategory of hazardous waste, is waste containing any of those substances designated by the EPA in regulations as "toxic."[18] Despite the common tendency to equate the two, hazardous waste actually pertains to a much broader, more inclusive category than toxic waste — one that includes toxic waste and much more.)

Over 500,000 businesses and individuals are subject to regulation under RCRA with respect to the generation, transportation, and storage of hazardous waste.[19] To say the least, this regulation imposes significant expenses on domestic industry. The regulation of hazardous waste under RCRA alone was recently estimated by the EPA to cost American industry some $2 billion annually (in 1986 dollars), with that figure predicted to surpass $12 billion by the year 2000.[20] Most of these costs of compliance relate to the ongoing operations of manufacturers and are best viewed as an opportunity cost of doing business for firms engaged in such activities. At the same time, the significant cost of complying with RCRA may create perverse incentives for some industries. For example, if the cost of compliance is greater than the cost of noncompliance, evasion is

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[13] Solid waste is defined in RCRA as any "garbage, refuse, sludge from a waste treatment plant, water supply treatment plant or air pollution control facility and other discarded material, including solid, liquid, semisolid, or contained gaseous materials resulting from industrial, commercial, mining, and agriculture activities . . . ." 42 U.S.C. § 6903(27) (1998).

[14] 42 U.S.C. § 6903(5) (1998).

[15] A solid waste is deemed "hazardous" if it is listed in 40 C.F.R. pt. 261 (D) (1997) ("listed" hazardous waste), or if it exhibits one of the four physical or chemical characteristics described in 40 C.F.R. pt. 261(C) (1997). Subpart C identifies the four general characteristics of hazardous waste: ignitability, corrosivity, reactivity, and toxicity.

[16] *See* U.S. ENVIRONMENTAL PROTECTION AGENCY, ENVIRONMENTAL BACKGROUNDER 113 (Jan. 1989). *See also* CHARLES A. WENTZ, HAZARDOUS WASTE MANAGEMENT 105 (1989).

[17] CONGRESSIONAL BUDGET OFFICE, HAZARDOUS WASTE MANAGEMENT: RECENT CHANGES AND POLICY ALTERNATIVES 17-18 (1985).

[18] The EPA presently designates some 450 chemicals as "toxic." 40 C.F.R. § 261.30-261.33 (1997).

[19] DAVID R. CASE, *RESOURCE CONSERVATION AND RECOVERY ACT*, *in* ENVIRONMENTAL LAW HANDBOOK 60 (Thomas F. P. Sullivan ed., 1993).

[20] U.S. ENVIRONMENTAL PROTECTION AGENCY, ENVIRONMENTAL INVESTMENTS: THE COST OF A CLEAN ENVIRONMENT - A SUMMARY 3-4 (1991).

encouraged. This distorted economic structure is often present in cases involving the disposal of hazardous waste. According to one commentator:

> Before RCRA, companies frequently disposed of waste using inexpensive techniques. Complying with hazardous waste regulations imposes substantial financial burden, which may result in a company's product or service becoming economically noncompetitive (or substantially reduce the profit margin). One response to these new burdens is to ignore them. Firms may gamble that illegal practices will not be detected, or, if they are, that the penalties will be less onerous than the compliance costs.[21]

To counter these perverse incentives, criminal sanctions are imposed.[22] Still, sites have been and continue to be contaminated — at times intentionally in defiance of existing law.

Under CERCLA, the EPA is authorized to clean up a site at which there is a "release or substantial threat of release" of any pollutant or contaminant which presents "an imminent and substantial danger to the public health or welfare or the environment."[23] Following investigation of a potentially contaminated site, the EPA is required to make a determination as to whether the contamination warrants placing the site on the National Priorities List ("NPL") of the most dangerous hazardous waste sites. (A site listed on the NPL is commonly referred to as a "Superfund" site.) The EPA uses the so-called Hazardous Ranking System ("HRS") as a preliminary means for evaluating a new site with respect to its likely impact on the environment and for determining whether it should be placed on the NPL and hence, earmarked for federal cleanup. As of January 1995, some 1,088 sites were deemed imminent threats to human health and placed on the NPL as Superfund sites.[24] However, remediation of contaminated sites has proceeded at a slow pace. During the first decade under CERCLA, only forty-eight of the approximately 1,100 Superfund sites on the NPL had been cleaned up.[25] This figure is dwarfed by the more than 30,000 sites identified by the EPA as sites where hazardous wastes have been improperly stored, spilled, abandoned, or dumped.[26]

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[21] NANCY K. KUBASEK AND GARY S. SILVERMAN, ENVIRONMENTAL LAW 204 (2d ed. 1996).

[22] In addition to civil penalties, RCRA includes criminal sanctions where any person "knowingly" transports or disposes of hazardous waste without a permit or in violation of a permit. 42 U.S.C. § 6928(d) (1994). Under CERCLA, the failure to notify state and federal authorities of a release of a "reportable quantity" of a hazardous substance into the environment can result in criminal penalties of up to $250,000 per individual and $500,000 per entity. Stricter provisions apply to the intentional concealment of a release of a hazardous substance or contamination of a site. 42 U.S.C. § 9603(b) (1994).

[23] 42 U.S.C. §9604(a)(1) (1994). Under RCRA, the EPA is also authorized to bring a suit to restrain any "imminent or substantial endangerment to health or the environment." The federal courts have held that the EPA may recover response costs under RCRA from past non-negligent, off-site generators and transporters of hazardous waste. *See, e.g.*, United States v. Northeastern Pharmaceutical, 810 F.2d 726 (8th Cir. 1986).

[24] U.S. ENVIRONMENTAL PROTECTION AGENCY, THE SUPERFUND PROGRAM: TEN YEARS OF PROGRESS (1991).

[25] FRONA M. POWELL, LAW AND THE ENVIRONMENT 359 (1998).

[26] U.S. ENVIRONMENTAL PROTECTION AGENCY, ENVIRONMENTAL PROGRESS AND CHALLENGE: EPA UPDATE (1989).

The main reason that remediation projects have proceeded at such a slow pace is that cleaning up a Superfund site is extremely expensive, with the average cost estimated to be $30 million.[27] The General Accounting Office ("GAO") has determined that as of the close of the 1993 fiscal year, $8.7 billion had already been spent by government, private businesses and individuals to clean up sites designated by the EPA as in violation of CERCLA.[28] Furthermore, it has been estimated by the Congressional Budget Office ("CBO") that the total cost of cleaning up all currently identified hazardous waste sites and all sites so designated at a future date by the EPA will range from an additional $106 billion to as much as $463 billion.[29] As noted in a recent assessment of the Superfund program: "Even if the federal government financed only a quarter of the cleanups [on the NPL] and contributed only $10 million to each (a conservative estimate), the cost would exceed $1 trillion, or approximately 160 times EPA's annual budget."[30] Clearly, significant expenditures have already been and will continue to be made to clean up hazardous waste sites designated as a threat to the environment and human health.

Under CERCLA, the EPA is authorized to act in the event of a release or substantial threat of release of a hazardous substance from a "facility" or vessel.[31] The EPA has the option either to clean up the hazardous waste site or to order any "potentially responsible person" ("PRP") to remediate the site. Persons who have liability as a PRP with respect to a designated Superfund site include the generator of the hazardous waste disposed of at the site, the transporter of such hazardous waste, the original owner and/or operator of the contaminated site, and successors in interest to the original owner, generator, or transporter.[32] In addition, owner and operator liability has been extended beyond the apparent categories. For instance, lenders to financially troubled operators have been held liable for the cleanup costs associated with sites owned by their borrowers.[33] Similarly, parent corporations have been held liable for the obliga-

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[27] U.S. ENVIRONMENTAL PROTECTION AGENCY, ENVIRONMENTAL STEWARDSHIP: EPA'S FIRST TWO YEARS IN THE BUSH ADMINISTRATION (1991). The EPA also estimates that the cost of investigating the average Superfund site and developing specific remediation proposals, including technical feasibility and environmental impact studies, is approximately $1.3 million. This cost does not include any actual remediation work, but merely the *planning* for such work.

[28] UNITED STATES GENERAL ACCOUNTING OFFICE, SUPERFUND: EPA HAS OPPORTUNITIES TO INCREASE RECOVERIES OF COSTS 2 (1994). The EPA itself has estimated that as much as $30 billion has been spent to clean up Superfund sites. *Superfund Program (Part I): Hearings Before the Subcomm. on Transp. and Hazardous Materials of the House Comm. on Energy and Com.*, 103rd Cong. 479-80 (1993) (testimony of Carol M. Browner, Administrator of EPA).

[29] CONGRESSIONAL BUDGET OFFICE, THE TOTAL COSTS OF CLEANING UP NONFEDERAL SUPERFUND SITES (1994).

[30] JOHN A. HIRD, SUPERFUND: THE POLITICAL ECONOMY OF ENVIRONMENTAL RISK 7 (1994).

[31] Under CERCLA, "facility" is broadly defined as "any site or area where a hazardous substance has . . . come to be located." The term includes any real property, building, structure, plant, or equipment. A "release" is defined broadly as: "any spilling, leaking, pumping, pouring, emitting, emptying, discharging, injecting, escaping, leaching, dumping, or disposing into the environment." 42 U.S.C. § 9601(22) (1994).

[32] *See* 42 U.S.C. § 9607(a) (1994).

[33] *See* United States v. Fleet Factors Corp., 901 F.2d 1550, 1557-8 (11th Cir. 1990).

tions of a subsidiary PRP where the parent controls or dominates the activities of its subsidiary.[34] The Supreme Court recently held that for a parent corporation to be held liable for the remediation of a site owned by its subsidiary, the parent must have had some involvement in the contamination of the site, and not merely in controlling the subsidiary.[35] Attempting to define what would constitute such "involvement" in the contamination of the site, Justice Souter stated that the parent can be held liable, for example, if some of its employees managed or supervised the pollution of the site.[36]

In cases where the EPA itself cleans up a site, the project will be funded out of the Superfund trust.[37] The EPA is authorized to bill any or all PRPs for the costs incurred by the EPA in remediating such site, with any reimbursements actually collected from the PRPs turned over to the Superfund trust.[38] Regardless of whether the PRP is ordered to clean up a contaminated site itself or reimburse the EPA, the liability of a PRP with respect to a site on the NPL can be financially devastating. Under judicial interpretations of CERCLA (and notwithstanding the absence of statutory language supporting such interpretation), PRPs may be jointly and severally liable for costs to clean up a contaminated site.[39] This means that each PRP can be held liable for the entire cost, regardless of the magnitude of that PRP's individual contribution to the hazardous waste disposed of at the Superfund site.[40] In addition, a PRP has "strict" liability — meaning the government need not prove that the PRP was negligent in disposing of the hazardous waste.[41] There is no "good faith" defense available to a PRP under the

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[34] *See, e.g.*, United States v. Nicolet, Inc., 712 F.Supp. 1193, 1202 (E.D. Pa. 1989); United States v. Kayser-Roth Corp., 724 F.Supp. 15, 24 (D.R.I. 1989), *aff'd*, 910 F.2d 24 (1st Cir. 1990); Idaho v. Bunker Hill Co., 635 F. Supp. 665, 673 (D. Idaho 1986) (holding that parent corporation may be held liable for response costs attributable to wholly-owned subsidiary if it actively participated in management of the subsidiary); *but see* Joslyn Mfg. Co. v. T.L. James & Co., 893 F.2d 80, 82 (5th Cir. 1990).

[35] United States v. Bestfoods, 118 S.Ct. 1876, 1887 (1998).

[36] *Id.* at 1889.

[37] *See* 42 U.S.C. § 9611(a)-(c) (1994) (authorizing the EPA to use Superfund resources to clean up hazardous waste sites). A $1.6 billion Superfund trust was established under the original 1980 legislation. Of this amount, 87.5 percent was derived from an excise tax on the products of the petroleum and chemical industries, and the remaining 12.5 percent was from general revenues of the federal government. The Superfund Amendments and Reauthorization Act of 1986 raised the authorization for the trust to $8.5 billion and provided for additional funding from the corporate income tax. *See also* Kubasek and Silverman, *supra* note 21, at 208.

[38] *See* 42 U.S.C. § 9607(a),(c)(3) (1994).

[39] *See* United States v. Chem-Dyne Corp., 572 F. Supp. 802 (S.D. Ohio 1983) (denying summary judgment because of possibility of joint and several liability even where the PRP only disposed of a small portion of hazardous waste at a site).

[40] For an account of the financial woes that can result when a small firm is found to have contributed to the contamination of a large Superfund site, see John J. Fialka, *Superfund Ensnares Thousands of Small Firms In a Legal Nightmare, Fueling Overhaul Drive*, WALL ST.J., March 19, 1997, at A20.

[41] *See, e.g.*, United States v. Northeastern Pharm. & Chem. Co., 180 F.2d 726, 731 (8th Cir. 1986); New York v. Shore Realty Corp., 759 F.2d 1032, 1042 (2d Cir. 1985).

strict liability imposed by the federal courts.[42] For example, generators exercising great care in providing for the transportation and disposal of their hazardous waste have been held liable for the failures of their transporters.[43]

Furthermore, liability under CERCLA can be applied retroactively for waste generated, transported, or disposed of prior to the enactment of the statute. Retroactive liability is one of the most controversial and costly aspects of CERCLA.[44] Says one critic:

> Throughout its history, CERCLA has been roundly criticized by industry as a draconian system that hinders economic growth and penalizes individual companies by requiring them to perform extensive and costly cleanups without regard to when the original disposal took place or the fact that a company may have exercised due care in handling hazardous materials.[45]

Because of the joint and several liability of PRPs for the costs associated with cleaning up a contaminated site — even one contaminated prior to the enactment of RCRA or CERCLA — there is great resistance to the admission of any liability. This contributes to the seemingly endless litigation involving assertions of liability under CERCLA, and, consequently, the significant expenses associated with environmental regulation in the United States. Indeed, a good deal of the total amounts spent in Superfund cases goes toward legal and consulting fees, as opposed to actual remediation of the contaminated sites. Of course, these legal and consulting fees also represent costs imposed on businesses by environmental regulation, and the tax treatment of such expenditures must be considered as well.

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[42] The 1986 amendments to CERCLA under SARA provided an "innocent purchaser" defense. However, this is a difficult defense to assert as the buyer must prove that it "did not know and had no reason to know" that the property was contaminated. To assert the innocent purchaser defense, the buyer must show that it conducted "all appropriate inquiry into the previous ownership and uses of the property consistent with good commercial or customary practice in an effort to minimize liability." 42 U.S.C. § 9601(35) (1994).

[43] *See* O'Neil v. Picillo, 883 F.2d 176 (1989). In this case, Rohm & Haas Company, American Cyanamid Company, and Hydron Laboratories, Inc., were held liable for the cleanup costs for a site contaminated by the transporter of the hazardous waste generated by the chemical companies. Notwithstanding that the chemical companies complied with all EPA procedures with respect to the production and disposal of the hazardous wastes that were byproducts of their manufacturing operations, and made diligent efforts to ensure that the waste was transported by licensed transporters in EPA-approved containers, they were held liable for the cleanup costs under CERCLA.

[44] The retroactive application of CERCLA has been controversial from the beginning, although federal courts have generally sustained such application. *See, e.g., Northeastern Pharmaceutical,* 810 F.2d 726 (1986). One recent case, United States v. Olin, 927 F. Supp. 1502 (S.D. Ala. 1996), called into question the retroactive application of CERCLA in light of the U.S. Supreme Court's decision in Landgraf v. USI Film Products, 511 U.S. 244 (1994). However, the district court was subsequently reversed by the Eighth Circuit in United States v. Olin, 107 F.3d 1506 (8th Cir. 1997). In recent years, there have been legislative efforts in the 104th and 105th Congresses to revise the retroactive liability imposed under CERCLA, as well as the imposition of joint and several liability by the courts on PRPs. To date, none of these initiatives have been enacted.

[45] Robert T. Lee, *Comprehensive Environmental Response, Compensation, and Liability Act, in* ENVIRONMENTAL LAW HANDBOOK 430 (Thomas F. P. Sullivan ed., 1997).

B. *Taxation and Environmental Policy*

Most businesses that face environmental cleanup projects mandated by EPA enforcement proceedings or pursuant to a court-approved consent decree with the EPA, are guided by legal advisers who focus primarily on compliance with the federal environmental statutes. Consequently, tax considerations often play a secondary role in structuring a settlement of the controversy. Accordingly, the tax treatment of a PRP's expenses incurred with respect to a cleanup project is often already established by the time a tax adviser is brought in for consultation. Of course, even in cases where planning opportunities are lost, the daunting task remains to ascertain the proper tax treatment of the agreed environmental transaction.

