I. INTRODUCTION

Two things in life are certain: enormous hazardous waste cleanup costs and taxes. Despite the obvious significance of the tax consequences of the billions of dollars in cleanup costs spent in the United States,\(^1\) the federal tax treatment of these costs remains uncertain.\(^2\) Perhaps the most basic question—whether cleanup expenses may be immediately deducted or must be capitalized—remains an issue that the Internal Revenue Service ("IRS") has been unable to resolve.

In the past few years, the IRS has issued a series of controversial opinions that have given little clear guidance on the proper tax treatment of cleanup costs. In several Technical Advice Memoranda ("TAM") issued in 1992 and 1993, the IRS suggested that most cleanup costs would not be deductible as ordinary expenses.\(^3\) In 1994, however, the IRS issued Revenue Ruling 94-38, which held that expenses incurred by a taxpayer to clean up its own property contaminated in the course of its business activities were

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3. See infra part IV.A.
generally deductible as ordinary expenses.\(^4\) The ruling, although limited in scope and sparse in logic or analysis, was hailed by some as an indication that the IRS would generally give favorable tax treatment to cleanup costs.\(^5\) Revenue Ruling 94-38 addressed a relatively simple situation, however, and its logic (or lack thereof) gave little guidance on how the IRS would deal with more complex situations. In a TAM issued in 1995, the IRS apparently reversed course once again, and it now appears to be stating that most cleanup costs (including the investigation and legal fees associated with a cleanup) cannot be deducted.\(^6\)

The IRS continues to struggle with the problem,\(^7\) and, as discussed below, analysis of the current tax treatment of the most common types of remediation expenses produces no clear answers. In analyzing the same set of facts, the IRS and taxpayers can legitimately reach conflicting conclusions.

Perhaps the basic problem is that traditional tests used to distinguish capital expenditures from ordinary and necessary business expenses are inappropriate for environmental remediation expenses. It makes little sense to ask whether remediation, essentially the cleaning up of dirt, is more like a “repair” or an “improvement.” The current approach of the IRS not only creates uncertainty and complicates tax planning, but also has the potential to perversely influence the selection of cleanup standards and technology based upon an inappropriate consideration of tax consequences. The IRS, in attempting to apply traditional tax analysis to the complex requirements of environmental remediation, may be making both bad tax policy and bad environmental policy.

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\(^5\) See, e.g., 25 Env’t Rep. (BNA) 309 (June 17, 1994).
\(^6\) See infra Author’s Note following Conclusion.
\(^7\) The IRS has appointed a task force to develop approaches to tax treatment of environmental expenditures. See 59 TAX NOTES 1408 (November 15, 1993). To date, however, there have been no general policies adopted by the IRS and no indication of when additional clarification will be provided. In 1993, the Subcommittee held hearings in which, among other things, it considered a proposal to require capitalization of remediation expenses. During the hearings, the Assistant Treasury Secretary took no position on the proposal but stated that the Treasury Department was studying the issue. See Hearings Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means, 103rd Cong., 1st Sess. (1993) (statement of Leslie B. Samuels, Assistant Secretary (Tax Policy) Department of Treasury). See infra note 181.

Additionally, the Emerging Issues Task Force (“EITF”) of the Financial Accounting Standards Board has sought to provide general recommendations for the tax treatment of remediation expenses. The EITF has generally recommended that such expenses should be deductible. See infra discussion at note 201.
This Article proposes that either the IRS, through regulation, or Congress, by amendment of the Internal Revenue Code, authorize the deduction as ordinary expenses of costs that are incurred pursuant to federal or state environmental laws, including the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"). Despite its imperfections, this solution would provide taxpayers with some certainty and would ensure that appropriate environmental decisions are made without regard to tax consequences.

II. BASIC ENVIRONMENTAL CONSIDERATIONS IN REMEDIATION OF HAZARDOUS SUBSTANCES

To appreciate the complexity of the tax treatment of remediation expenditures it is important to understand the various elements of environmental law. This includes not only the legal requirements that may compel or encourage remediation of hazardous substances, but also the provisions that affect the selection of a final cleanup standard and the technical options for achieving those standards.

