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"Preparing for the Knock on the Door." This is the first of three articles aimed at helping companies effectively respond to a government investigation of potential environmental violations. This article explains what is at stake when the government investigates potential environmental violations and provides steps that a company can take now to prepare for the prospect of a government investigation.

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Tax Treatment of Environmental Transactions. Businesses subject to any part of the vast array of laws and regulations implementing federal and state environmental policy may incur compliance-related expenditures. This article - the first of a three part series - focuses on the tax issues and how to plan to maximize actual costs by maximizing the tax structuring of the expenses. This article focuses particularly on whether environmental remediation costs are currently deductible or must be capitalized. **Page 16**

Preparing for the Knock on the Door

Judson W. Starr and Gregory S. Braker
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I. INTRODUCTION.

This article (Part I in the series) explains what is at stake when the government investigates potential environmental violations and provides steps that a company can take now to prepare for the prospect of a government investigation. Part II addresses a company's initial response once it learns that a government investigation is underway, and Part III addresses ongoing issues in an investigation.

II. THE STAKES ARE HIGH

Criminal penalties resulting from violations of federal (and state) environmental laws come in many forms — fines, jail time, and loss of government contracts or permits. Any one of these results can be severe. In combination, they can be devastating.

> ***Environmental enforcement is one area in which government resources continue to grow and the standard of intent for proving environmental crimes is minimal; therefore, potential criminal liability for environmental violations is a more significant risk than many people realize***

A. Penalties Can Be Devastating

1. Fines.

It's easy to see how fines can add up quickly. Most federal (and many state) environmental laws establish criminal fines for individuals of $50,000 per violation, and treat each day of continuing noncompliance as a separate violation. The statutory maximum fine for organizations per each violation is $500,000. In the alternative, violators (whether individuals or companies) may be fined up to twice the gross monetary gain or loss resulting from the violation.

> ***The average criminal fine for an environmental violation reached nearly $2 million by 1997.***

2. Jail Time.

As recently as 1990, about 75% of all environmental criminal charges were brought against companies (as opposed to individuals). Since that time, the focus of environmental investigations has changed dramatically, with charges against individuals now making up nearly 75% of all environmental criminal enforcement actions. The statutory maximum prison term for most felony

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This is the first of three articles aimed at helping companies effectively respond to a government investigation of potential environmental violations. The series is largely based on The Knock on the Door: Preparing for and Responding to a Criminal Investigation, a book written by Messrs. Starr and Braker to be published shortly by the Chemical Manufacturers Association (CMA).

COST CONTROL CORNER

Tax Treatment of Environmental Transactions

Sheldon D. Pollack

I. INTRODUCTION

Businesses in the United States incur significant economic costs complying with the vast array of laws and regulations implementing federal and state environmental policy. 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.

The most prominent tax issue is whether environmental remediation costs are currently deductible or must be capitalized.

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 U.S. industry and manufacturing. 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 these outlays 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 U.S. Environmental Protection Agency (EPA) or settlements with other parties in environmental litigation under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) or the Resource Conservation and Recovery Act of 1976 (RCRA), involving millions of dollars, 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 U.S. businesses by federal environmental regulation. 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 the environmental statutes. This article evaluates 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). EN1

Under a Supreme Court ruling, the infrequency, unusual nature, and magnitude of environmental remediation costs is not necessarily a bar to a current deduction under section 162 of the Internal Revenue Code.

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, acquisition of permits, 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, dumped 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 businesses entering into environmental transactions (as well as in litigation arising out

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This is the first of two articles on this issue.

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of such transactions) be aware of the various tax issues. Rather than an afterthought, tax issues should be a driving factor from the very first stage of the environmental transaction just as they are for any other complex, expensive business transaction.

II. ENVIRONMENTAL TRANSACTIONS

A. 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.

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.

After becoming liable for a clean-up, the tax treatment of the expenses incurred by the "potentially responsible person" (PRP) with respect to the project is often already established by the time a tax adviser is brought in for consultation.

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, hence, 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 an 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. EN2

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.

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. Tax issues that long ago were settled as they applied to other industries are only now being addressed with respect to the environmental statutes.

III. MAJOR TAX ISSUES

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 single 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 a requirement imposed under an environmental statute, is currently deductible or must be capitalized for purposes of federal income taxation.

Conversely, different and generally less favorable tax consequences follow when an expenditure is capitalized.

If a clean-up cost is currently deductible, an immediate tax benefit may be gained from the expenditure, thereby reducing its after-tax cost.

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 (TAMs), 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." EN 3

This deduction for business expenses is intended to match the costs of doing business with the income produced by such activity and, thereby, accurately measure the income of the taxpayer.

Considerable litigation has arisen over the question of whether particular expenses qualify as "ordinary and necessary" under Code section 162. In *Welch* v. *Helvering,* EN4 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 payments of the defunct corporation's debts was "in a high degree extraordinary." EN5

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." EN6 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. EN7

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." EN8 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.

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

It is often not readily evident whether particular expenses are in the nature of repairs or maintenance - which are deductible - or whether they add to the value of the underlying property or prolong the useful life of such property and hence, must be capitalized.

Obviously, the difference between an immediate deduction and capitalization can be significant. Each deduction allowed reduces the tax due for that year, thereby improving the taxpayer's after-tax cash-flow. 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.

The difference between deduction and capitalization has an impact of immediate deductibility on the taxpayer's tax and cash-flow position.

The federal courts have struggled to define the facts 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. EN9 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." 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.

Another line of cases looks to whether the expenditure at issue materially prolongs the useful life of the property. Still other courts have looked to whether the expenditure was incurred to alter or adapt the property to a new or different use, or whether the expenditures were part of a "systematic plan" that increased the value of the taxpayer's property. A number of courts have required capitalization where expenses are incurred pursuant to an overall plan of rehabilitation that enhances the value of the underlying property.

Still other courts have applied the so-called future benefit test, which is based on the principle that 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. The various standards applied by the courts, as well as the Treasury regulations, evi-

dence 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.

Courts have held that expenditures to bring property into compliance with governmental requirements must be capitalized, even where such expenditures do not result in any new or improved use of the property.

These cases are particularly relevant to the question of whether expenditures made in compliance with the 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.

3. Casualty Loss

Section 165 allows a deduction for "any loss sustained during the taxable year and not compensated for by insurance or otherwise." EN10

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." EN11

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." EN12 Furthermore, the Service has ruled that a casualty loss results not from gradual deterioration of property, but rather from a sudden, catastrophic event. 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 ó for instance, where polychlorinated bipheny's (PBCs), 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). EN13

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.

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. EN14 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.

The author is particularly grateful to Professor Timothy F. Malloy of the UCLA School of Law, for his significant contributions to this article. A longer version of this article was published in Vol. 52, the Fall 1998 issue of ABA's *The Tax Lawyer.*

1. 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.

2. This treatment may be required under section 263A of the Internal Revenue Code (the "Code") of 1986, as amended, the so-called Uniform Capitalization Rules.

3. I.R.C. 162(a).

4. 290 U.S. 111 (1933).

5. Id. at 114.

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

7. 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).

8. Reg. 1.162-4.

9. *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333, 336 (1962).

10. I.R.C. 165(a).

11. 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, ß 711).

12. Reg. 1.165-1(b).

13. Rev. Rul. 71-560, 1971-2 C.B. 126.

14. 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 under I.R.C. 165(h). ECCR