The most prominent tax issue is whether environmental remediation costs are currently deductible or must be capitalized. Questions also arise with respect to the tax treatment of expenditures for legal and accounting advice, as well as engineering reports prepared during the stages *prior* to the instigation of a mandatory cleanup of a contaminated site. Other costs incurred in complying with the environmental statutes are more routine and are properly viewed as part of the ongoing cost of doing business. But even these routine costs (*e.g.*, the cost of disposing of hazardous by-products of manufacturing processes that must be transported and disposed of in a RCRA approved hazardous waste site) raise problematic tax issues. For instance, to the extent that such routine compliance costs relate to the production of "inventory" of the manufacturer (such as the chemicals produced in the manufacturing process), such compliance costs arguably must be capitalized.[46] However, if the manufacturer was less stringent in complying with the environmental protection statutes, and perhaps even created a Superfund site by contaminating the manufacturing plant through spillage of hazardous wastes, the costs incurred in cleaning up the contaminated manufacturing site would likely be currently deductible. In this respect, the "reward" for complying with RCRA may be to put the conforming manufacturer in a worse tax position than the violator.

Because of the peculiar structure of economic costs imposed under the environmental statutes, those who enter into settlement negotiations with the EPA and those who must comply with RCRA regulations may be guided by different strategies. Once the tax consequences are understood, payments pursuant to an EPA enforcement proceeding, to a court-approved consent decree with the EPA, or to efforts to comply with RCRA requirements, often can be advantageously structured to reduce the financial impact on the PRP. For this reason, legal counsel negotiating such a settlement would do well to seek tax advice during the earliest stages of negotiations with the EPA.

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[46] This treatment may be required under section 263A of the Internal Revenue Code (the "Code") of 1986, as amended, the Uniform Capitalization Rules. *See* I.R.C. § 263A and *infra* text accompanying notes 73-74.

Despite the uncertainty surrounding the tax treatment of environmental remediation and compliance costs, the development and implementation of sound tax strategies is really no more or less complicated than that involving other highly regulated business activities — for instance, the construction or defense industries, or even farming. Because the environmental statutes were enacted so recently, the most controversial tax issues have, in many cases, only recently been litigated and addressed by the courts. Accordingly, tax issues that long ago were settled (or at least, accommodated) as they applied to other industries are only now being addressed with respect to the environmental statutes.

While there has been a flood of speculation and brooding in recent years among academics and practitioners as to controversies involving the tax treatment of environmental cleanup and compliance costs, there is no need for such hand-wringing and consternation.[47] Through the interaction of the Service and tax professionals representing regulated businesses, an accommodation is being reached with respect to the application of the income tax laws to those environmental transactions motivated or mandated under the environmental statutes and regulations. Some suggest that the gravity or complexity of the problems associated with environmental regulation somehow requires a new set of tax rules or warrants special treatment — such as allowing current deductions for all environmental compliance and remediation costs.[48] Others argue that Congress must immediately address these issues through new tax laws, not only because there is such "great controversy" and the potential for "costly and time-consuming litigation," but also because "our environment depends on it."[49] Presumably, such views are based on the rationale that the tax treatment of environmental transactions is just too complicated and important to allow for the application of the general tax principles developed by the Service, the federal courts, and tax professionals over the past eighty years.

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[47] Examples of articles by commentators who believe that there is considerable "controversy" with respect to the IRS's position include: Mark J. Silverman, et. al., *IRS Remediates Environmental Cost Deduction Mess*, 70 TAX NOTES 1541 (March 11, 1996); Jeffrey M. Gaba, *Tax Deduction of Hazardous Waste Cleanup Costs: Harmonizing Federal Tax and Environmental Policies*, 20 HARV. ENVTL. L. REV. 61 (1996); Thomas H. Yancey, *Emerging Doctrines in the Tax Treatment of Environmental Cleanup Costs*, 70 TAXES 948 (December 1992); Mark W. March & Julia K. Brazelton, *Superfund Cleanups: The Financial Costs High, the Tax Treatment Uncertain*, 69 TAXES 682 (November 1991).

[48] In general, the IRS, through adoption of a treasury regulation, or Congress, through amendment to the Internal Revenue Code, should adopt a provision of general applicability; such provisions should provide for the deduction as ordinary expenses (in the year in which economic performance occurs) of all costs that are incurred to remediate hazardous substances or hazardous or solid wastes under the requirements of federal and state laws or pursuant to federal or state regulations that authorize the recovery of such expenses from private parties.

Jeffrey M. Gaba, *Tax Deduction of Hazardous Waste Cleanup Costs: Harmonizing Federal Tax and Environmental Policies*, 20 HARV. ENVTL. L. REV. 61, 105 (1996); "In short, the IRS should reevaluate what appears to be its position on expenditures made on equipment that will be used in remediation . . . [W]e believe that expenditures made for equipment dedicated to remediation should be deductible in the current year." Sanjay Gupta & Howard M. Shanker, *Taxing the Environment*, 74 TAX NOTES (TA) 1451, 1456 (March 17, 1997).

[49] *See* Sloane Elizabeth Anders, *The Federal Tax System and the Environment: Should Payments Made Pursuant to CERCLA Be Deductible?*" 10 VA. TAX REV. 707, 729-30 (1991).

In fact, the old rules work just fine — or at least, no worse than in other cases. Many business transactions are complicated and continually raise new and perplexing tax issues. But if the Service can devise rules for the treatment of the more exotic derivative financial instruments promoted by Wall Street investment bankers, and the tax regulators can decipher those convoluted business transactions concocted by tax lawyers to "strip" earnings out of U.S. companies or reward investors with artificial tax losses, then surely the tax community can reach some level of common understanding with respect to the appropriate treatment of environmental cleanup and compliance costs. If anything, this is a much *less* complicated area of the law.

Those who argue in favor of special tax treatment (*i.e.*, expensing) for expenditures incurred in environmental transactions base their case on the supposed difficulty of distinguishing between capital expenditures and currently deductible ordinary business expenses. Perhaps this struggle is attributable to the fact that most environmental lawyers are generally less familiar with the income tax laws than with the environmental statutes and Federal Rules of Civil Procedure. On the other hand, tax professionals recognize that other complicated business transactions and economic arrangements raise similar issues, and that tax concepts designed for those other business situations are equally appropriate for environmental transactions.

First, the claim that current expensing of environmental cleanup costs is warranted as a means for inducing businesses to clean up the environment is open to serious question. The idea that current deductions should be allowed for expenditures that, in the context of any other business transaction, would be required to be capitalized — this based on the premise that special tax treatment will "encourage" polluters to clean up the sites which they themselves contaminated — is neither very convincing nor appealing. Allowing current tax deductions for capital expenditures would create just one more special tax "preference" — the environmental remediation tax loophole. Such departures from the general rules of income taxation are defined under federal law as "tax expenditures,"[50] and they cost the Treasury revenue as businesses engage in the tax-preferred activity in response to the incentives provided.[51] A tax expenditure is the functional equivalent of a direct subsidy from the U.S. Treasury. By providing a new tax preference for expenditures related to environmental transactions, taxpayers will effectively assume a portion of the cost of cleaning up contaminated sites.

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[50] The concept of tax expenditures was first formally introduced to budget analysis by the Treasury Department in 1968. Subsequently recognized by statute, tax expenditures are defined as "those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." Congressional Budget and Impoundment Act, Pub. L. No. 93-344, § 3(a)(3), 88 Stat. 298, 299 (1974).

[51] For fiscal year 1997, the total revenue loss attributable to tax expenditures was $554 billion — a 4.1 percent increase over 1996. Projections for fiscal year 1998 put the figure at $567 billion.

Second, tax preferences for businesses that clean up their contaminated sites could actually give them distinct tax advantages over those businesses that complied with the law and environmental regulations in the first place. In other words, those firms that comply with the environmental laws (or in the case of pre-RCRA "legal" contamination, those that followed "good conscience" in not polluting the environment with hazardous waste) will be placed in a *worse* tax position than the polluters. Now, some might argue that polluters need not be denied *all* tax benefits for their cleanup expenditures. But there simply is no justification for *rewarding* polluters with *more* favorable tax treatment than that afforded more diligent businesses. Conversely, the notion that "polluters should pay" makes considerable sense.

Rather than advancing public policy arguments for or against denying or extending tax preferences to those subject to environmental regulation, the approach here is more modest: delineate the subtle nuances of the existing income tax laws as they apply to all business transactions and then suggest how these same concepts may be applied to expenditures incurred by business and industry involved in environmental transactions. Once it is recognized that the established tax concepts can be applied successfully to the expenditures incurred in environmental transactions, the case for creating new, special rules is much less compelling. From the perspective of sound tax policy, there is no strong argument in favor of creating new tax preferences for polluters, and likewise, from the perspective of sound environmental policy, there is no need to use the tax laws to inflict additional punishment (*i.e.*, costs) on taxpayers subject to environmental regulation.

III. MAJOR TAX ISSUES

Notwithstanding the numerous complaints voiced in recent years regarding the "complexity" of the tax laws as applied to environmental transactions, there are really only a limited number of issues raised. Furthermore, these tax issues are not unique to environmental transactions, and there is already in place a well developed body of relevant case law to guide the analysis. Much of this authority was generated early in the history of the income tax, as the federal courts struggled to interpret the new tax statutes and construct an administrable system of rules governing the most common business transactions. Because the general principles of taxation applicable to environmental transactions have already been worked out over the past eight decades, the task of the tax adviser is fairly straightforward—to apply the existing law to the particular facts and circumstances that arise in the environmental transaction under consideration. While the facts and circumstances of each environmental transaction will inevitably differ, there are enough similarities to generate basic rules applicable to a wide variety of cases. Contrary to what is asserted by some commentators, the general principles of federal income taxation can be applied to environmental transactions without violating either tax policy or environmental policy.[52]

[52] Professor Gaba takes quite the opposite position: "The IRS, in attempting to apply traditional tax analysis to the complex requirements of environmental remediation, may be making both bad tax

The following is an overview of the tax issues that commonly arise in environmental transactions. The status of the law with respect to these issues is considered, as well as the application of these rules to the most common environmental transactions.

A. *Deductibility of Expenditures vs. Capitalization*

The most important tax issue that arises with respect to environmental transactions is whether an expenditure made in compliance with, or in satisfaction of a liability or requirement imposed under an environmental statute, is currently deductible or must be capitalized for purposes of federal income taxation. If currently deductible, an immediate tax benefit may be gained from the expenditure, thereby reducing its after-tax cost. Conversely, different and generally less favorable tax consequences follow when an expenditure is capitalized. In some instances, tax benefits may be recovered over time as the capitalized expenditure is amortized. However, in other cases, taxpayers may never derive a tax benefit for the capitalized outlay.[53]

The classification of an expenditure as a currently deductible expense or as an item that must be capitalized is more an art than a science. Nonetheless, the often difficult determination as to whether a particular expenditure is deductible or must be capitalized is hardly unique to environmental transactions, and general principles of federal income taxation are applicable. Furthermore, in several well-publicized rulings and technical advice memoranda ("TAM"), the Service has addressed the specific issue of capitalization as it applies to expenditures incurred in the most common environmental transactions. The rulings of the Service focus on the deductibility of expenditures directly related to the remediation of contaminated soil and groundwater, as well as the incidental costs incurred in the cleanup. In addition, the tax treatment of costs incurred in asbestos remediation projects has been considered.

1. *Ordinary Business Expense*

The federal income tax has always allowed a deduction for expenses incurred in a trade or business. The current allowance is found in section 162, which permits a deduction for all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."[54] This deduction for business expenses is intended to match the costs of doing business with the

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policy and bad environmental policy." Jeffrey M. Gaba, *Tax Deduction of Hazardous Waste Cleanup Costs: Harmonizing Federal Tax and Environmental Policies*," 20 HARV. ENVTL. L. REV. 61, 62 (1996). There is no evidence, however, that environmental transactions impose more "complex requirements" on the tax laws than other major business transactions.

[53] Considering the magnitude of environmental cleanup costs, not receiving a current tax benefit could be a financial disaster. On the other hand, where a taxpayer already has significant losses for the current taxable year, or net operating losses (NOLs) carried over to the current year from prior taxable years, capitalization may not produce any worse result since a deduction still would not produce an immediate tax benefit.

[54] I.R.C. § 162(a).

income produced by such activity and thereby, accurately measure the income of the taxpayer.[55] The taxpayer has an affirmative duty to prove that he is entitled to a deduction, as the Supreme Court has indicated that "deductions are exceptions from the norm of capitalization."[56]

Considerable litigation has arisen over the question of whether particular expenses qualify as "ordinary and necessary" under Code section 162.[57] In *Welch v. Helvering*,[58] the U.S. Supreme Court defined "ordinary" as that which is customary or typical. The Court disallowed a deduction for the payments at issue (payments by a businessman of his bankrupt corporation's debts in order to appease customers and establish goodwill for future business relations) on the grounds that the taxpayer's gratuitous payment of the defunct corporation's debts was "in a high degree extraordinary."[59] However, the Supreme Court has held elsewhere that unusual or infrequent expenses *may* be deducted as "ordinary" business expenses where they are the kind of expenses incurred by other taxpayers in a similar trade or business.[60] This principle is important as it applies to costs incurred in an environmental remediation project — which may be unusual, infrequent, and highly "extraordinary" to the particular business that incurs such costs, but customary or common to that kind of business in general. Hence, the infrequency and unusual nature (and magnitude) of environmental remediation costs should not bar a current deduction under section 162.[61]

In order to claim a deduction under section 162, the relevant expenses must have been incurred by the taxpayer in carrying on a "trade or business." Which activities rise to the level of a trade or business is another issue that is often litigated under the tax laws.[62] Activities such as the passive holding of undeveloped real property for investment purposes generally do *not* rise to the level of a trade or business. Conversely, owning and operating rental property with significant management activity may be a trade or business.[63] In between lies a considerable gray area. Even where the taxpayer's activity does not rise to the level of

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[55] *See* INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84; 112 S. Ct. 1039 (1992); Commissioner v. Idaho Power Co., 418 U.S. 1, 16 (1974); Massey Motors v. United States, 364 U.S. 92, 104 (1960).

[56] *INDOPCO*, 503 U.S. at 84.

[57] An excellent introduction to the subject of whether expenses are "ordinary and necessary" is found in Marvin A. Chirelstein, FEDERAL INCOME TAXATION § 6.03 (8th ed. 1997).

[58] 290 U.S. 111 (1933).

[59] *Id.* at 114.

[60] *See* Commissioner v. Tellier, 383 U.S. 687, 690 (1966); Deputy v. du Pont, 308 U.S. 488, 495 (1940).

[61] *See, e.g.*, H.G. Fenton Material Co. v. Commissioner, 74 T.C. 584 (1980) (holding that expenses incurred by the taxpayer in removing and disposing of waste materials produced in the taxpayer's business were deductible).

[62] In general, there can be no trade or business unless the taxpayer enters into and carries on the activity with a good faith purpose of turning a profit or in the belief that a profit can be made from the activity. *See* Doggett v. Burnet, 65 F.2d 191, 194 (D.C. Cir. 1933), *rev'g* 23 B.T.A. 744 (1931).

[63] *See, e.g.*, Slack v. Commissioner, 35 B.T.A. 271, 281 (1937) (holding rental property management to be trade or business of taxpayer).

a trade or business, a current deduction may be possible under section 212, which allows a deduction for expenses incurred "for the management, conservation, or maintenance of property held for the production of income."[64] This provision may apply, for example, where a taxpayer holds raw undeveloped land for investment purposes.

The kinds of expenses for which an ordinary business deduction is allowed under sections 162 and 212 include amounts spent for "incidental repairs and maintenance." As defined in Treasury regulations, incidental repairs are those which "neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition."[65] Conversely, repairs in the nature of "replacements" or those which "arrest deterioration" or "appreciably prolong the life of the property" *cannot* be expensed, but rather must be capitalized (and perhaps depreciated or amortized) under the rules discussed below.

Of course, other provisions of the Code may bar or defer a current deduction — even those for which a current deduction is allowed under section 162. For instance, the "at-risk" rules of section 465 or the "passive activity loss" ("PAL") rules found at section 469 might defer a current deduction otherwise allowed under sections 162 or 212. For instance, as real estate rental activity is a passive activity *per se* under section 469(c)(2), any net loss for the current taxable year attributable to expenses incurred in a real estate rental activity may be suspended under the PAL rules. The tax benefit for such a loss would be allowed in the year in which the taxpayer has income from a "passive activity" or in such year as the taxpayer disposes of his interest in such passive activity (*e.g.*, sells the real property). The PAL rules are relevant to environmental transactions where the taxpayer is a limited partner in a real estate limited partnership that is required to remediate contamination of its property. The expenses incurred in cleaning up such a site might generate net losses for the partnership that would pass through to the taxpayer — whose deduction for his share of such loss might be suspended under the PAL rules. Again, a tax adviser must consider the deductibility of each such item by reference to the tax posture of the individual taxpayer.