A. Legal Requirements Compelling or Encouraging Expenditures for Environmental Remediation

There are a variety of federal and state statutory provisions, contractual requirements, and common law tort requirements that may affect whether a taxpayer incurs environmental cleanup costs. Although some of these provisions actually impose remedial obligations, in many cases landowners voluntarily clean up the property either to prepare the property for sale or to avoid potential regulatory or tort obligations. In these cases, statutes like CERCLA or contractual indemnification provisions establish incentives to remediate by creating legal causes of action that allow recovery of all or a portion of cleanup costs from other parties.


Although there are several federal statutes that may require remediation of hazardous substances,9 the two most significant are CERCLA10 and the Resource Conservation and Recovery Act ("RCRA").11 Additionally, most states have statutes that are comparable to CERCLA and RCRA, and some have statutes requiring remediation under circumstances not addressed by CERCLA or RCRA.

a. CERCLA

Under CERCLA, broadly defined classes of people are potentially liable for the cleanup of a site where there has been a "release or threat of release" of a "hazardous substance" from a "facility."12 The definition of "hazardous substance" is particularly broad and includes substances that have been designated as hazardous under a variety of federal statutes.13 CERCLA does not, however, apply to the release of petroleum or crude oil, and thus its application to oil spills is limited.14 Additionally, CERCLA has been held not to cover removal of asbestos within buildings.15

Under section 107(a) of CERCLA, there are four classes of liable parties, known as "potentially responsible parties" ("PRPs"), who may be obligated either to remediate the site or to reimburse others for the cost of remediation. The classes of PRPs include the following persons:

(1) the current owner and operator of the site;\textsuperscript{16}
(2) the past owner or operator of a site;\textsuperscript{17}
(3) persons who arranged for disposal of the hazardous substance
that was disposed of at the site;\textsuperscript{18} and
(4) the person who transported the substances to the site if they
were involved in selection of the site.\textsuperscript{19}

Liability of PRPs is not only "strict" in that courts do not consider
fault or negligence,\textsuperscript{20} but it is also "joint and several." This means
that each PRP is potentially responsible for the entire cost of
cleanup of a site.\textsuperscript{21}

Pursuant to section 106 of CERCLA, the EPA has the authority
to issue an order compelling PRPs to clean up the site them-

\textsuperscript{16} 42 U.S.C. § 9607(a)(1) (1988). Owners may have a defense to liability. The
"innocent landowner" provisions, for example, establish a defense if the owner both
purchased without knowledge of the existence of contamination and undertook "appropri-
ate inquiry" at the time of purchase to determine if contamination existed. 42 U.S.C.
tion Corp., 964 F.2d 85 (2d Cir. 1992); United States v. Serafini, 791 F. Supp. 107 (M.D.
"innocent landowner" defense is extremely difficult, but it is one of the reasons why
environmental audits of property are undertaken prior to the purchase of property. See
Geoffrey D. Patterson, A Buyer's Catalogue of Prepurchase Precautions to Minimize

\textsuperscript{17} 42 U.S.C. § 9607(a)(2) (1988). Although CERCLA only imposes liability on
parties if they previously owned or operated the site "at the time of disposal of any hazardous
substances," several courts have held that prior owners are liable if hazardous substances
leached or migrated during the time they owned the property, or if they undertook
construction activities that resulted in some movement of preexisting contamination.


\textsuperscript{20} See New York v. Shore Realty Corp., 759 F.2d 1032 (2d Cir. 1985); United

\textsuperscript{21} See United States v. Monsanto Co., 858 F.2d 160 (4th Cir. 1988). Although most
courts have indicated that parties may escape joint and several liability if the harm is
"divisible," few courts have actually found the harm to be divisible. Several recent
decisions, however, have suggested that liability is not inevitably joint and several. See,
e.g., Bell Petroleum Services v. Sequa Corp., 3 F.3d 889 (5th Cir. 1993); United States v.
Alcan Aluminum Corp., 990 F.2d 711 (2d Cir. 1993); United States v. Alcan Aluminum

\textsuperscript{22} 42 U.S.C. § 9606(a) (1988). Although Section 106 orders may be issued to "any
person," liability in most cases has been limited to persons classified as PRPs. See United
authority to implement CERCLA. See Exec. Order No. 12,316, 46 Fed. Reg. 42,237
agree to undertake specified actions to remediate a site.\textsuperscript{23} Parties to a settlement generally obtain limited protection from future suits by other PRPs and by the government.\textsuperscript{24}