2. *Capitalization*

Where expenditures are incurred in the purchase or production of an asset which generates income beyond the current taxable year, the expenditures generally must be capitalized. In some cases, these capitalized expenditures may be amortized and recovered for income tax purposes over the useful life of the asset, thereby offsetting the income produced by such business or investment property. In other cases, expenditures must be capitalized and added to the basis

[64] I.R.C. § 212.
[65] Reg. §1.162-4.

of another asset and recovered over time through the depreciation or amortization of that asset.

When an expenditure is capitalized, several tax issues arise. First, it must be determined whether a tax depreciation deduction may be claimed for cost recovery under section 167. A deduction is allowed under section 167 "for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in the trade or business, or of property held for the production of income."[66] If an asset is eligible for cost recovery under section 167, the Modified Asset Recovery System ("MACRS") under section 168 may apply. If an asset does not have a readily ascertainable useful life, cost recovery is not allowed under section 167. However, in the case of certain special assets, cost recovery still may be allowed. For instance, under section 197, certain intangible assets acquired by the taxpayer in the acquisition of a business may be amortized.[67]

Some assets (most particularly, land) are nondepreciable *per se*. Thus, to the extent expenditures are capitalized and added to the taxpayer's basis in a parcel of land, no tax benefit will be received until the land is sold. On a sale of the land, the basis attributable to the capitalized expenditure will reduce the amount of gain (or increase the loss) realized on the sale. For example, where land held for investment or in connection with a trade or business is cleared and graded, the cost of such operation must be capitalized and added to the taxpayer's basis in the land.[68] Likewise, legal costs incurred in perfecting title to real estate must be added to the taxpayer's basis in the real estate.[69] If the land is never sold, the owner will never enjoy a tax benefit for the capitalized expenditures — although his heirs may receive an indirect tax benefit for the expenditures via a stepped-up basis in the land (equal to its fair market value) provided for under section 1014.[70]

Obviously, the difference between an immediate deduction and capitalization can be significant. Each deduction allowed reduces the tax due for that year,

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[66] I.R.C. § 167(a)(1) and (2).

[67] Section 197(d) was added to the Code in 1993. Such acquired intangible assets include customer-based intangibles, supplier-based intangibles, subscription lists, patents, copyrights, know-how, non-compete covenants, franchises, trademarks, and trade names. This statute also defines "intangible assets" to include assets in the nature of goodwill and going concern value. Under section 197, these intangible assets can be amortized over the same fifteen-year recovery period when purchased in the acquisition of a going-concern business. *See* Michael J. Douglass, *Tangible Results for Intangible Assets: An Analysis of New Code Section 197*, 47 TAX LAW. 713 (1994); Sheldon D. Pollack, *Amortization of Intangible Assets in a Business Acquisition*, 58 TAX'N ACCT. 336 (June 1997).

[68] A taxpayer's basis in realty includes the original purchase price as well as acquisition expenses such as transfer taxes, legal expenses, title search, etc. Expenses for capital improvements, such as grading the land, are also added to basis. *See* I.R.C. §§ 164(a), 1011, 1012, and 1016(a)(1); Reg. §§ 1.212-1(k), 1.263(A)-1(a)(1), (b), 1.263(A)-2(a), and 1.1016-2(a).

[69] Legal and professional fees paid to defend or perfect title to real estate must be capitalized. *See, e.g.*, Flint v. Commissioner, 62 T.C.M. (CCH) 541, 548, 1991 T.C.M. (RIA) ¶ 91,405; Estate of Franco v. Commissioner, 40 T.C.M. (CCH) 1070, 1071, 1980 T.C.M. (P-H) ¶ 80,340.

[70] I.R.C. § 1014(a).

thereby improving the taxpayer's after-tax cash flow.[71] Where a current deduction is not allowed and the capitalized expenditure is amortized over years, the present value of the tax benefit is reduced. Similarly, the value of the immediate deduction is less to the extent that it does not reduce tax in the current tax year (*e.g.*, in the case of an NOL). This difference (representing the time value of money, or the discounted value of a future tax deduction as opposed to a current deduction) is even more significant where the expenditure is capitalized and added to the taxpayer's basis in a nondepreciable asset such as land. In that case, no amortization deduction is allowed — even while the land may be producing a steady stream of income.

Several Code provisions determine when expenditures incurred with respect to an asset must be capitalized. For example, section 263 prohibits a current deduction for amounts "paid out for . . . permanent improvements or betterments made to increase the value of any property or estate."[72] Regulations promulgated under section 263 provide that expenses incurred in a trade or business may *not* be deducted where such amounts are paid for "permanent improvements or betterments to increase the value" of the property or in "restoring property" subject to an allowance for depreciation.[73] Furthermore, a current deduction is not allowed for amounts paid or incurred to "add to the value" of the property or "substantially prolong the useful life" of the property or "adapt property to a new or different use."[74] In addition, section 263A requires that costs incurred in the production of real property or tangible personal property used in a trade or business must be capitalized.[75] This provision applies to the production, manufacture, or development of property used in a trade or business by the taxpayer, as well as property sold to customers, which would include the inventory produced by a manufacturing company, or the chemicals produced by a chemical manufacturing plant.[76] It also requires that a real estate builder capitalize all costs associated with the production of a building and amortize such expenditures ratably over the life of the building, or in the event of a sale of the building, recover a tax benefit for capitalized basis by reducing the amount of gain (or increasing the loss) realized in the sale.

Despite the impact of immediate deductibility on the taxpayer's tax and cash-flow position, it is often not readily evident whether particular expenses are in the nature of deductible repairs or maintenance, or whether they add to the value of the underlying property or prolong the useful life of such property — and hence, must be capitalized. The federal courts have struggled to define the facts

[71] The exact amount by which the deduction will reduce the taxpayer's tax liability will depend on the taxpayers tax bracket. For an individual taxpayer in the highest tax bracket, the tax deduction for an expenditure of $100 will be worth $39.60.

[72] I.R.C. § 263(a)(1).

[73] Reg. § 1.263(a)-1(a).

[74] Reg. § 1.263(a)-1(b).

[75] I.R.C. §§ 263A(b)(1) and (c)(1).

[76] Reg. § 1.263A-1(a)(3).

and circumstances that distinguish between the different categories of expenditures. A number of courts have focused primarily on whether the expenditures materially add to the value of the property as determined *prior* to the expenditure.

In *Plainfield-Union Water Co. v. Commissioner*, the taxpayer was a water company that cleaned its cast iron water pipes and lined them with cement to protect them from further deterioration.[77] The company deducted these expenditures, while the Service argued that such amounts should be capitalized. The U.S. Tax Court analyzed whether the expenditures enhanced the life expectancy of the asset by comparing the condition of the asset after the expenditure with its condition prior to the expenditure. According to the court, "[t]he proper test is whether the expenditure materially enhances the value, use, life expectancy, strength, or capacity compared with the status of the asset prior to the condition necessitating the expenditure."[78] In other words, the expenditure is deductible as a repair if it merely returns the asset to the original condition (and same value) it was in *prior* to the condition "necessitating the expenditure" in the first place.[79]

Another line of cases looks to whether the expenditure at issue materially prolongs the useful life of the property.[80] Still other courts have looked to whether the expenditure was incurred to alter or adapt the property to a new or different use,[81] or whether the expenditures were part of a "systematic plan" that increased the value of the taxpayer's property.[82] The latter standard is similar to that applied in a leading Third Circuit case, *Stoeltzing v. Commissioner*.[83] The taxpayer there had incurred significant expenses in renovating an old building. The court acknowledged that many of the individual expenditures would have been deductible if incurred alone as simple repairs. However, collectively the expenditures were made in what constituted a systematic plan for rehabilitation of the property. A number of courts have followed this logic and required capitalization where expenses are incurred pursuant to an overall plan of rehabilitation that enhances the value of the underlying property.[84] Still other courts have applied the so-called future benefit test, which is based on the principle that

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[77] Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333, 336 (1962).

[78] *Id.* at 338.

[79] This test was also applied in Oberman Manufacturing Co. v. Commissioner, 47 T.C. 471, 483 (1967); *see also* Rev. Rul. 94-38, 1994-1 C.B. 35.

[80] *See, e.g.*, Illinois Merchant Trust Co. v. Commissioner, 4 B.T.A. 103, 106 (1926), *acq.* 1926-2 C.B. 2.

[81] *See, e.g.*, Midland Empire Packing Co. Commissioner, 14 T.C. 635, 640 (1950), *acq.* 1950-2 C.B. 3.

[82] Wolfsen Land & Cattle Co. v. Commissioner, 72 T.C. 1, 17 (1979). In *Wolfsen*, the taxpayer deducted the cost of restoring irrigating canals to their full function. The Tax Court disallowed any deduction because the maintenance costs would produce benefit for several years. The court agreed with the Service, which argued that the remediation effort was part of a "systematic plan" that increased the value of the taxpayer's property.

[83] Stoeltzing v. Commissioner, 266 F.2d 374, 377 (3d Cir. 1959).

[84] *See, e.g.*, Mountain Fuel Supply Co. v. United States, 449 F.2d 816, 820 (10th Cir. 1971); Wehrli v. United States, 400 F.2d 686, 689-90 (10th Cir. 1968).

expenditures should be matched with the revenue to which it is related, providing a deduction in the taxable year or years in which the income is realized.[85] The various standards applied by the courts, as well as the Treasury regulations, evidence the considerable uncertainty that pervades efforts to determine whether particular expenditures are deductible business expenses or capital in nature.

Another important consideration is whether the expenditures at issue were incurred to bring property in compliance with governmental requirements. If so, courts have held that such expenditures must be capitalized, even where such expenditures do not result in any new or improved use of the property.[86] These cases are particularly relevant to the question of whether expenditures made in compliance with CERCLA, RCRA, and other environmental statutes must be capitalized. Whether cleanup costs incurred outside of an EPA-mandated remediation project should be afforded a different treatment is another question that must be considered.

More recently, the Supreme Court addressed the question of what expenditures must be capitalized. In *INDOPCO, Inc. v. Commissioner*,[87] the Court considered the deductibility of professional fees paid to the legal adviser and investment banker of a corporation which was a party to a corporate reorganization. The corporation was the target of a friendly merger acquisition. The Service took the position that such expenditures related to the corporate reorganization, and hence, would provide a future benefit to the corporation. The corporation argued that such expenses were ordinary and necessary business expenses that were currently deductible. On appeal, the Supreme Court held that the expenses could not be deducted because they provided "significant future benefits." In reaching this decision, the Court focused on the significant long-term, future benefit to the corporation resulting from the acquisition: "a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization."[88] Under this test, the Court held that the professional expenses would provide a long term benefit to the corporation, and hence, such expenditures were capital in nature. However, the professional fees related *not* to the acquisition of a separate asset, but rather related to the organizational structure of the corporation itself. The existence of a separate asset was held *not* to be a prerequisite to capitalization. Furthermore, as a capital expenditure with no readily ascertainable value, no amortization deduction was allowed.

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[85] *See, e.g.*, United States v. Mississippi Chem. Co., 405 U.S. 298, 309-10 (1972); Howard Paper Co. v. Commissioner, 49 T.C. 275, 285-88 (1967).

[86] Teitelbaum v. Commissioner, 294 F.2d 541, 544 (7th Cir. 1961) (cost of converting electrical system of building to comply with city code must be capitalized); Blue Creek Coal v. Commissioner, 42 T.C.M. (CCH) 1504, 1508, 1984 T.C.M. (RIA) ¶ 84,579, at 2339 (cost of refitting bulldozers to comply with requirements of Federal Mine, Health and Safety Administration must be capitalized even though useful life and value of bulldozers not increased).

[87] 503 U.S. 79 (1992).

[88] *Id.*, 503 U.S. at 87.

Possibly expanding upon the Supreme Court's holding in *INDOPCO*, the Service has required capitalization in other contexts where current deductions might otherwise have been considered allowable. For example, in a public ruling issued subsequent to the *INDOPCO* ruling, the Service took the position that expenses incurred by a business in training its employees in a new line of business could not be deducted, but instead must be capitalized.[89] Likewise, the Service takes the position that the cost of retraining employees in new work techniques (such as "total quality management" or "just-in-time" manufacturing) cannot be deducted and must be capitalized.[90] Finally, in a recent technical advice memorandum, the Service ruled that the costs associated with reconstructing jet airline engines as mandated by FAA rules must be capitalized over the remaining life of the airline.[91] These rulings suggest that the Court's holding in *INDOPCO* may be applicable to a wide range of other cases, including environmental remediation projects — although exactly how remains uncertain.[92]

3. *Casualty Loss*

Section 165 allows a deduction for "any loss sustained during the taxable year and not compensated for by insurance or otherwise."[93] For corporations and other business entities, a deduction is allowed for any uncompensated loss suffered during the taxable year, including a loss suffered with respect to property owned by such entity. In the case of an individual, section 165(c) limits the deduction to: (1) losses incurred in a trade or business; (2) losses incurred in any transaction entered into for profit; and (3) losses of property not connected with a trade or business, where such losses arise from "fire, storm, shipwreck, or other casualty."[94]

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[89] Rev. Rul. 96-62, 1996-2 C.B. 9 (training costs must be capitalized where the training is intended primarily to obtain future benefits significantly beyond those traditionally associated with training provided in the ordinary course of a taxpayer's regular trade or business).

[90] T.A.M. 95-44-001 (July 21, 1995) (various costs incurred in adopting new "just-in-time" manufacturing process held to be capital expenditures).

[91] T.A.M. 96-18-004 (January 23, 1996). Apparently, many airlines had been treating such expenses as "ordinary and necessary" maintenance expenses deductible under section 162.

[92] *See Report on Capitalization Issues Raised Under Sections 162 and 263 by INDOPCO, Inc. v. Commissioner*, Comm. on Tax Accounting, ABA Tax Sec., 50 TAX LAW. 181-215 (1996). In Rev. Rul. 94-12, 1994-1 C.B. 36, the Service held that *INDOPCO* does *not* change or affect the treatment of amounts paid for incidental repairs as ordinary and necessary business deductions "even though they may have some future benefit." *See also* Rev. Rul. 92-80, 1992-2 C.B. 57 (holding that the Supreme Court's decision in *INDOPCO* does not affect the treatment of advertising costs as business expenses which are generally deductible under I.R.C. § 162); Rev. Rul. 94-77, 1994-2 C.B. 19 (holding that the *INDOPCO* decision does not affect the treatment of severance payments, made by a taxpayer to its employees, as business expenses which are generally deductible under I.R.C. § 162).

[93] I.R.C. § 165(a).

[94] I.R.C. § 165(c); Reg. § 1.165-7(a)(1). *See* amendments to section 165(c) made by TEFRA (Pub. L. No. 97-248, 96 Stat. 325, § 203) and the 1984 TRA (Pub. L. No. 98-369, § 711).

Whether a loss deduction is allowed under section 165 in the case of property destroyed in a fire, storm, or shipwreck is fairly straightforward. Either there was a fire, storm, or shipwreck, or there was not. On the other hand, section 165 provides little guidance as to the requirements for other forms of casualty loss. Treasury regulations indicate that a casualty loss must be "sustained during the taxable year."[95] Furthermore, the Service has ruled that a casualty loss results not from gradual deterioration of property, but rather from a sudden, catastrophic event.[96] This would suggest that a casualty loss deduction is not allowed where property has been destroyed, damaged, or otherwise rendered worthless over the course of many years by a process of slow and gradual contamination — for instance, where polychlorinated biphenyls ("PCBs"), lead, zinc, or some other hazardous waste is disposed of at the taxpayer's property.

Conversely, where property is destroyed or its value significantly diminished by a sudden contamination, a casualty loss deduction may be allowable. For example, the Service has ruled that a loss from damage to the exterior of a home caused by "sudden and severe" smog containing an unusual concentration of chemical fumes qualifies as a casualty under section 165(c)(3).[97] Arguably, losses sustained by a business or individual with respect to property destroyed or damaged by a sudden contamination (such as an explosion or accident that results in contamination of land by some toxic substance) would warrant a deduction under section 165.[98] (Even if a casualty loss is allowable, the amount of the allowed deduction may be significantly less than either the cost of remediating the damaged or destroyed property, or the amount of the reduction in the value of the property resulting from the casualty.) On the other hand, where the owner of property has contaminated it himself through voluntary acts (for instance, by dumping hazardous waste produced by the taxpayer's manufacturing plant on real estate behind the plant, as was commonly done prior to RCRA and CERCLA), a casualty loss may not be allowed.