PRPs who do not actually undertake the cleanup may be liable under CERCLA to reimburse parties who originally incurred the cleanup costs. Section 104 of CERCLA authorizes the government to clean up sites using money from the federal Hazardous Substances Trust Fund, known as "Superfund,"\textsuperscript{25} and the government may then recoup these expenses by bringing a cost recovery action against PRPs.\textsuperscript{26} Such suits are typically resolved through settlement agreements in which PRPs pay some proportionate share of the government costs in exchange for a limited release from liability.\textsuperscript{27}

Additionally, private parties, who may themselves be PRPs, are authorized under CERCLA to bring cost recovery actions against other PRPs.\textsuperscript{28} In general, courts in these actions will equitably allocate remediation costs among PRPs,\textsuperscript{29} even if there has been no governmental involvement in the cleanup.\textsuperscript{30}

One major factor may affect the ability of the government and private parties to recover their cleanup costs: to be eligible for cost

\textsuperscript{23} Most parties ultimately agree to settle since penalties for noncompliance with the order include daily penalties of up to $25,000 per day, 42 U.S.C. § 9606(b)(1) (1988), and treble the final amount of the cleanup, 42 U.S.C. § 9607(c)(3) (1988). Further, parties have only very limited ability to obtain pre-enforcement judicial review of these orders. 42 U.S.C. § 9613(h) (1988). Section 122 of CERCLA specifically addresses requirements for settlements with the government. 42 U.S.C. § 9622 (1988).


\textsuperscript{29} See, e.g., Gopher Oil Co. v. Union Oil Co., 955 F.2d 519 (8th Cir. 1992); United States v. Moore, 703 F. Supp. 460 (E.D. Va. 1988).

\textsuperscript{30} See 40 C.F.R. § 300.700 (1994).
recovery, government and private cleanups must be “consistent” with the “National Contingency Plan” (“NCP”).31 The NCP, promulgated by the EPA, specifies the substantive and procedural requirements for a proper cleanup action.32 Among other things, the NCP establishes the regulatory requirements that define the necessary level of cleanup.33

**b. Resource Conservation and Recovery Act**

The Resource Conservation and Recovery Act (“RCRA”) deals largely with the regulatory requirements for the disposal of solid and hazardous waste.34 Several important sections, however, can be the basis for compelling the cleanup of contaminated property.

**i. Imminent and Substantial Endangerment**

Section 7002(a)(1)(B) of RCRA gives citizens the authority to bring an action in federal court to obtain an order to abate an “imminent and substantial endangerment” due to the release of solid or hazardous waste.35 In many ways, section 7002(a)(1)(B) is a counterpart to CERCLA since it authorizes courts to order remediation of contaminated property in circumstances in which private parties can only recover costs under CERCLA. Although courts have generally held that private parties can only obtain injunctive relief, at least one court has now held that parties may recover past response costs under this section.36

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33. See 40 C.F.R. § 300.430 (1994).
34. 42 U.S.C. §§ 6901–6992k (1988). Subtitle C of RCRA defines the requirements for the disposal of hazardous wastes. RCRA establishes requirements for the generators, transporters and facilities that treat, store or dispose of those wastes. Additionally, RCRA requires the disposal of such wastes in facilities that have received RCRA permits. See generally The Law of Environmental Protection, Ch. 13 (Sheldon M. Novick et al. eds., 1989).
Section 7002(a)(1)(B) is also of considerable importance for at least two other reasons. First, it has been interpreted to apply to releases of petroleum that are not otherwise covered by CERCLA. Second, it authorizes recovery of attorney’s fees that are not recoverable in private party cost recovery actions under CERCLA.

ii. Corrective Action

Several sections of RCRA authorize the government to compel parties to remediate past contamination. Section 3004(u) of RCRA gives the government the authority to require parties seeking a RCRA hazardous waste permit to clean up past contamination at “solid waste management units.” Although RCRA has no cost recovery provisions, at least one court has held that there is a right of contribution for costs incurred under the corrective action provisions of RCRA.

iii. Underground Storage Tanks

Finally, RCRA also has a set of provisions applicable to Underground Storage Tanks (“USTs”). Subtitle IX of RCRA applies to USTs containing products, including petroleum, and non-hazardous wastes. In addition to establishing regulatory requirements for management of USTs, Subtitle IX also imposes “corrective