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[95] Reg. § 1.165-1(b).

[96] Rev. Rul. 72-592, 1972-2 C.B. 101 (to qualify as a "casualty loss," a loss must result from some event that is (1) identifiable, (2) damaging to the property, and (3) "sudden, unexpected, and unusual"); *see also* Rev. Rul. 63-232, 1963-2 C.B. 97 (loss from termite damage is not casualty; damage done is result of gradual deterioration); *but see* Rosenberg v. Commissioner, 198 F.2d 46 (8th Cir. 1952) (time of damage to residence was only one year; sudden enough to qualify as casualty).

[97] Rev. Rul. 71-560, 1971-2 C.B. 126.

[98] Where property held in a trade or business or held for profit is so damaged or destroyed, the deduction for a casualty loss is limited to the lesser of the taxpayer's adjusted basis in the property or the reduction in the value of the property resulting from the casualty. The amount that an individual taxpayer may claim for a nonbusiness casualty loss is subject to further limitations. A nonbusiness casualty and theft loss suffered by an individual is deductible only to the extent that: (i) the amount of each such casualty or theft loss exceeds $100, and (ii) the aggregate amount of all such losses sustained by the individual (after applying the $100 per loss reduction) exceeds 10% of the individual's adjusted gross income. I.R.C. § 165(h).

B. *Treatment of Environmental Compliance and Remediation Costs*

In recent years, the federal courts have struggled to apply these general principles governing the issue of "deduction versus capitalization" to the kinds of expenses incurred in environmental transactions. This requires subjecting a new set of facts (*e.g.*, the various types of environmental compliance and remediation costs) to the existing case law. If it is concluded that some recognized general rule is applicable, it remains necessary to determine how to apply the old rule to the new case.[99] Although easy enough in theory, the application of an existing legal rule to a new case is seldom a straightforward task. The development of the law with respect to the tax treatment of expenditures incurred in environmental transactions has been no exception. However, after several false starts (discussed further below), the Service devised a general scheme that provides adequate guidance to tax professionals whose clients are impacted by the environmental statutes. Furthermore, the Service has recently announced that it will issue private rulings with respect to the tax treatment of environmental remediation expenditures.[100] This should provide taxpayers with some certainty with respect to the tax treatment of environmental transaction costs incurred under anomalous facts and circumstances.

1. *Soil and Groundwater Remediation*

The most significant expenses under the federal environmental statutes are those related to soil and groundwater remediation required under CERCLA — a statute less than two decades old. Because the statute is so recent, controversy and disputes over the tax treatment of expenditures incurred in a Superfund cleanup did not commence until the mid to late 1980s. None too surprisingly, a considerable number of taxpayers treated such expenses as ordinary business expenses deductible under section 162. Indeed, a good argument can be made under the aforementioned case law that such expenditures are in the nature of a "repair." The most obvious support for such a position is that environmental remediation expenses are incurred to repair or restore property that has been damaged by some form of contamination. Cases such as *Plainfield-Union* support the proposition that soil or groundwater remediation merely restores property to its pre-contaminated condition and value. Also, as discussed above, under the right set of facts a good case can be made that where property is contaminated in a sudden single spill or a series of spills suffered in a single taxable year, the taxpayer has suffered a "casualty loss" for which a current deduction is allowed under section 165. On the other hand, tax professionals must recognize that there also is substantial authority (such as *Wolfsen, Stoeltzing,* and *INDOPCO*) to the effect that such expenditures are capital in nature. At any rate, there is certainly ground for disagreement over which treatment is most warranted.

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[99] This is the method of legal reasoning taught to generations of lawyers in the classic treatise, EDWARD H. LEVI, AN INTRODUCTION TO LEGAL REASONING (1949).

[100] Rev. Proc. 98-17, 1998-5 I.R.B. 21. It should be noted that Rev. Proc. 98-17 does not provide substantive guidance as to the deductibility of such expenditures.

In late 1992, the Service issued its first public statement on this issue in a highly publicized technical advice memorandum.[101] In that memorandum the Service considered whether a current deduction is allowable for expenditures incurred in remediating contaminated soil. Considerable controversy arose within the community of tax professionals after the Service issued this ruling, which focused on a taxpayer that had contaminated its own property with PCBs in the course of earlier manufacturing activities. The EPA brought an enforcement action against the taxpayer under RCRA. Negotiations eventually resulted in a settlement pursuant to which the taxpayer agreed to implement an extensive remediation project. The taxpayer claimed an ordinary business deduction for its clean-up costs other than those directly related to the construction of groundwater monitoring wells and related equipment, which costs were capitalized. The Service ruled that all the costs were capital in nature. In so ruling, the Service declined to follow the logic of the Tax Court in *Plainfield-Union*, wherein a deduction was allowed for expenditures incurred in restoring deteriorated property to its prior condition. Instead, the Service relied on *Wolfsen*, which held that costs incurred as part of an overall plan of rehabilitation of a property are capital expenditures for which no deduction is allowed.

At numerous conferences and in tax journals, tax professionals took issue with T.A.M. 93-15-004. Thereafter, the Service re-visited the issue in Revenue Ruling 94-38.[102] In an unusual about-face, the Service reversed its position with respect to the deductibility of costs incurred to clean up land and treat groundwater contaminated by the taxpayer's own manufacturing activities. In Revenue Ruling 94-38, the taxpayer was a corporation that owned and operated a manufacturing plant. Subsequent to the purchase of the site in 1970, the taxpayer contaminated the site with hazardous waste produced by the manufacturing plant. In order to comply with environmental regulations, the taxpayer commenced soil and groundwater remediation in 1993. The project consisted of excavation, transportation and disposal of the contaminated soil, and backfilling the excavated site with uncontaminated soil. The project also included construction of a groundwater treatment facility, including wells, pipes, pumps, and other equipment. A groundwater monitoring system was also constructed at the site. The remediation project was designed to restore the land to its pre-contamination physical condition. The taxpayer also incurred legal and consulting costs prior to and in anticipation of this soil remediation project.

The Service ruled that the taxpayer's expenditures relating to the soil remediation and ongoing groundwater treatment were deductible as ordinary and necessary business expenses. The holding was based upon the fact that the remediation project did not produce any permanent improvement to the taxpayer's land or otherwise provide significant future benefits. The Service expressly cited

[101] T.A.M. 93-15-004 (Dec. 17, 1992).
[102] Rev. Rul. 94-38, 1994-1 C.B. 35.

Plainfield-Union, stating that the appropriate test is to compare the status of the property after the expenditure with the status of the property before the condition arose that necessitated the expenditure. In this regard, the taxpayer's land and groundwater were merely restored to their condition prior to the contamination. Furthermore, the useful life of the land was not increased on account of the relevant expenditures, nor was the land adapted to any new or different use. Hence, the Service acknowledged that capitalization was not required under section 263.[103] Likewise, because land is not a depreciable asset, capitalization was not required under section 263A, which only applies to depreciable assets.[104] Accordingly, the Service ruled that the expenditures were ordinary and necessary business expenses deductible under section 162.

In addition to allowing a deduction for the expenditures incurred directly in the remediation project, the Service ruled that related costs incurred to "evaluate" the contaminated soil and groundwater were also deductible under section 162. Presumably, such expenditures would include the cost of engineering studies and plans for the remediation project. On the other hand, the revenue ruling reaffirmed that the direct costs incurred in constructing the groundwater treatment plant, as well as an allocable portion of the indirect costs related to the construction, were required to be capitalized because the treatment plant had a useful life beyond the taxable year in which it was constructed.[105] The cost of the groundwater treatment plant would then be recoverable through depreciation as allowed under section 168. Under the MACRS depreciation recovery period for nonresidential real estate, the recovery period would be forty years, while the recovery period for equipment would be five years.[106]

Revenue Ruling 94-38 provides reasonably clear guidance as to the tax treatment of the major expenditures incurred in most environmental transactions, stating the following: (1) the actual costs of soil and groundwater remediation are deductible under the taxpayer's regular method of tax accounting; (2) incidental expenses incurred with respect to studying, planning, negotiating and implementing such a remediation project (such as engineering and legal fees) are also deductible; and (3) expenditures incurred in constructing a new asset (such as a groundwater treatment plant) with a useful life beyond the current taxable

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[103] *See supra* text accompanying notes 72-74.

[104] *See supra* text accompanying notes 75-76.

[105] The Service has recently stated a similar position with respect to costs incurred to remove and replace underground gasoline storage tanks. *See Petroleum Industry Replacement of Underground Storage Tanks At Retail Gasoline Stations*, IRS Coordinated Issue Paper (effective January 9, 1998). In this Issue Paper, the IRS held that all costs incurred in removing old tanks and replacing them with new tanks must be capitalized as the taxpayer is acquiring a "new" asset with a useful life of more than one year. However, costs associated with the remediation of any contaminated soil surrounding the old tank may be deducted under the holding in Rev. Rul. 94-38. *See supra* note 102. *But see* Rev. Rul. 98-25, 1998-19 I.R.B. 1 (allowing deduction for costs incurred to replace underground storage tanks containing by-products, including the cost of removing, cleaning, and disposing of the old tanks, as well as acquiring, installing, and filling the new tanks, where taxpayer's tanks are filled, sealed, and have no salvage value or value beyond the current taxable year).

[106] I.R.C. § 168(g)(2)(C)(iii).

year must be capitalized, along with an allocable portion of indirect costs, and recovered over the relevant recovery period. However, it must be emphasized that the holding in this ruling is expressly limited to cases wherein the taxpayer *itself* contaminates the property and then incurs costs to clean up its own property, restoring the land to its pre-contaminated condition. Conversely, the holding is *not* applicable in cases where the taxpayer purchases property that is already contaminated.

In what was surely a regrettable after-thought, the Service reached a contrary conclusion in a case only slightly distinguishable from that examined in Revenue Ruling 94-38. In Technical Advice Memorandum 95-41-005, the taxpayer (a subsidiary corporation which was part of an affiliated group of corporations) held raw, undeveloped farm land.[107] The land was used by the taxpayer as a site for the disposal of industrial waste, including agricultural chemical waste and coke oven by-products; through such use, the land was contaminated. Thereafter, the taxpayer contributed the land to the local county government, which planned to use the land as a recreational park. The taxpayer claimed a deduction under section 170 for the fair market value of the land on the date of the contribution. The next year, the county discovered the contamination of the land and conveyed it back to the taxpayer for $1. Two years later, the EPA and state environmental agency conducted tests of the soil and groundwater at the site. The tests found that the land was contaminated by various hazardous wastes, including arsenic, heptachlor, chlordane, and polynuclear aromatic hydrocarbons ("PAHs"). Subsequently, the site was classified as a Superfund site under the jurisdiction of the EPA pursuant to authority granted under CERCLA. The taxpayer thereafter entered into a consent order with the EPA for the purpose of conducting a Remedial Investigation and Feasibility Study to determine the extent of the contamination, the risk of release of hazardous substances into the environment, and develop a plan for remediation of the land. The taxpayer acknowledged its remediation liability under CERCLA.

The taxpayer claimed that its remediation expenditures were deductible business expenses under the authority of Revenue Ruling 94-38. The Service disagreed, asserting that such expenditures must be capitalized. In reaching this conclusion, the Service asserted that Revenue Ruling 94-38 was not applicable to the facts and circumstances at issue. The critical fact that the Service relied upon in distinguishing Revenue Ruling 94-38 was that the taxpayer acquired the land uncontaminated and held it continuously until the cleanup. Conversely, the taxpayer in T.A.M. 95-41-005 transferred the land to the county and subse-

[107] T.A.M 95-41-005 (Sept. 27, 1995). The acquisition of the land by the taxpayer from a corporate predecessor was accomplished through a tax-free reorganization, and apparently was not relevant to the Service's analysis. The Service had previously held that contingent environmental liabilities transferred from a parent to a subsidiary in a tax-free reorganization under section 351 were not a bar to the deduction of such expenses by the subsidiary, assuming that such expenses would have been deductible by the parent. Rev. Rul. 95-74, 1995-2 C.B. 36.

quently re-acquired it following recision of the gift. The remediation project was commenced after the re-acquisition. The Service refused to apply the holding in *Plainfield-Union*, stating: "The restoration principle envisions that the taxpayer acquire the property in a clean condition, contaminate the property in the course of its everyday business operations, and incur costs to restore the property to its condition at the time the taxpayer acquired the property.[108] The value of the land following the remediation project was significantly greater than its value of $1 on the date that it was acquired by the taxpayer from the county. On the date that the corporation "acquired" the property, it was already contaminated: "Subsidiary acquired the property in a contaminated condition . . . when it purchased the Land from the County for $1.[109] In refusing to follow Revenue Ruling 94-38, the Service suggested that future expenditures incurred in the remediation project were not deductible business expenses, but rather must be capitalized.

The Service next considered in Technical Advice Memorandum 95-41-005 whether the expenditures for the initial hazardous waste study conducted by an engineering firm, as well as the legal fees paid for the negotiation and drafting of the EPA consent order and consulting contracts were deductible as ordinary and necessary business expenses. None of these expenses were related to the actual remediation of the site, but rather were incidental costs incurred in planning for such a remediation project, as well as negotiating with the regulatory agencies. The Service applied the general tax principle that the tax treatment of expenditures is determined by reference to the nature of the transaction that gave rise to such payments. The Service found that the taxpayer had failed to carry its burden of proving that these incidental expenditures were ordinary and necessary business expenses deductible under section 162. Accordingly, it ruled that the legal and consulting costs also must be capitalized. The logic underlying the Service's position seemed to be that because the expenditures incurred in the remediation project were not ordinary and necessary business expenses, the incidental expenses incurred in anticipation of the remediation project (*e.g.*, the engineering study and legal fees) must also be capitalized—presumably added to the taxpayer's basis in the land.

The Service's holding in Technical Advice Memorandum 95-41-005 was based upon its position asserted in prior cases such as *Wolfsen* and *Stoeltzing*, wherein it claimed that capitalization is required for all expenses incurred in a "general plan of rehabilitation." The same position was taken by the Service in Technical Advice Memorandum 93-15-004, wherein the taxpayer incurred expenses pursuant to a consent decree with the EPA for the cleanup of the taxpayer's contaminated property. The Service ruled that such expenses were incurred pursuant to a "general plan of rehabilitation" resulting in "permanent betterments" to the

[108] T.A.M. 95-41-005 (Sept. 27, 1995).
[109] *Id.*

taxpayer's property and hence, were not currently deductible as an ordinary and necessary business expense, but instead must be capitalized.[110]

The position of the Service in Technical Advice Memorandum 95-41-005 was widely criticized by tax and environmental commentators.[111] Rather than clarifying, refining, or expanding its holding in Revenue Ruling 94-38, the Service merely muddied the waters. The harsh and negative response of the tax community to Technical Advice Memorandum 95-41-005 led the Service to form a task force of Treasury and Service experts to reconsider the whole issue of the deductibility of environmental cleanup costs.[112] Thereafter, in a rare reversal, the Service revoked Technical Advice Memorandum 95-41-005 and ruled that such legal and consulting fees were deductible expenses. The Service abandoned its position that the break in the taxpayer's ownership of the contaminated land was a distinguishing fact that warranted a different tax treatment, holding instead that "because the same taxpayer contaminated the property and incurred the [cleanup] costs, the interim break in ownership should not, in and of itself, operate to disallow a deduction under the general principles of section 162 of the Code.[113] On this basis, the holding of Revenue Ruling 94-38 was applicable, the remediation expenses were deductible, and the incidental expenses (legal and consulting fees) were deductible as well.

These developments can be confusing and troublesome. Nevertheless, several general principles emerge from the Service's pronouncements.[114] First, it is clear that where a taxpayer acquires land, and then contaminates the land himself, the direct costs incurred in cleaning up the soil and groundwater at the site will be deductible as ordinary and necessary business deductions. Incidental costs incurred with respect to the cleanup project (such as engineering consulting fees, the cost of a survey, legal fees for negotiating with the EPA and determining the taxpayer's liability under the environmental statutes, etc.) will also be deductible

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[110] T.A.M. 93-15-004 (Dec. 17, 1992). In this ruling, the Service held that all expenses incurred in removing PCBs released into the groundwater were capital expenditures. The taxpayer had capitalized only the costs related to building facilities and equipment used for groundwater monitoring wells.

[111] Typical of such criticism are the comments of Mark J. Silverman et al., *IRS Remediates Environmental Cost Deduction Mess*, 12 TAX NOTES (TA) 1541, 1545 (Mar. 11, 1996) ("The IRS appeared oblivious to the absurd results arising from the fixation on the company's break in ownership of the land. If the company had never contributed the land to the county, the company would have been entitled to deduct the costs").

[112] The Service organized a task force to consider the tax treatment of remediation expenditures. Representatives of the Service also met with members of the tax bar in an effort to obtain input from practitioners. See 58 *Tax Notes* 1408-1409 (Mar. 15, 1993). To date the Service has not announced any conclusions of that investigation. More recently, representatives of industry and private sector groups met with the Service and Treasury officials to discuss the tax treatment of environmental remediation expenditures. See *Private Sector Groups Meet With IRS, Treasury on Environmental Cleanup*, DAILY TAX REP. (BNA), Feb. 3, 1995, at G-8.

[113] T.A.M. 96-27-002 (July 5, 1996), *rev'g* T.A.M. 95-41-005.

[114] For a more complete discussion of Revenue Ruling 94-38 and the various Technical Advice Memoranda, see Sanjay Gupta and Howard M. Shanker, *Taxing the Environment*, 74 TAX NOTES (TA) 1451 (Mar. 17, 1997).

to the extent that the remediation project itself falls under the authority of Revenue Ruling 94-38. Second, non-taxable transfers of the contaminated property (for instance, within a group of affiliated corporations or in tax-free reorganization under section 368) should not affect this tax treatment. Even where a transfer is effected through a taxable transfer that is subsequently rescinded, such as in Technical Advice Memorandum 95-41-005, the tax treatment should not be affected. Third, in all cases, expenditures related to the creation or construction of assets with a useful life greater than one taxable year (such as equipment, a ground water treatment plant, etc.) must be capitalized, with cost recovery deductions allowable over the course of the relevant recovery period. Fourth, where the taxpayer acquires land that is already contaminated, expenditures incurred in cleaning up the property may not be deducted as ordinary business deductions under the authority of Revenue Ruling 94-38, but rather must be treated as outlined below in Section III(G).

2. *Asbestos: Removal Versus Encapsulation*

Tax issues similar to those involving soil and groundwater remediation arise in the context of asbestos abatement projects. Asbestos was commonly used as insulation (typically for pipes and heating ducts) prior to the 1970s. However, numerous studies have found that friable asbestos may cause cancer and in general, endanger the health and safety of workers. Despite the potential risk, asbestos is *not* a hazardous substance under CERCLA, and no environmental statute requires that friable asbestos be removed from a building. In many cases, the asbestos need merely be encapsulated to reduce or eliminate any risk to human health. Nevertheless, the market value of buildings that contain asbestos insulation (whether friable or not) is often diminished by the presence of such a potentially dangerous substance. For this reason, many building owners decide to encapsulate or remove asbestos insulation voluntarily. This may be done to protect the health and safety of workers, as well as to protect the value of the property.

When the asbestos in a building is removed or encapsulated, the issue arises as to the tax treatment of the costs incurred. The Service addressed this issue in Technical Advice Memorandum 92-40-004.[115] In this memorandum the taxpayer decided to remove and replace asbestos insulation in his building, although not expressly required to do so by any federal or state statute or regulation. The taxpayer claimed that such expenditures as were incurred in removing and replacing the asbestos were ordinary and necessary business expenses deductible under section 162. The taxpayer asserted that such expenditures did not add to the value of the building or significantly prolong its useful life, but merely restored the building to its original condition. The Service rejected this claim, ruling that the expenses incurred in the asbestos removal project must be capital-

[115] T.A.M. 92-40-004 (Oct. 2, 1992).

ized (and added to the taxpayer's basis in the building) because the project increased the value of the taxpayer's property and resulted in a permanent improvement to such property by: (1) increasing the marketability of the property; (2) reducing the health risks to the taxpayer's employees, and accordingly, reducing the potential future liabilities of the taxpayer; and (3) reducing the risk of a suspension of plant operations by the appropriate state and federal regulatory authorities. The Service refused to apply *Plainfield-Union* on the grounds that it was impossible to value the property prior to the condition that gave rise to the remediation project (because the building had originally been constructed with the asbestos), and therefore, the property was not returned to its pre-contamination state as in *Plainfield-Union.*

Notwithstanding protests of tax professionals, the Service maintained its position that the cost of removing asbestos and replacing it with a non-hazardous material is a capital expenditure. In a subsequent ruling, Technical Advice Memorandum 94-11-002, the Service reaffirmed its stance with respect to requiring capitalization for expenses incurred in asbestos removal.[116] However, the Service took a somewhat more lenient position with respect to costs incurred in encapsulating friable asbestos. Specifically, the Service ruled that a deduction is allowed for expenses incurred in encapsulating damaged asbestos pipes on the grounds that such expenses were "incidental repairs" deductible under section 162.

More recently, the Tax Court affirmed the Service's principle that expenses incurred in removing asbestos from a building must be capitalized. In *Norwest Corporation and Subsidiaries v. Commissioner*,[117] the taxpayer entered into a general renovation of one of its properties, a commercial office building built in 1969. Pursuant to the general renovation, the taxpayer incurred $1.9 million in removing an asbestos-based fire retardant insulation. The taxpayer and the Service stipulated that the useful life of the building had not been extended by the asbestos removal, but that the building was made safer for employees as a result of the remediation project. The taxpayer claimed that the cost of removing the asbestos was deductible as an ordinary and necessary business expense under section 162. The balance of the cost of the renovation project was capitalized and added to the taxpayer's basis in the building. The Service disallowed the deduction and required that the cost of the entire project be capitalized, arguing that *Plainfield-Union* did not apply because there was no way to compare the value of the building before the condition that gave rise to the need for the remediation project. This is because the building was originally built with the asbestos and thus, was always "contaminated." On this account, the Service argued that Revenue Ruling 94-38 did not apply since the taxpayer had not acquired the building uncontaminated and thereafter contaminated it itself, but rather that the property was contaminated on the original date of acquisition.[118]

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[116] T.A.M. 94-11-002 (Mar. 18, 1994).

[117] 108 T.C. 265, 285 (1997).

[118] For a more complete summary of the arguments of the parties in *Norwest*, see Leonard G. Weld and Charles E. Price, *The Tax Court Rules on Asbestos Abatement*, 75 TAXES 378 (July 1997).

The Tax Court held for the Service on narrow grounds, viewing the costs incurred with respect to asbestos removal as part of the general plan of restoration. On these grounds, the entire cost of the project was capital in nature. The court did not address the question of whether such expenditures would be deductible if incurred outside a general renovation project. Based on its previously announced rulings, the Service would still reject such a claim. The Tax Court gave no indication that it would be particularly sympathetic to a taxpayer's claim that such costs are deductible if incurred in a separate asbestos removal project unconnected with a general renovation of the property.

3. *Cost of Environmental Audits*

In recent years, companies subject to environmental regulation have increasingly turned to outside consulting and legal firms to conduct so-called environmental audits of their manufacturing premises. Through such voluntary programs, companies can identify potential violations under RCRA before they develop into more serious problems. "Environmental audits should be an important part of corporate environmental policy. Through internal environmental audits, businesses can identify liabilities and address problems which can avert civil actions and criminal prosecutions."[119] To encourage environmental audits, the EPA has adopted the position that the agency will eliminate or reduce punitive fines for civil or administrative violations that were discovered through environmental audits or other voluntary review procedures.[120] Outside consultants can keep the business in compliance with new rules and regulations with which the company's own internal managers may be unfamiliar.

Where businesses expend funds for such environmental audits, the expense of consulting/legal fees associated with such investigations should be treated like ordinary RCRA-mandated compliance costs or any other environmental compliance cost. Where such expenses relate to the production of manufactured goods, arguably they too must be capitalized under the uniform capitalization rules of section 263A. As noted above, section 263A requires that costs incurred in the production of real property or tangible personal property used in a trade or business must be capitalized.[121] For example, this provision might apply to the production of chemicals or petroleum products by a manufacturing plant. Otherwise, the expense of an environmental audit (as well as all other ordinary RCRA-mandated compliance costs) should be deductible under section 162.

4. *Qualified Environmental Remediation Expenditures*

The tax treatment of certain environmental remediation expenditures was revised by Congress pursuant to the Taxpayer Relief Act of 1997.[122] The act

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[119] FRONA M. POWELL, LAW AND THE ENVIRONMENT 381 (1998).

[120] *See* Nancy Kubasek, *EPA Establishes Policy Recommending Against Prosecutions of Companies That Disclose Environmental Crimes, Environment and Business Newsletter*, Vol. 3, No. 1, May 1998, p. 1.

[121] *See supra* text accompanying notes 73-74.

[122] Pub. L. No. 105-34, 111 Stat. 788.

allows a deduction for certain environmental remediation expenditures that otherwise would not be deductible under prior law. New section 198 provides that any "qualified environmental remediation expenditure" may be expensed, rather than charged to capital account.[123] Deductions for qualified environmental remediation expenditures are subject to recapture as ordinary income upon the sale or disposition of the property with respect to which the expenditures were incurred.[124]

The ostensible purpose of this provision is to further the "cleanup of contaminated sites" through economic incentives resulting from a more favorable tax treatment of remediation expenditures.[125] Such tax preferences are commonly associated with so-called brownfields programs designed to encourage the remediation and reuse of contaminated commercial and industrial sites, most often located in urban areas. Notwithstanding the apparent application of this new deduction to the kinds of environmental transactions discussed above, the scope of the new provision is actually quite narrow and will have limited impact since it applies to very specific environmental remediation expenditures.

The new section 198 deduction applies only to a "qualified environmental remediation expenditure," which is any expenditure that is otherwise chargeable to capital account and paid or incurred in connection with the abatement or control of "hazardous substances" at a "qualified contaminated site."[126] The limitation is found in the definition of "qualified contaminated site." Under the provision, such a site is any area used by the taxpayer in a trade or business, or for the production of income, where there has been a release (or threat of release) of a hazardous substance, and where such site is within a "targeted area." Targeted areas include certain depressed regions (both urban and rural) as defined by the population census, any empowerment zone or enterprise community (as well as twenty yet to be announced empowerment zones authorized under the 1997 act), and any site included in the EPA's Brownfields Pilot Project. However, most importantly, sites on the National Priorities List (*i.e.*, designated Superfund sites) are *not* included as targeted sites. Hence, expenditures incurred in the remediation of Superfund sites are not covered by section 198. However, this is precisely where most environmental remediation expenditures are incurred.

Furthermore, the new provision applies only to expenditures paid or incurred prior to January 1, 2001, and hence, sunsets as of that date unless otherwise renewed by Congress. For these reasons, the impact of section 198 is likely to be rather limited. Indeed, the revenue impact of the new tax preference was esti-

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[123] I.R.C. § 198(a).

[124] The Service recently announced procedures for making the election under section 198 with respect to the deduction of qualified environmental remediation expenditures. Rev. Proc. 98-47, 1998-37 I.R.B. 1.

[125] Senate Comm. Report, 105-33, Sec. 941.

[126] I.R.C. § 198(b)(1).

mated by the Joint Committee on Taxation to be only $417 million over the four-year life of the provision.[127] This reflects the committee staff's estimation that few expenditures would qualify for the section 198 deduction.

C. *Deductibility of Fines and Penalties*

Under section 162(f), a deduction is denied for any expense incurred in carrying on a trade or business which is a "fine or similar penalty paid to a government for the violation of any law."[128] This provision was added to the Code in 1969 to codify the general case law that developed under the general principle that "public policy" would be frustrated were fines and penalties deductible as a business expense.[129] No deduction is allowed for criminal fines and civil penalties that are imposed on account of a violation of a federal or state statute.[130]

Notwithstanding the rather broad scope of this provision, the courts and the Service have tempered it somewhat. The prohibition does not apply to every payment to a government entity on account of a violation of law. As a general matter, courts have held that a civil penalty is a "fine or similar penalty" when it is punitive in nature, *i.e.*, imposed to punish a violation or force compliance. However, regulations of the Treasury Department provide that "compensatory damages . . . paid to a government do not constitute a fine or penalty."[131] Thus, civil penalties or other payments that are compensatory in nature (*i.e.*, those that compensate other parties or the government) are *not* penalties for purposes of the prohibition.[132] Furthermore, the Service has concluded that penalties intended to recapture economic advantage gained by noncompliance were compensatory in nature and thus, were not "fines" for these purposes.[133]

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[127] JOINT COMMITTEE ON TAXATION, 105 CONG., 1ST SESS., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997 136 (1997).

[128] I.R.C. § 162(f); *see also* Reg. § 1.162-21(c).

[129] For example, the Supreme Court has held that fines paid by a trucking company for intentionally overloading its trucks in contradiction of state law were nondeductible. *See* Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958). The Court stated that allowing a deduction for such fines would undermine the public policy expressed in the state law — i.e., the load limitation for trucks. *See also* S. Pac. Transp. Co. v. Commissioner, 75 T.C. 497, 646-54 (1980) (holding that taxpayer could not deduct a penalty assessed pursuant to a civil statute because payment served the same purpose as a criminal fine).

[130] S. REP. NO. 91-552, at 273 (1969). The regulations define the statutory phrase "fine or similar penalty" to include "all civil penalties." In addition, a fine or penalty is defined in the regulations to include any amount "paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal)." Reg. § 1.162-21(b)(1)(iii). One commentator points out that this is an unwarranted expansion of the statute. *See* Sloane Elizabeth Anders, *The Federal Tax System and the Environment: Should Payments Made Pursuant to CERCLA Be Deductible?* 10 VA. TAX REV. 707, 712 (1991).

[131] Reg. § 1.162-21(b)(2).

[132] Colt Industries, Inc. v. United States, 11 Cl. Ct. 140, 144 (1986), *aff'd*, 880 F.2d 1311 (Fed. Cir. 1989).

[133] Rev. Rul. 88-46, 1988-1 C.B. 76.

In the context of an environmental transaction, the question may arise as to whether particular payments constitute a fine or penalty for which a deduction is barred by section 162(f).[134] However, what is nominally designated as a "penalty" by the EPA may very well qualify as a deductible business expense for tax purposes. In other words, practitioners need to carefully examine particular charges to see whether they are compensatory in nature, and hence potentially deductible, or really nondeductible "fines." Because of the different tax treatment, as well as the possibility of restructuring a transaction with the EPA to obtain a more favorable treatment, there are planning opportunities that counsel should consider.

The application of these rules is particularly relevant to two aspects of enforcement action settlements — pursuant to which significant fines and penalties are a common element.[135] First, it may be argued that payments made to the EPA to compensate for governmental expenses incurred to clean up a Superfund site are not in the nature of a fine or "similar penalty" for which a deduction is denied, but rather represent "compensatory damages" imposed under the environmental statutes. In support of this position is the case of *Mason & Dixon Lines, Inc. v. U.S.*,[136] where a trucking company paid a "fine" to a state for using trucks with excess weight on state highways. The company also paid an amount to compensate the state for the damage done to the highways by the overweight trucks. The Sixth Circuit allowed a deduction for the latter payment, as it represented "compensatory damages" not in the nature of a fine or penalty.

On the other hand, a different conclusion was reached by the Federal Circuit in *Colt Industries v. United States*,[137] wherein the taxpayer entered a consent agreement with the EPA with respect to court-ordered payments to the Pennsylvania Clean Air and Clean Water Funds of $25,000 per day for its willful violations of the Clean Air Act of 1970 and the Clean Water Act of 1972. Although these payments were denominated as a "penalty" in the consent agreement, the taxpayer claimed a deduction on the grounds that they were "compensatory" in nature. The court held that the payments were punishment "to further retribution and deterrence," and were in the nature of fines or penalties for which a deduction was disallowed under section 162(f). Likewise, where payments were made to an environmental trust fund pursuant to a court order and in

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[134] *See, e.g.*, Rev. Rul. 88-46, 1988-1 C.B. 76 (nonconformance penalty assessed by EPA under Clean Air Act is not a "fine or similar penalty" under section 162(f), and hence, is deductible). *But see* William L. Raby, *No Deduction for Pollution Fund Payment that Reduces Criminal Fine*, 55 TAX NOTES 943, 944 (1992).

[135] A record high of $38.5 million in civil judicial penalties and $22.8 million in administrative penalties was imposed in 1990. OFFICE OF CIVIL ENFORCEMENT AND COMPLIANCE ASSURANCE, EPA, ENFORCEMENT AND COMPLIANCE ASSURANCE ACCOMPLISHMENT REPORT FY 1994 (May 1995).

[136] 708 F.2d 1043 (6th Cir. 1983).