38. See 42 U.S.C. § 6972(e) (1988). The Supreme Court has held that litigation-related attorney’s fees are not recoverable in private party cost recovery actions under CERCLA. Key Tronic Corp. v. United States, 114 S. Ct. 1960 (1994).
39. Section 7003 of RCRA authorizes the government to seek injunctive relief in certain cases when there is an “imminent and substantial endangerment.” 42 U.S.C. § 6973 (1988). In large part, this section has been superseded by the government’s authority to act under CERCLA.
40. 42 U.S.C. § 6924(u) (1988). Section 3004(v) authorizes the government, in certain cases, to include requirements for remediation of contamination beyond the facility boundary. Id. § 6924(v). Additionally, section 3008(h) gives the government the authority to issue a “corrective action” order for the cleanup of hazardous waste at property that received or should have applied for “interim status.” Id. § 6928(h). See JEFFREY M. GABA & DONALD W. STEVER, LAW OF SOLID WASTE, POLLUTION PREVENTION AND RECYCLING, § 3.03 (1994); Guida, Corrective Action under the Resource Conservation and Recovery Act, 44 Sw. L.J. 1331 (1991).
action" obligations that require tank owners or operators to reme-
diate releases from USTs.43


All states have some statutory provisions by which they can compel landowners to cleanup contaminated property.44 In Texas, for example, the Texas Natural Resources Conservation Commission has broad authority to issue orders compelling the cleanup of property under the Texas Solid Waste Disposal Act45 and the Texas Water Code.46 Additionally, a number of states have statutes that require the remediation of property prior to the transfer of the property.47 In addition, most states (and in some cases the federal government as well) require the reporting and remediation of certain spills of environmental contaminants.48

2. Contract

Contractual provisions negotiated as part of the sale of property may also affect remediation obligations. Depending on the particular representations, warranties and indemnification provisions, or other liability provisions, either the buyer or seller may have contractual liability for the cleanup of property.49 For example, it is not uncommon for a real estate contract to include an indemnification agreement in which the seller agrees to reimburse

44. See generally DANIEL P. SELMI & KENNETH A. MANASTER, STATE ENVIRON-
MENTAL LAW Ch. 9 (1993) (discussing hazardous waste site cleanup legislation).
47. See, e.g., N.J. STAT. ANN. § 13:1K-6 to -13 (West 1991) (New Jersey Industrial Site Recovery Act, previously known as the Environmental Cleanup Responsibility Act); CONN. GEN. STAT. ANN. § 22a-134 to -134e (West Supp. 1995).
48. See generally ENVIRONMENTAL SPILL REPORTING HANDBOOK (CBC 1995), Morgan, Lewis & Bockius.
49. See generally Penny L. Parker & John Slavich, Contractual Efforts to Allocate the Risk of Environmental Liability: Is There a Way to Make Indemnities Worth More than the Paper They Are Written On?, 44 SW. L.J. 1349 (1991) (discussing the legal principles regulating contractual risk allocation provisions); Michael O. Ellis, Private Indemnity Agreements Under Section 107(e) of CERCLA, 22 Env't Rep. (BNA) 1953 (Dec. 6, 1991). Although parties cannot contractually transfer their liability under CERCLA, they can enter into contracts that require other parties to indemnify them for costs that they incur. See, e.g., AM Int'l, Inc. v. International Forging Equip. Corp., 982 F.2d 989 (6th Cir. 1993).
the buyer for any environmental cleanup costs that the buyer incurs as a result of existing contamination at the time of sale.

3. Common Law Torts

Environmental remediation is also affected by potential tort liability. Contamination of neighboring property may give rise to liability in nuisance, negligence, strict liability and trespass, and available remedies may include both damages and injunctive relief.

B. Determining Cleanup Levels

Determining the necessary level of cleanup to be attained by a remediation effort is one of the most difficult and contentious issues in environmental law. The resolution of this issue, frequently referred to as "how clean is clean," is obviously significant since it will affect not only the cost and technology employed in a remediation, but also the possible future uses of contaminated property.

In general, determination of cleanup levels typically may be based on one or more of the following approaches. In some cases, cleanup may require attainment of "background" levels of pollution. This may mean removal of all contamination. In other cases, cleanup levels are established based on some determination of "health-based" requirements, where cleanup levels are based on some assessment of the effects of residual contamination on human health. Another approach sets cleanup levels based on considerations of cost and technological feasibility. The process is even

53. Under CERCLA, for example, health-based standards for carcinogens generally require removal of carcinogenic pollutants to levels that will not result in an increased cancer risk to an exposed individual ranging from 1 in 1 million to 1 in 10,000. 40 C.F.R. § 300.430(e)(2)(A)(2) (1994).
54. The role of costs and technological feasibility in setting cleanup standards under CERCLA is confusing. See Brown, supra note 51. Groundwater standards must in many cases attain "Maximum Contaminant Levels" ("MCLs") set under the Safe Drinking Water Act, 40 C.F.R. § 300.430(c)(2)(B) (1994), and these MCLs are established based in part
more difficult if cleanup standards are tailored to possible future uses of property. For example, cleanup levels may be less stringent under some statutes if deed restrictions limit the property to non-residential use.\textsuperscript{55}

Since the elements for establishing cleanup levels are unclear, hazardous waste remediation will not always require restoration of the property to pre-existing conditions. In almost no case will remediation levels be based on conditions that existed at the time a landowner purchased the property. In some cases, especially when landowners remediate property that has been put to industrial use for many years, the remediation may effectively mean that property can be put to greater use. However, if some form of deed restriction is employed, it may mean that certain uses are now precluded.

\textbf{C. Cleanup Technologies}

There are a wide variety of techniques available for remediation of contaminated property. In many cases, the same levels of cleanup can be attained through the use of different technologies that vary with respect to cost, necessity for construction of on-site physical treatment systems and need for long term operation and maintenance. Generally, techniques involve either removal of the contaminated material from the property,\textsuperscript{56} treatment of the contamination on-site\textsuperscript{57} or containment of the contamination to prevent further migration.\textsuperscript{58} Selection of the appropriate technique typically involves consideration of an array of factors including cost, the

\begin{itemize}
\item \textsuperscript{55} \textit{See}, e.g., 30 Tex. Admin. Code § 335.560 (West Supp. 1995).
\item \textsuperscript{56} In many cases, especially with contaminated soil from leaking underground storage tanks, contaminated soil is excavated and sent for off-site disposal in an approved landfill or incinerator. \textit{See}, e.g., Tex. Admin. Code § 335.554 (b)-(c) (West Supp. 1995).
\item \textsuperscript{57} In many cases, contaminated groundwater is handled by the construction of wells to pump the groundwater to the surface for treatment at on-site treatment facilities to remove contaminants. The treated groundwater is then reinjected back into the ground. \textit{See} Ferris & Rees, \textit{supra} note 1, at 815.
\item \textsuperscript{58} "Slurry walls," for example, are sometimes constructed to prevent migration of contaminated groundwater. In other cases, contaminated areas are simply paved with an impermeable material to minimize the possibility that rain will leach into the ground and cause further migration. Cf. Randy M. Mott, \textit{Acquifer Restoration under CERCLA: New Realities and Old Myths}, 23 Env't Rep. (BNA) 1301 (Aug. 28, 1992).
\end{itemize}
permanence of the remediation, the technological feasibility of removal and assessment of future uses of the property.

III. BASIC TAX CONSIDERATIONS AFFECTING DEDUCTION OF THE COSTS OF REMEDIATION OF HAZARDOUS SUBSTANCES

Persons who have incurred hazardous waste remediation costs face several tax issues. The central concern is whether these costs are to be treated as “expenses” or “capital expenditures.” The distinction between “expense” and “capital expenditure” has significant financial implications. Ordinary expenses can, in most cases, be deducted against ordinary income in the year in which they are incurred. Capital expenditures, however, are not deductible in the year in which they are incurred. If the expenditures relate to items that have a determinable useful life, taxpayers may be allowed to recover their costs through amortization or depreciation of the expense over some fixed period of time. Capital expenditures for items that do not have a fixed life, such as land, are neither deductible nor depreciable. Rather, these expenditures are added to the “basis” of the property, and the tax consequence of the expen-

59. This Article does not address all tax consequences associated with environmental expenditures. These include, among others, issues relating to property tax assessment of contaminated property, see Bonnie H. Keen, Tax Assessment of Contaminated Property: Tax Breaks for Polluters?, 19 B.C. ENVTL. AFF. L. REV. 885 (1992); estate tax issues, see Patricia G. Copeland, Ownership of Contaminated Property Raises Estate Planning Concerns, 81 J. TAX’N 50 (1994); or the deductibility of fines paid for violating environmental laws or “supplemental environmental projects” undertaken to reduce environmental fines, see Evan Slavitt, An Overview of the Tax Implications of Environmental Litigation, 20 ENVT. L. REP. (ENVT. L. INST.) 10547 (Dec. 1990).