[137] 11 Cl. Ct. 140 (1986), *aff'd*, 880 F.2d 1311 (Fed. Cir. 1989)

lieu of a direct payment to the government, a deduction was denied under section 162(f).[138]

Claiming a deduction for such expenditures also may be problematic where the payments are made under an EPA settlement agreement. First, the EPA typically requires a statement in settlement documents acknowledging that the defendant will not seek a tax deduction for any penalty payment made under the agreement. However, in most cases, the penalty consists of a gravity-based component and an economic benefit component. The gravity-based component is intended to punish the alleged violation and deter future violations.[139] Under section 162(f), this portion of the penalty would be nondeductible as punitive in nature. However, the economic benefit component is intended to offset the economic advantage that the alleged violator may have obtained over its competitors as a result of its noncompliance.[140] Arguably, this portion is compensatory in nature and outside the scope of section 162(f). There is little authority directly on point with respect to CERCLA. However, the Service has ruled that payments required for nonconformance with other federal environmental statutes are not considered fines or similar penalties for purposes of section 162(f).[141] Cleanup costs imposed under CERCLA represent payments to reimburse the EPA for its own out-of-pocket expenses, and arguably are not fines or penalties to which the section 162(f) disallowance rule applies.[142] Of course, this does not mean that such expenditures are necessarily deductible under section 162, but only that they are not expressly disallowed under section 162(f). At the same time, it is clear that penalties imposed under section 107(f) of CERCLA for the unlawful disposal of hazardous waste are clearly nondeductible under section 162(f). Nevertheless, the EPA's insistence on a unconditional waiver of the right to seek a deduction is inconsistent with the case law and existing administrative guidance concerning section 162(f).

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[138] *See* Allied-Signal Inc. v. Commissioner, 54 F.3d 767 (3d Cir. 1995). However, the Tax Court has held elsewhere that payments to an environmental fund created under a Pennsylvania statute were not "fines or similar penalties," and hence, were deductible. The payments were made pursuant to the statute in exchange for permission to continue to discharge raw sewage until a new treatment plant was available, and hence, were in *furtherance* (and not violation) of the state's public policy. *See* S & B Restaurant, Inc. v. Commissioner, 73 T.C. 1226 (1980).

[139] *See* EPA, RCRA CIVIL PENALTY POLICY 1-3 (Oct. 1990).

[140] *Id.* at 47-48.

[141] *See* Rev. Rul. 88-46, 1988-1 C.B. 76 (holding that the nonconformance penalty assessed by the EPA against a manufacturer of trucks and engines for nonconformance with provision of the Clean Air Act of 1970 was deductible under section 162; the penalty was not punitive in nature nor was it a penalty for the "violation of the law," but rather was in the nature of compensatory damages imposed on violators who would otherwise gain an economic advantage over competitors who comply with the statute). *See also* Rev. Rul. 74-323, 1974-2 C.B. 40.

[142] The imposition of "response cost liability" under CERCLA "was not intended to operate, nor does it operate in fact, as a criminal penalty or punitive deterrent." U.S. v. Monsanto Co., 858 F.2d 160, 175 (4th Cir. 1988). *See* Robert A. Kilinskis, *Tax Consequences of Remedial Liabilities*, Unpublished Outline for 25th Annual Conference on Environmental Law of the ABA Section of Natural Resources, Energy and Environmental Law (March 21-24, 1996), pp. 38-43; Sloane Elizabeth Anders, *The Federal Tax System and the Environment: Should Payments Made Pursuant to CERCLA Be Deductible?*, 10 VA. TAX. REV. 707, 721 (1991).

Second, violators will often enter into a supplemental environmental project ("SEP") with federal and state regulators as part of the enforcement action settlement. In a typical SEP, the defendant will receive a reduction in the penalty amount in return for implementing an environmentally beneficial project.[143] The amount of the reduction varies from case to case. In some instances, each dollar spent on the SEP will reduce the penalty by one dollar, while in others less reduction is available. Therefore, in some cases, the cost of implementing the SEP will be significantly higher than the penalty amount being offset. On the other hand, where a PRP performs an SEP in lieu of a penalty or fine, such expenditures are usually treated the same as any other environmental expenditure.[144]

As a general matter, payments made to third parties or to charities in lieu of a nondeductible fine or penalty are themselves deemed nondeductible.[145] However, it is unclear whether the section 162(f) prohibition applies to SEP costs that exceed the nondeductible penalty amount being forgiven. While the regulations note that the prohibition reaches any amount paid in settlement on the assessed fine, such an approach is unnecessarily harsh, and discourages the use of the SEP mechanism. In any event, parties considering a SEP proposal should take the possible imposition of section 162(f) into account in selecting potential projects. For example, a project whose costs must be capitalized even without the application of section 162(f) might be selected over one whose costs would otherwise be deductible.

D. *Economic Performance*

Even after it is determined that a particular environmental remediation expenditure is deductible as an ordinary and necessary business expense (rather than treated as a capital expenditure), it still must be determined which is the "proper taxable year" for claiming such deduction. A deferral of the tax deduction for environmental remediation expenditures for even one taxable year can have a significant economic cost to a taxpayer. Conversely, the ability to accelerate a tax deduction into an earlier taxable year can significantly reduce the after-tax cost of an environmental transaction.

In general, an expense is deductible in the taxable year as determined under the taxpayer's "method of accounting used in computing taxable income."[146] Where a taxpayer reports on the cash method of accounting, a deduction generally will be allowed in the taxable year in which payment is made. Where the

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[143] *See* EPA, INTERIM REVISED SUPPLEMENTAL ENVIRONMENTAL PROJECTS POLICY (May 8, 1995).

[144] *See* Sanjay Gupta & Howard M. Shanker, *Taxing the Environment*, 74 TAX NOTES (TA), 1451, 1457 (Mar. 17, 1997) ("SEPs are generally, although not always, treated the same as other environmental expenditures that can be either deducted or capitalized depending on the specific nature of the project.").

[145] *See* Allied-Signal, Inc. v. Commissioner, 54 F.3d 767 (3d Cir. 1995).

[146] I.R.C. § 461(a).

taxpayer uses the accrual method of accounting (which generally will be the case where the taxpayer is a business corporation[147]), a deduction may be accrued only in the taxable year in which the "all-events" test of section 461 is satisfied. Under the all-events test, a deduction with respect to a liability may be accrued only in the taxable year in which: (1) all events have occurred which determine the "fact of liability;" (2) the amount of such liability can be determined with reasonable accuracy; and (3) "economic performance" occurs.[148]

A PRP may confront a number of issues under the all-events test with respect to claiming a deduction for a liability arising under CERCLA. First, if the taxpayer contests the liability (which is often the case, given the costs associated with a Superfund cleanup), no deduction will be allowed under the all-events test as the "fact of liability" remains in dispute. Second, even if liability has been admitted by the PRP, the exact *amount* of the liability may still remain in doubt. Only after the amount of the liability has been fixed (for example, pursuant to a court-approved consent decree with the EPA or pursuant to a judicial determination) will the second requirement of the all-events test be met. Even then, to the extent that the PRP's liability for cleanup costs (or reimbursement to the EPA for such expenditures) is subject to a right of refund (or refund by contribution from another PRP), a deduction may not yet be allowed.[149] On the other hand, if agreement is reached with respect to some portion of the PRP's liability, a deduction should be allowed for that portion of the liability which is agreed.[150] This is important because the PRP may end up in litigation for years with the EPA over that portion of the liability which remains in dispute. The fact that the PRP disputes some portion of the overall liability asserted by the EPA should not undermine the deduction for that portion of the environmental remediation expenditure that is agreed, fixed and determinable.

The most significant issue arising with respect to the timing of a deduction for environmental remediation expenditures arises under the all-events test of section 461 with respect to satisfying the requirement for "economic performance." The requirement for economic performance was added to the Code in 1984, and was intended to address the timing disparity under the all-events test wherein a party contracts for services to be performed by another party in a subsequent taxable year. If the payor of a contractual obligation (which is fixed and determinable) reports on the accrual method, it could accrue a deduction for the

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[147] Under Reg. § 1.448-1T(a) and (f), corporations taxable under Subchapter C must use the accrual method, unless they have less than $5 million of annual gross receipts. S corporations are generally permitted to use the cash method of accounting.

[148] I.R.C. § 461(h)(1), (4).

[149] For example, if the PRP is on the cash method, a deduction may be disallowed on the grounds that a right of refund means that a completed payment has not yet been made. *See* Prop. Reg. §1.461-4(g)(1)(ii)(A), (g)(3), 60 Fed. Reg. 39,903 (1995). For an accrual method taxpayer, a right of refund may bar a deduction as the amount of the liability is not fixed and determinable until such time as the right of refund lapses.

[150] "[T]he fact that the exact amount of the liability cannot be determined does not prevent a taxpayer from taking into account that portion of the amount of the liability which can be computed with reasonable accuracy within the taxable year." Reg. § 1.461-1(a)(2)(ii).

liability before the taxable year in which the service performer actually performs the services. If the service performer reports on the cash method, it would not include in income the service fee until the year of receipt. This creates the possibility of a discrepancy between the timing of the deduction and income, a discrepancy which is decidedly at the expense of the U.S. Treasury. This mismatch was duly noted in the Conference Committee Report to the 1984 legislation which introduced the correction: "Whether an expense involving a future obligation can satisfy the all-events test in a year significantly earlier than the year in which the taxpayer must fulfill the obligation has been the subject of controversy under present law."[151] The all-events test was amended to defer accrual of the deduction until such time as "economic performance" occurs.

How and when economic performance occurs with respect to a particular liability depends upon the nature of that liability. For example, economic performance occurs for "service liabilities" at such time as the service is provided.[152] On the other hand, for tort liabilities and any action arising out of a workers compensation statute, economic performance occurs when payment to the injured party is made.[153] This rule also applies for other so-called payment liabilities, which include liabilities arising under breach of contract, liabilities for taxes and insurance, and other liabilities which cannot properly be classified under one of the other categories included in section 461. For all such payment liabilities, economic performance occurs as payments are made.

Where a PRP's liability arises under CERCLA, the classification of such liability under the all-events test can be crucial to the timing of the deduction. Under CERCLA, a liability may be asserted against a PRP by either the EPA or another private party (most likely another PRP). In many cases, the liability arising under CERCLA is not *to* the EPA or the other private party, but rather is a requirement that expenditures be incurred by the PRP for the cleanup of a Superfund site. This makes classification of a CERCLA liability problematic. Likewise, while a liability arising under CERCLA bears some similarities to a liability arising under tort or a workers compensation act, it also is clearly distinguishable. Most significantly, negligence is not a prerequisite to a liability arising under CERCLA, as it is for a tort. Furthermore, a tort liability arises under state law, while the liability of a PRP arises under a federal statute. Obviously, a CERCLA liability does not fall into any of these classifications.

In many other enforcement proceedings, payments by a PRP to the EPA or another private party often will be in the nature of reimbursement for expenses already incurred by the other party in cleaning up the designated Superfund site. In such cases, it may make more sense to classify a PRP's liability under CERCLA

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[151] H.R. REP. No. 98-861, at 871 (1984).

[152] I.R.C. § 461(h)(2)(A)(i); *see also* Reg. § 1.461-4(d)(2), (5).

[153] "If the liability of the taxpayer requires a payment to another person and arises under any workers compensation act, or arises out of any tort, economic performance occurs as the payments to such person are made." I.R.C. § 461(h)(2)(C)(i), (ii).

as a payment liability. Some experts argue that "with a character similar to other payment liabilities and without any policy reason to exclude Superfund liabilities from the category of payment liabilities, Superfund liabilities should be payment liabilities."[154] Under such a treatment, a deduction will be allowed under the all-events test at such time as payment of the PRP's obligation is made. Nevertheless, it is not so clear that all liabilities arising under CERCLA should be treated as "payment liabilities" under section 461. To the extent that the liability imposed on a PRP under CERCLA is an obligation to clean up a Superfund site, such liability would appear to be more in the nature of a service liability.[155] As such, economic performance will occur when the "services" have been rendered (*e.g.*, in the taxable year wherein the contaminated site has been remediated by the PRP).

To summarize, a deduction will be allowed to a PRP reporting on the accrual method when liability has been admitted or adjudicated, the amount of the PRP's liability with respect to the cleanup operation has been fixed or is reasonably determinable, and the remediation of such site has been completed. The economic performance requirement generally will not create a significant obstacle to a PRP. This is because the EPA often cleans up a Superfund site before there is an agreement or judicial determination with respect to the PRP's liability. Hence, economic performance often occurs *before* the other elements of the all-events test have been met. Where this is the case, the PRP's deduction may be accrued at such time as the liability has been admitted and fixed.

E. *Funding Remediation Obligations*

Not all of a PRP's obligations relate to the current cleanup of the Superfund site. Obligations are also imposed by the EPA and state environmental authorities requiring that the site be monitored for a future period, typically ranging from ten to thirty years. For example, substantial future obligations are imposed where groundwater has been contaminated and monitoring facilities are constructed pursuant to the terms of a judicial proceeding or consent agreement. The EPA requires that the PRPs required to operate the facilities submit proof of their financial ability to fund such operations for the relevant future period. Methods permitted to satisfy the future obligation to operate the facility include a trust funded by cash, surety bond, stand-by letter of credit, insurance, or

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[154] Mark W. March & Julia K. Brazelton, *Superfund Cleanups: The Financial Costs High, the Tax Treatment Uncertain*, TAXES 687 (1991). Others conclude that the classification is less clear-cut: "If Superfund cleanup cost liabilities are satisfied by doing cleanup work, then they appear to be Service Liabilities. If the liabilities are satisfied through payment to another person, it is presently unclear whether they will be classified as Service Liabilities or Performance Liabilities." Thomas H. Yancey, Tax Consequences and Implications of Environmental Liabilities, 8 (April 22-23, 1991) (unpublished outline, Current Issues in Environmental Accounting, SEC Reporting, Tax and Finance, Washington, D.C.).

[155] "The costs related to the liability are not generally paid to the EPA, but are paid to third parties engaged to clean up the property for the taxpayer. Thus, the liability is generally more in the nature of a service liability." Robert A. Kilinskis, *supra* note 142, at 29.

corporate guarantee.[156] A significant tax issue arises with respect to the PRP's ability to deduct expenditures relating to fulfilling such future obligations.

The primary tax issue arises with respect to the timing of a deduction for contributions to such a trust where neither performance nor payment (*i.e.*, expenditures to operate the facility) will occur until a later taxable year. As a general rule, payment to a trust, escrow account, or similar funding vehicle will *not* constitute economic performance.[157] Furthermore, to the extent that the PRP may have the right to recover any funds in the trust that are not spent during the term of the trust, no deduction will be allowed under section 461.

Congress has provided a legislative solution to allow a deduction to PRPs for amounts contributed to a trust or other entity meeting certain requirements. A current deduction is allowed for a transfer to a trust or entity that is a Qualified Settlement Fund as provided under section 468B and defined under Treasury Regulations.[158] A Qualified Settlement Fund must be a trust under state law, or have its assets otherwise segregated from other assets, and must be established pursuant to an order of, or approved by, and subject to, the continuing jurisdiction of a governmental authority. The Qualified Settlement Fund must be established to "resolve or satisfy" claims arising under CERCLA (as well as under a tort, breach of contract or other violation of law). The requirement that such liability be resolved or satisfied presents a problem with respect to a liability arising under CERCLA since the EPA will always retain the right to proceed against a PRP for additional amounts that might be required to clean up a Superfund site. A court-approved consent order will reserve such right to the EPA. Nevertheless, Treasury regulations provide that a CERCLA liability will be deemed "extinguished" notwithstanding that the PRP has a continuing "remote, future obligation to provide services."[159] Upon payment by the PRP to the Qualified Settlement Fund pursuant to the consent order, the EPA will grant a covenant not to sue, subject to a right to "reopen" the proceedings at a later date.

Where a payment is made to an entity that is a Qualified Settlement Fund, a current deduction will be allowed, even where the funds are not actually expended until a subsequent taxable year. Absent the special rule created for a Qualified Settlement Fund, the PRP would not be allowed a deduction until the funds are actually expended for the remediation or monitoring services; as noted above, in some cases that might not be for as much as ten years. Hence, use of a

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[156] 40 C.F.R. § 264.143-.145 (1988).

[157] "If the terms of the settlement require that EPA or any other transferee place the money or property received into a trust, escrow account or similar fund to pay for the cleanup, the transfer may be incomplete resulting in no deduction at transfer." Thomas H. Yancey, Tax Consequences and Implications of Environmental Liabilities 11 (Apr. 22-23, 1991) (unpublished outline, Current Issues in Environmental Accounting, SEC Reporting, Tax and Finance, Washington, D.C.); *see also* Prop. Reg. § 1.461-4(g)(1)(ii)(B), 55 Fed. Reg. 23,235 (1990) (requiring actual or constructive receipt by transferee before economic performance is deemed to have occurred).