60. “Expenses” will be used as a term to describe costs or outlays that are deductible as ordinary and necessary business expenses. “Capital expenditures” will be used to describe costs or outlays that may be capitalized. The terms “expenditures,” “costs” or “outlays” will be used to describe costs without reference to their status as expenses or capital expenditures.


63. I.R.C. §§ 167, 168 (1994). Additionally, in 1993, Congress added I.R.C. § 197(a), which allows the amortization over a 15-year period of some “intangible” capital items such as goodwill.

64. See Treas. Reg. § 1.167(a)-2 (1994); BITTKER & LOKKEN, supra note 61, at § 23.25.
diture is realized, if at all, at some indefinite future time on the sale or other disposition of the asset.\textsuperscript{65}

Despite the importance of the issue, there are no certain answers on classification of costs as “expenses” or “capital expenditures.” Provisions of the Internal Revenue Code give some guidance, but neither the Code, IRS regulations and rulings nor caselaw establish consistent principles that resolve the ambiguities.

\textbf{A. Basic Code Provisions}

There are several provisions of the Code that directly address the classification of expenditures. Section 162(a) establishes the basic requirements for deduction of ordinary and necessary expenses in any given tax year. Sections 263 and 263A generally prohibit deductions for capital expenditures.

1. \textit{Section 162(a)}

Section 162(a) provides for the deduction of “all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.”\textsuperscript{66} There are several prerequisites for the deduction of ordinary expenses in a given tax year. To be deductible under section 162(a), an expenditure must be (1) ordinary and necessary, (2) part of an ongoing trade or business, (3) paid or incurred in the tax year and (4) an expense (as opposed to capital expenditure).\textsuperscript{67} Additionally, penalties such as civil fines may not be deducted.\textsuperscript{68}

\textbf{a. “Ordinary and Necessary”}

An expense may not be deducted under section 162 unless it is an “ordinary and necessary” business expense. Establishing that

\textsuperscript{65} I.R.C. § 1001(a) (1994). See generally BITTKER & LOKKEN, supra note 61, at §§ 5.4, 40.1. A requirement that an expenditure be capitalized without the opportunity for depreciation or amortization can have a significant economic impact on the taxpayer. The taxpayer loses the time value of the money paid immediately in taxes, since the U.S. Treasury, not the taxpayer, earns the interest on that money until sale of the asset.

\textsuperscript{66} I.R.C. § 162(a) (1994).

\textsuperscript{67} I.R.C. § 162 (1994).

\textsuperscript{68} Id.
an expense meets this criteria generally does not raise difficult issues.\textsuperscript{69} Even unusual or infrequent expenses can be ordinary and necessary if they are normally incurred by average taxpayers in a particular type of business.\textsuperscript{70}

\textit{b. Ongoing Trade or Business}

To be deductible as an ordinary expense, the expense must also have been incurred as part of an ongoing trade or business. A taxpayer's expenses in preparation for a new trade or business may not be deductible.\textsuperscript{71} Therefore, expenses incurred while investigating a new business, such as preliminary environmental audits of a business that was not purchased, may raise some questions relating to status as deductible expenses.\textsuperscript{72}

\textit{c. Paid or Incurred}

An expense must be paid or incurred during the tax year to be deducted.\textsuperscript{73} Determination of the time at which an expense is incurred is mandated by the accounting method of the taxpayer. Expenses by taxpayers under a "cash" method of accounting are generally incurred in the year in which the money is actually spent.\textsuperscript{74} Expenses by taxpayers using the "accrual" method are not incurred until "economic performance" has occurred.\textsuperscript{75} In general, the "economic performance" test means that an accrual basis taxpayer cannot deduct expenditures until money is paid or services are actually performed.\textsuperscript{76}

Particular issues of timing are raised when environmental remediation expenses are paid into a settlement fund for later use.
In 1986, Congress enacted section 468B of the Code providing that economic performance occurs when money is paid into certain "designated settlement funds." In 1992, the IRS adopted new regulations that expressly provide that money paid pursuant to CERCLA liability into a "qualified settlement fund" will be treated as economic performance in most cases.\(^7\) Under the regulation, some limited class of taxpayers may be able to treat the date of payment of money to an EPA or court ordered CERCLA settlement fund as the time at which economic performance occurs.\(^7\) It is important to note that the regulations do not determine whether the payment is deductible as an ordinary expense.\(^7\) They merely address the timing of economic performance for the purpose of determining tax consequences.