[158] Reg. § 1.468B-1(c).

[159] Reg. § 1.468B-1(f)(2).

Qualified Settlement Fund will be most advantageous where the PRP can actually benefit from a current deduction for the entire amount of its obligation to perform future services, for instance, where the PRP has taxable income in the current taxable year that it wishes to shelter.[160] Where the PRP does not need a current deduction — for instance, because it has a current loss or NOL carryforwards — it may be preferable for a PRP to satisfy its obligation to the EPA under the consent order through use of a letter of credit, a surety bond, insurance, or on the strength of its own balance sheet. This will minimize the current outlay (maximizing its cash-flow posture) and defer payments (and tax deductions) until future years as the services are actually performed.

Often a trust that is not a Qualified Settlement Fund is used by parties to satisfy their respective obligations with respect to cleaning up a contaminated site. Perhaps the site is not a Superfund site or even under the supervision of the EPA or a state agency, but is only a contaminated site for which a liability or potential liability under environmental laws might reasonably be expected to arise in the future. The parties merely desire to clean up the site to avoid future litigation and controversy. To achieve this, the parties may wish to contribute their respective share of the total remediation expenses to the trust, with the trustee making payments as needed on the project. The primary purpose for using such a trust is to provide for the collection and disbursement of funds for the remediation project.

For years, the tax treatment of such a trust has been uncertain. Potentially, the Service could classify such a trust as a partnership or as an entity taxable as a corporation.[161] The latter would be highly disadvantageous as an entity-level tax would be owed by the "trust." Recently, the Service issued rules clarifying the treatment of such a trust. Under new regulations, such a trust may qualify as an "environmental remediation trust".[162] An environmental remediation trust is recognized as a grantor trust for purposes of federal income taxation.[163] This means that the trust itself is not a taxable entity (so long as it does not engage in profit-making business or investment activities), and each contributor (or grantor) is treated as the owner of its respective share of the trust corpus (as well as the interest earned thereon) for purposes of federal income taxation. Accordingly, no deduction is allowed for a contribution to the trust. A deduction is allowed only when the trust makes payments for the remediation project, with each grantor taking into account its share of the deductible expenses.

An entity will qualify as an environmental remediation trust if: (1) the entity is a trust under state law; (2) the primary purpose for such entity is the collection

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[160] Alternatively, the PRP could borrow from a lender and use the loan proceeds to satisfy its obligation to the EPA, and thereafter, make payments to the lender over the term of the loan.

[161] The tax treatment of the trust would be determined under the entity classification rules found at Reg. § 301.7701.

[162] *Environmental Settlement Funds*, 61 Fed. Reg. 19,189 (May 1, 1996); Reg. § 301.7701-4(e).

[163] The grantor trust rules are found at section 671.

and disbursement of funds for the remediation of the site; (3) the contributors are liable or potentially liable with respect to such site under state or federal environmental laws; and (4) the entity is not a Qualified Settlement Fund.[164] Environmental remediation trusts include trusts created under the order of a governmental authority, as well as trusts voluntarily created by parties merely wishing to avoid future liability under the environmental statutes by addressing a problem at the earliest stages of discovery. As such, a trust may be a useful funding device for multiple parties connected to a contaminated site.[165]

Even after reaching a final agreement with the EPA with respect to the PRP's liability for cleaning up a contaminated site, it is often necessary that treatment facilities be maintained and operated for periods ranging from ten to thirty additional years. This is most common in cases where groundwater has been contaminated and a water treatment plant must be operated for many years subsequent to the actual cleanup. In such cases, the EPA requires proof of the financial ability of the PRPs to operate the plant during that post-cleanup phase. EPA regulations under RCRA require owners and operators of hazardous waste treatment, storage and disposal facilities to post financial assurance for closure and post-closure operation of such facilities. Commonly, some variety of settlement trust is used to fund such obligations of PRPs.[166]

The use of the many different funding vehicles permitted by the EPA can raise complex tax issues.[167] How such funds are financed (*e.g.*, through cash, insurance, letter of credit) can result in different tax results to the payor. Because the EPA grants a good deal of discretion to PRPs in structuring the financing for a CERCLA-mandated cleanup, there is actually considerable room for tax planning in negotiations with the EPA. For this reason, tax considerations ought to play a significant role in guiding the terms of this type of structured settlement with the EPA. Assessing the potential tax impact of cleanup settlements and PRP agreements is thus the first step in developing a settlement structure. Working in conjunction with the client's tax advisor, the environmental attorney can evaluate alternatives to identify the structure that results in the tax and environmental results for the client.

F. *Deferred Payment of Cleanup Costs: PRP's Lingering Liability*

Under CERCLA, the owner of a contaminated Superfund site "at the time of disposal of any hazardous substance" can be held jointly and severally liable for

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[164] Reg. § 301.7701-4(e)(1).

[165] For a fuller discussion of the use and value of environmental remediation trusts, see RESEARCH INSTITUTE OF AMERICA, ENVIRONMENTAL CLEANUP COSTS 11-14 (1996).

[166] As noted above, a contribution to a trust which meets the requirements of section 468B as a "qualified payment" to a "designated settlement fund" may be currently deductible. *See* I.R.C. § 468B.

[167] *See* 40 C.F.R. §§ 264.143-.145 (1997). For a discussion of several of the financial arrangements commonly used, and in particular, the use of bank stand-by letters of credit, see Paul Devine & David G. Mandelbaum, *Standby L/Cs for Environmental Self-Indemnification*, J. COM. BANK LENDING 52 (1989).

all costs associated with cleaning up the property.[168] This liability is imposed on the party that owned the site at the time of disposal of the hazardous substance even where such party no longer owns the property. In addition, the party that generated the hazardous substance disposed of at the site may be held liable for the cleanup costs. The generator remains liable as a PRP even after a sale of the business that generated the hazardous waste that contaminated the site. Where the PRP that owned the land or the business is an individual or corporation, the liability for such environmental remediation costs remains with such individual or corporation. If the owner was a general partnership, the liability is that of the partnership, as well as the individual partners of the partnership.[169]

Where the former owner of the land upon which the hazardous waste was disposed or the business that generated the hazardous substance is held liable for the cleanup of a Superfund site and actually makes a payment with respect to the remediation of the site, the tax treatment of such expenditure is problematic. Since the PRP no longer owns the asset (*i.e.*, the contaminated land or the business) to which the expenditure relates, the deductibility of the expenditure is based on general principles of income taxation, most particularly, the principles enunciated by the Supreme Court in *Arrowsmith v. Commissioner*.[170]

In *Arrowsmith*, the taxpayer was a shareholder of a liquidated corporation. The shareholder properly reported his liquidation distribution as a capital gain. In a tax year subsequent to the liquidation, the shareholder (as transferee of the corporation's assets) was required to make a payment of a debt of the liquidated corporation. The Supreme Court characterized the payment as capital in nature, as opposed to giving rise to an ordinary loss. The character of the payment was determined by reference to the nature of the original transaction. In the context of the original transaction, the payment by a shareholder of a corporate debt would have been treated as a capital contribution to the corporation, and hence, would have given rise to a capital loss on liquidation of the corporation. Hence, the payment of the debt in a tax year subsequent to the liquidation of the corporation was treated as giving rise to a capital loss.

The *Arrowsmith* principle may be applicable to a PRP required to reimburse the government for cleanup costs (or directly expend amounts for the cleanup operation) in a tax year during which the PRP no longer owns the contaminated land or business that generated the hazardous substance that contaminated the land. The characterization of such a payment should be determined by reference to the original facts and circumstances that gave rise to the PRPs liability under CERCLA. In other words, if the payment would have been currently deductible had it been made when the PRP still owned the site or business that generated the hazardous substance, then a payment in a subsequent tax year should have the same character. Conversely, if the payment would have been properly treated

[168] 42 U.S.C. § 9607(a) (1997).
[169] *See* section 13 of the Uniform Partnership Act.
[170] 344 U.S. 6 (1952).

as a capital expenditure (for instance, because it relates to the construction of a water treatment facility), then it should be treated as a capital expenditure when made in a subsequent tax year, even if the PRP no longer owns the land on which the water treatment facility is built. If the PRP has no legal claim to such capital asset, then such expenditure would give rise to a capital loss in the taxable year of payment.

In some cases, a PRP is able to recover from another PRP all or a portion of his expenditures for remediation of a Superfund site. This might be the case, for example, where the EPA holds the generator of the hazardous substance liable for the cleanup of a contaminated site, and the generator looks for reimbursement from the owner or operator of that site. Suits for "private cost recovery actions" and "contribution actions" are authorized under CERCLA.[171] These allow a PRP that is forced to pay more than its individual share of the cleanup costs to recover by way of contribution from other PRPs that contributed to the contamination of the site.

In the event that a recovery from another PRP takes place in the same tax year as the payment to the EPA, there are no tax consequences resulting from the transaction; the payment to the EPA (to the extent of the recovery) is not deducted and the recovery is not includable in income. However, where a recovery from a contributing PRP takes place in a tax year subsequent to the year of the taxpayer's payment to the EPA, several issues are raised. First, to the extent that the payment to the EPA was originally subject to reimbursement (for example, where the PRP has a right of reimbursement under an insurance policy), it would not be deductible as a loss under section 165.[172] However, where reimbursement is only a remote possibility, a deduction should be allowed.[173] This could be the case where recovery is sought from another PRP in an action for contribution. The mere knowledge that an action will be pursued against another PRP for contribution should not bar a deduction.

Where all or a portion of payment that was deducted in a prior taxable year is subsequently recovered, the recipient would be required to include such recovery in income in the year of actual (or constructive) receipt.[174] Where the PRP

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[171] Private cost recovery actions are authorized under section 107(a)(4)(B) of CERCLA and contribution actions are authorized under section 113(f) of CERCLA. 42 U.S.C. §§ 9607(a)(4)(B), §9613(f) (1997). For an in-depth discussion of such recovery actions, see Jeffrey M. Gaba, *Recovering Hazardous Waste Cleanup Costs: The Private Cause of Action under CERCLA*, 13 ECOLOGY L.Q. 181 (1986).

[172] "There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise." I.R.C. § 165.

[173] *See* William Johnson, Jr. v. Commissioner, 41 T.C.M (CCH) 849, 1981 T.C.M. (RIA) ¶ 81,055 (casualty loss deduction allowed in year of loss because possibility of recovery through lawsuit brought in year of loss was remote).

[174] In general, if an amount deducted from gross income in one tax year is recovered in a subsequent tax year, the recovery is included in gross income (subject to the so-called tax benefit rule) in the year of receipt to the extent the prior deduction resulted in a tax benefit. *See, e.g.*, Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983) (holding that a corporation that purchased supplies and properly deducted the cost, obtaining a tax benefit therefrom, was required to include in gross income the lesser of the amount deducted or the fair market value of the supplies in the taxable year it liquidated and distributed the unused supplies to its shareholders).

that made the original settlement payment to the EPA, or itself expended amounts to remediate a contaminated site, originally capitalized such expenditures (for instance, because the payments were for the construction of a groundwater treatment facility or other property with a useful life longer than one year), then the recovery in the subsequent tax year should be treated as a "return of capital."[175] As such, the taxpayer would reduce its basis in such capital asset. To the extent that the recovery exceeds the taxpayer's adjusted basis in the capital asset, the excess would be treated as a capital gain.

G. *Liability for Prior Contamination in an Asset Acquisition*

Under CERCLA, the purchaser of a contaminated Superfund site may also be held liable as a PRP for cleanup costs.[176] Furthermore, under certain facts and circumstances, the purchaser of the *business* that generated the hazardous substance that contaminated a Superfund site can be held liable for the environmental remediation costs associated with such site. The purchaser of a business can be responsible for a liability of the seller under the judicial doctrine of "successor" liability.[177] Under this common law principle, where the purchaser of all or substantially all of the assets of a business continues the historic business of the seller and retains most of the workforce of the seller, such purchaser may be treated as the "successor" of the seller. As the successor, certain liabilities of the seller (even those not expressly assumed) may be imputed to the purchaser/successor. Accordingly, where the transferred business previously generated hazardous substances that were improperly disposed of at a site presently designated as a Superfund site, the purchaser of the business may be held liable for the cleanup costs.[178]

If the purchaser of the contaminated land, or the purchaser of the business that generated the hazardous substance, actually pays to cleanup the site, the question arises as to whether (and under what authority) such party is entitled to a deduction for its payments. Clearly, Revenue Ruling 94-38 does not apply in such cases. That revenue ruling is expressly limited to cases wherein the *owner* of the land contaminates the site; it does not apply where the land was contaminated by a prior owner, *e.g.*, the seller of the land.

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[175] The character (whether ordinary or capital) of the amount included in gross income on account of a "recovery" follows the character of the original transaction (whether a deduction or capitalized expenditure). *See* Dobson v. Commissioner, 320 U.S. 489, 493 (1943); Mandt v. Commissioner, 14 T.C.M. (CCH) 909, 1955 T.C.M. (P-H) ¶ 55,226; *cf.* Arrowsmith v. Commissioner, 344 U.S. 6 (1952) (subsequent deductions have character of original transaction).

[176] 42 U.S.C. § 9607(a)(1).

[177] *See, e.g.*, Smith Land Improvement Corp. v. Celotex Corp., 851 F.2d 86 (3d Cir. 1988); SmithKline Beecham Corp. v. Rohm & Haas Co., No. CIV.A.92-5394, 1995 WL 117671 (E.D. Pa. Mar. 17, 1995), *rev'd & remanded on other grounds*; In Re Achusnet River & New Bedford Harbor, 712 F.Supp. 1010 (D. Mass. 1989); Chemical Waste Management, Inc. v. Armstrong World Industries, Inc., 669 F.Supp. 1285 (E.D. Pa. 1987).

[178] *See* Kathryn A. Barnard, *EPA's Policy of Corporate Successor Liability Under CERCLA*, 6 STAN.ENVTL.L.J. 78 (1986-87); John C. Solomon, Comment, *Successor Corporate Liability for Improper Disposal of Hazardous Waste*, 7 W.NEW ENG.L.REV. 909 (1985).

Where the cleanup costs are paid by a purchaser of the contaminated land or business that generated the hazardous waste, a deduction for such expenditures is not allowed. The liability for cleaning up the Superfund site is viewed as having arisen at the time of the transfer of the land or business. In all likelihood, such a liability would have been contingent in nature at the time of the purchase — this because there would have been no final determination of any PRP's liability at such time. Hence, the issue revolves around how to treat a contingent liability that transfers to the buyer in an asset acquisition.

In an asset acquisition, when the buyer assumes a fixed and determinable liability of the seller, the liability is treated for tax purposes as additional consideration paid for the assets. As such, the amount of the assumed liability is added to the rest of the consideration paid and is included in the buyer's cost basis in the acquired assets.[179] Where the purchaser of the business is required to pay a liability of the seller that was not fixed and determinable at the time of the asset sale, the purchaser must include such amount in its basis at such time as the liability becomes fixed and determinable.[180] This treatment applies even where the underlying expenditure would have generated a deductible business expense if paid by the seller himself. For example, assume that a business has certain contractual obligations to purchase supplies, the satisfaction of which would give rise to an ordinary business deduction if paid by the business. In the event of a sale of the business, the buyer assumes all obligations under such contracts. The value of that obligation is part of the total purchase price paid by the buyer, and as such, is allocated among the various acquired assets.

Generally, where a buyer of property either assumes a contingent liability or takes the property subject to a contingent liability, such liability (once no longer contingent and determinable as to amount) should be treated as additional purchase price.[181] As one commentator has put it: "The tax treatment of contingent liabilities in asset acquisitions is not rocket science. . . . The theoretically correct answer is that a liability that existed before the sale and traveled with the assets

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[179] *See* Magruder v. Supplee, 316 U.S. 394, 398 (1942). Where the acquired assets constitute a "going concern" business, the buyer (and seller) must allocate the total purchase price among the various acquired assets based upon a complicated procedure provided for under section 1060. For a discussion of this purchase price allocation, see Michael L. Schler, *Sales of Assets After Tax Reform: Section 1060, Section 338(h)(10) and More*, 43 TAX L. REV. 605 (1988); Andrew M. Eisenberg, *Amendments to the Sec. 1060 and 338(b) Regulations Conforming Allocations of Purchase Price to the 1993 Intangibles Legislation*, 28 TAX ADVISER 356 (1997).

[180] For example, in David P. Webb Company, Inc. v. Commissioner, 77 T.C. 1134 (1981), *aff'd*, 708 F.2d 1254 (7th Cir. 1983), the purchaser of a business assumed the obligation to make future payments pursuant to an unfunded pension plan. Payments were made to the widow of a former employee. The Seventh Circuit affirmed the Tax Court's holding that the payments were capital expenditures includable in the purchaser's basis in the business assets. For a discussion of this principle, see Kilinskis, *supra* note 142 at 13-25.

[181] *See, e.g.*, David P. Webb Company, Inc. v. Commissioner, 77 T.C. 1134 (1981), *aff'd* 708 F.2d 1254 (7th Cir. 1983); Pacific Transport Co. v. Commissioner, 483 F.2d 209 (9th Cir. 1973); Albany Car Wheel Co. v. Commissioner, 40 T.C. 831 (1963), *aff'd per curiam*, 333 F.2d 653 (2d. Cir. 1964).

— either because the buyer assumed it or took the assets subject to it — is part of the purchase price."[182] This additional purchase price must be added to the taxpayer's basis in the acquired asset. If the asset was land, the additional purchase price will give rise to additional basis in the land. The buyer will not recover such additional tax basis until such time as the property is sold. Where the acquired assets constitute an active trade or business, the additional purchase price resulting from payment of a contingent liability not originally recognized by the buyer as part of the purchase price must be allocated among the various acquired assets under rules set forth in Treasury regulations.[183] Part or all of the additional basis may be recovered through future depreciation or amortization of the acquired assets. Where the total consideration paid exceeds the hard assets of the business, the additional purchase price will be allocated to intangible assets in the nature of goodwill or going concern value, which may now be amortized over a 15-year recovery period.[184]

A PRP's liability to clean up contaminated land is a contingent liability. The purchaser of the contaminated land or the business that generated the hazardous waste is a PRP under CERCLA, and hence, the liability runs with the transferred property. To the extent that the buyer was aware of the contamination, this "assumed" contingent liability would have been taken into account in determining the sale price of the assets. Nevertheless, even where the buyer has no knowledge of the contamination, the same tax treatment should follow — the liability should be treated as additional purchase price. Additional purchase price must be capitalized, potentially resulting in an additional charge to the amortizable acquired goodwill of the business.

H. *Illustration of Tax Issues*

The complexities that arise in applying the tax law to payments incurred in an environmental cleanup project are best illustrated by way of a specific example. The following hypothetical (but quite typical) case illustrates some of the tax issues commonly arising in connection with the settlement of claims brought by the EPA under CERCLA. It also illustrates some of the quirky tax issues, and creative solutions, that can arise in settling environmental litigation with the EPA over a contaminated Superfund site.

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[182] Lee A. Sheppard, *Cognitive Dissonance on Contingent Liabilities in Asset Acquisitions*, 78 TAX NOTES (TA) 142 (1998); *see also* Daniel Halperin, *Assumption of Contingent Liabilities on the Sale of a Business*, 2 FLA. TAX REV. 673 (1996); Mark L. Yecies, *Contingent Liabilities in Taxable Asset Acquisitions*, in 2 *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructuring* 1239 (Louis S. Freeman, ed.) (1997); James M. Lynch, *Transferring Assets Subject to Contingent Liabilities in Business Restricting Transactions*, 67 TAXES 1061 (1989); Alfred D. Youngwood, *The Tax Treatment of Contingent Liabilities in Taxable Asset Acquisitions*, 44 TAX LAW. 765 (1991).

[183] *See* Regs. § 1.1060-1T(f)(2) (allocation of additional purchase price in applicable asset acquisition where a contingent liability is subsequently paid, resulting in additional purchase price for the business assets).

[184] I.R.C. § 197(a); *see also* Prop. Reg. § 1.197-2(f) 62 Fed. Reg. 2346-47 (1992). For a discussion of how purchase price is amortized under new section 197, see text at note 67.

1. *Facts of Case*

Taxpayer owns a parcel of real estate that has been designated as a Superfund site ("Site") under CERCLA. Claims have been asserted by the EPA against Taxpayer and other PRPs relating to the contamination of soil and groundwater at the Site. The other PRPs were the generators of hazardous waste dumped at the Site. Prior to the enactment of federal environmental legislation, the other PRPs routinely transported and disposed of solid waste (*i.e.*, by-products from their paper manufacturing plants) at the Site. The other PRPs were charged fees by Taxpayer to dispose of their solid waste at the Site. The solid waste was used as landfill at the Site. Under RCRA and CERCLA, the solid waste disposed of at the Site is classified as hazardous waste; remediation is required because the hazardous waste is now leaching into the groundwater.

Under the terms and conditions set forth in a consent decree entered into with the EPA, Taxpayer and the other PRPs agree to implement a comprehensive plan for the remediation of the Site. Under the terms of the consent decree, the PRPs agree to remediate the contaminated soil at the Site, build a groundwater treatment plant, and generally return the Site to its original (pre-contamination) state. This remediation plan involves constructing a twelve inch soil cap over the Site and fencing off the Site for an indefinite period of time. The project also calls for construction of a groundwater treatment plant and the continued monitoring of water quality. The project will cost approximately $5 million.

Subsequently, Taxpayer and the other PRPs propose revisions to the original remediation plan. The revised plan would have them construct a golf course on the Site following the soil and groundwater remediation phase of the project. Taxpayer (as owner of the land) also proposes to donate the Site following the remediation project to the local township (the "Township"), which will then own and operate the golf course. The construction of the golf course will cost $2 million. However, less extensive soil remediation will be needed if the property is converted into a golf course. In addition, the Site need not be fenced off. Because of this, the total cost of the project under the revised plan will actually be *less* than under the original plan providing for the 12-inch soil cap. Furthermore, the value of the Site as a golf course will be greater than that following the remediation project as originally conceived.

The EPA approves the project under the revised plan (*i.e.*, converting the Site to a golf course), contingent upon the Taxpayer contributing the golf course to the Township. The donation is not specifically provided for in the consent decree. However, Taxpayer enters into a separate binding agreement with the Township outlining the terms of his donation, subject to the EPA's approval of the terms of the agreement. The following tax issues arise with respect to costs incurred by Taxpayer in the remediation project:

(1) Is Taxpayer's share of the expenses incurred in remediating the Site deductible for purposes of federal income tax?
(2) Is Taxpayer's share of the expenses incurred in constructing the golf course on the Site deductible?

(3) Is the transfer of the Site to the Township deductible as a charitable donation by Taxpayer?
(4) If so, what is the amount of the deduction for the charitable donation of the Site?

2. *Analysis*

Under the authority of Revenue Ruling 94-38, the $5 million spent for soil and groundwater remediation under the original plan, as well as for installation of a twelve inch soil cap, will be deductible, as previously discussed. Likewise, engineering fees and legal fees associated with negotiating the settlement agreement will be deductible under the authority of Revenue Ruling 94-38. Taxpayer may deduct his allocable share of such expenses. Just as clearly, the construction costs (and an allocable portion of overhead) of the groundwater treatment plant and fence must be capitalized.

The tax treatment of expenditures incurred under the revised plan relating to the construction of the golf course is more problematic. It is doubtful that the expenditures incurred in building the golf course would be deductible. Arguably, merely because the EPA and the PRPs have redefined the remediation project to provide for a golf course, the character of the expenditures should not change — namely, these are still payments made to clean up a contaminated Superfund site. Under this theory, the entire project is a single, integrated environmental remediation cleanup mandated by the EPA under the authority of CERCLA. As such, the specific contour or use of the land at the Site following the remediation project should not matter with respect to the tax treatment of the expenditures.

The stronger argument, however, is that all expenditures incurred in the construction of the golf course must be capitalized. This phase of the project involves the construction of a new asset that has a different use than that of the Site prior to its contamination. Under the case law outlined above, where the remediation or renovation of property results in a "different use" or "longer life," the costs associated with the project must be capitalized. The Site will not have a "longer life" following the remediation project—as land always has an indefinite life. However, the use of the Site definitely will be different following the remediation project. On this basis, the Service should prevail in arguing that *only* expenditures directly related to the remediation of the soil at the Site are deductible, while all costs associated with building the golf course must be capitalized. Under this treatment, Taxpayer's share of the $2 million cost of constructing the golf course must be capitalized.[185] As such, Taxpayer would not enjoy an immediate tax benefit for his share of the expenditures incurred in building the golf course.

[185] Edinboro Co. v. United States, 224 F. Supp 301 (1963) (holding that costs associated with constructing tees, greens, fairways, traps and other hazards on a golf course are not distinguishable from the land which is molded and reshaped to form them; that like the land they have an unlimited useful life; and that no depreciation deduction is allowable under section 167).

Partly motivated by such a tax result, Taxpayer agrees to donate the Site to the Township, which will then own and operate the newly constructed golf course. A charitable donation would result in a current tax benefit to Taxpayer. At issue is the deductibility, as well as the amount of the deduction allowable for the donation of the Site.

Two potential issues arise with respect to claiming a charitable donation under section 170. The first relates to the requirement that a charitable donation must be voluntary and motivated by "donative intent." Where a donor receives an economic benefit for a transfer of property to a charitable entity, or where there is a *quid pro quo* for the transfer of the property, donative intent is missing and a deduction under section 170 is not allowed. Arguably, the transfer of the Site is required under the consent decree and hence, the transfer could be viewed as some kind of *quid pro quo* for the release of Taxpayer from liability under CERCLA. However, the stronger argument is that the transfer of the property was voluntary as Taxpayer was *not* required by the EPA to make the donation. Likewise, Taxpayer will be released from liability because the Site is remediated, not because of the donation. Taxpayer's settlement with the EPA is in no way dependent upon the donation of the Site to the Township — although the EPA knows of the donation and approves of this use of the land. Taxpayer will receive no *economic* consideration for his gift. The deduction under section 170 should be allowed on this account.

The second issue with respect to the donation of the Site is the *amount* of the deduction that may be claimed. Under section 170, a deduction is allowed in an amount equal to the "fair market value" of the donated property.[186] However, there still may be an issue with respect to the date for valuing the Site for purposes of determining the amount of the deduction under section 170. Taxpayer will become legally obligated to transfer the Site to the Township upon his execution of their agreement. Their agreement provides that the transfer will be at some future date, *i.e.*, following the construction of the golf course. Of course, by the time Taxpayer actually transfers a deed for the Site to the Township, the value of the land will likely be higher (as the construction of the golf course should substantially increase the value of the Site). Thus, the crucial issue is whether the Site should be valued as of the date of the agreement to make the donation or as of the date of the transfer of the Site to the Township.

There is legal precedent holding that the relevant date for valuing donated property is the date of transfer, and *not* the date on which the property was

[186] Treasury regulations state that fair market value is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." Reg. § 1.170A-1(c)(2). Under section 170, where donated property has been depreciated or otherwise would produce ordinary income on a sale, rather than long-term capital gain, the amount of the deduction must be reduced. I.R.C. § 170(e)(1)(A). However, these exceptions do not apply here, as a sale of the Site would result in the recognition of long-term capital gain only. Thus, a deduction for the full value of the Site may be claimed.

pledged. For example, in *Johnson v. United States*,[187] the taxpayer (Johnson) agreed in 1956 to donate land and building materials to a newly organized school (an entity for which a charitable donation is allowed). In 1957, local townsmen constructed a school on the land using the materials donated by Johnson. Thereafter, Johnson transferred a deed for the Site (with the new building on it) to the school. The Service claimed the donation was deductible in 1956, while the taxpayer claimed the deduction in 1957.[188] The court held that the proper year for the deduction was 1957, the year of the transfer. Under this theory, the taxpayer may not claim a deduction on the date on which he enters into an executory agreement with the charity to donate Site. A pledge or contract to make a future donation is only a promise for which no charitable donation is allowed.

Thus, the date of valuation of the donated Site should be the date of the transfer of the Site to the Township. A deduction for a charitable donation cannot be claimed until there is a "completed gift," which requires receipt or constructive receipt of the donated Site by the Township. The donation of the Site will become a completed gift when Taxpayer delivers an executed deed to the Township (or its agent). The value of the Site should be determined as of the date of the transfer of the deed, not as of the date of the binding pledge to make the gift.

A related problem may arise to the extent that the valuation date is determined to be the date of the transfer. The Service may assert that Taxpayer must recognize income on account of the "improvements" (or accessions) to the Site made by the other PRPs. There is authority holding that a charitable deduction for donated property may be offset by the income which was unrecognized when the taxpayer acquired the donated property. In *Holcombe v. Commissioner*,[189] an optometrist collected eyeglasses, frames, and lenses from his friends and patients, and subsequently contributed them to various charities. The Tax Court held that the taxpayer's income should be increased by the value of the eyeglasses, frames, and lenses transferred to the various charities since the transfer of such to the taxpayer were not gifts to the taxpayer, but instead constituted a taxable "accession to wealth" in the year of the contribution, which taxable income offset the tax benefit obtained by the charitable contribution.

Under this authority, income would be recognized by Taxpayer in an amount equal to the value of the improvements paid for by the other PRPs in constructing the golf course on the Site, *i.e.*, that portion of the $2 million construction

[187] 280 F. Supp. 412 (1967).

[188] It should be noted in the aforementioned case of *Johnson*, the value of the deduction was stipulated to be the value of the land and raw materials furnished by Johnson. No deduction was claimed for the value of the school building, *i.e.*, the value of the labor added to the materials by the local townsmen in constructing the school building.

[189] 73 T.C. 104 (1979).

costs funded by the other defendants. However, income is *not* recognized for the improvements to the Site resulting from the remediation project itself.[190] The value of these improvements is merely compensation to Taxpayer for the damage previously done to Taxpayer's property by the other PRPs when they contaminated the Site. Of course, even if income is recognized in an amount equal to the value of the improvements made by the other PRPs in constructing the golf course on the Site, this income would be more than offset by the charitable donation, which should be measured by the reference to the value of the golf course as a going concern, which is greater than the construction costs of the golf course.

This example illustrates some of the difficulties in applying the legal standard enunciated in Revenue Ruling 94-38, as well as other relevant authorities, to a fairly typical environmental remediation project. However, despite these difficulties, it is possible to analyze the expenditures at hand and classify them based upon the existing case law, statutes, and Service public rulings. In this case, compared to the remediation project as originally proposed by the EPA, conversion of the contaminated site into a golf course produced a significant tax advantage for the landowner-PRP, without in any way adversely affecting the tax posture of the transporter or generator-PRPs. This shows how creative solutions to tax problems can be found within the scope of options acceptable to the environmental regulatory authorities.

IV. CONCLUSION

Environmental law and the Code intersect in varied and complicated ways. The result is often unpredictable. However, as the Service and the federal courts have and continue to struggle with the various possibilities, the tax treatment of environmental transactions is becoming increasingly more predictable. Even so, great sums are expended by American businesses entering into environmental transactions without adequate awareness of their treatment under the federal income tax. This is most often the case where the environmental transactions are planned by legal counsel with expertise only in environmental law. While environmental lawyers are adept at dealing with the issues that typically arise in the Superfund context or in environmental enforcement cases, they are generally less familiar with the complicated tax issues that may be raised in such transactions. Integration of tax planning and environmental counseling requires environmental lawyers to identify potential tax issues from the outset and work closer with the client's tax advisors. Income taxation should be taken into account during the initial planning for an environmental transaction, just as it is for any other expensive business transaction.

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[190] P.L.R. 98-14-030 (December 29, 1997) (finding that when PRPs agree to fund the construction and operation of a water treatment facility and agree to turn over ownership of the facility to Taxpayer as a condition to settlement of Superfund litigation, Taxpayer will not recognize gross income under section 61 as a consequence of the construction and operation of the treatment facility.

It is easy to come to the conclusion that the rules governing the tax treatment of environmental transactions are too complex and must be simplified. Similarly, some will continue to argue that requiring capitalization of expenditures incurred in an environmental remediation project is too harsh and that those who incur such expenses should be allowed a deduction as an incentive to clean up the environment. This is an overly generous view and must be resisted. While the rules are complex, they are generally the same rules that apply to expenditures incurred in other complicated business transactions. Given time, patience and a bit of practice, these rules can be successfully navigated and applied to environmental transactions. Furthermore, allowing deductions for what would otherwise be capital expenditures (*e.g.*, the cost of constructing a golf course on a contaminated Superfund site) merely because they are incurred in the context of an environmental remediation project is misguided policy. This rewards polluters with a more favorable tax treatment than that afforded those who have diligently complied with state and federal laws enacted to protect the environment. The environmental statutes include criminal provisions intended to remind those who generate, transport, and dispose of hazardous wastes that they must comply with the rules and regulations of the EPA. Tax preferences are unnecessary and unwarranted as additional inducements.

In the end, those who enter into environmental transactions can decipher, and likewise ought to adhere to the same tax rules that apply to other business transactions. That those rules are complicated is a function of the income tax, rather than of the nature of environmental transactions.