\(d.\) Expense

Section 162(a) allows the deduction of "expenses" but not "capital expenditures." This distinction is explored in detail below.\(^8\)

\(e.\) Fines and Penalties

Section 162(f) of the Code prohibits the deduction of any fine or penalty paid to the government.\(^8\) Thus, characterization of an

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\(^7\) Treas. Reg. § 1.468B (1992). In general, payments made to a qualified settlement fund substitute "economic performance" for purposes of section 461(h) of the Code. Economic performance will not occur, however, if the transferor has, in certain cases, a right for a refund or reversion of the property. Id. § 1.468B-3(c).

\(^7\) Persons providing property or services to a "qualified settlement fund" in order to satisfy CERCLA liabilities are subject to section 468B rules only if, following the transfer of such property or services, the taxpayer's only remaining liability to the EPA is "a remote, future obligation to provide services or property." Treas. Reg. § 1.468B-1(f)(2) (1992). It is possible that only a class of _de minimis_ settlors, who are entitled to receive a broad release from future liability, may be able to take advantage of these provisions. See Glenn Carrington, _Tax Treatment of Environmental Clean Up Costs_, C967 ALI-ABA 861 (1994), available in WESTLAW, TP-ALL Library.

\(^8\) For a discussion of the issues raised by the regulation, see Ellen K. Harrison & Gary B. Wilcox, _Settlement Fund Final Regulations Answer Many Questions, But Problems Still Exist_, 78 J. TAX'N 342 (June 1993); Thomas H. Yancey & Nina B. Finston, _Qualified Settlement Funds and Their Use in Funding Environmental Cleanups_, 6 TOXICS L. REPT. (BNA) 1525 (May 13, 1992).

\(^8\) See _infra_ part III.B.

\(^8\) I.R.C. § 162(f) (1994). The section states: "No deduction shall be allowed under subsection (a) for any fine or similar penalty paid to a government for the violation of any law."
expense as a fine or penalty can affect its deductibility. In most cases, hazardous waste remediation expenses incurred under RCRA or CERCLA are not penalties.\(^{82}\) In some cases, however, agreements to perform remediation as a result of settlement can raise questions as to the proper classification of the expense.\(^{83}\)

2. **Sections 263 and 263A**

Section 263 prohibits the deduction of "any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."\(^{84}\) Section 263 is, in essence, the evil twin of section 162(a). It confirms the implication of section 162(a), that capital expenditures are not deductible under the provisions governing deduction of ordinary expenses.\(^{85}\)

Section 263A of the Internal Revenue Code provides that taxpayers must capitalize certain expenditures incurred in the production of real or tangible personal property in a trade or business.\(^{86}\) The word "produce" is defined in the Code to include "construct, build, install, manufacture, develop, or improve."\(^{87}\) Thus, the taxpayer must capitalize its costs associated with the construction of tangible equipment under this section. Its application to improvements of real property is much less clear.

B. **Distinguishing Ordinary Expenses from Capital Expenditures**

Ordinary expenses and capital expenditures are distinguished in order to allocate the deduction for an expense to the year in which the benefit from the expense occurs.\(^{88}\) Thus, ordinary ex-

\(^{82}\) Expenses under CERCLA, for example, have generally been held to have been incurred for remedial and not punitive purposes. See United States v. Monsanto, 858 F.2d 160 (4th Cir. 1988).


\(^{84}\) I.R.C. § 263 (1994).

\(^{85}\) I.R.C. § 161 (1994) also specifically provides that the provisions of section 263 limit the availability of deductions under section 162.


\(^{87}\) Id. at § 263A(g)(1).

\(^{88}\) See Indopco v. Commissioner, 503 U.S. 79 (1992); Commissioner v. Idaho
penses that produce a benefit in the year they are incurred are
deductible in that year. Capital expenditures, for items with a fixed
life that produce a long-term benefit over many years, must be
depreciated as costs allocated over a period that theoretically cor-
responds to the benefit of the expenditure. Although the Code
clearly authorizes deductions for ordinary expenses, the burden is
on the taxpayer to justify such deductions; the Supreme Court has
stated that "deductions are exceptions from the norm of capitaliza-
tion." However, there are no simple rules that clearly distinguish
between expenses and capital expenditures, and the Supreme Court
has recognized that the distinctions "are those of degree and not kind." There are a number of different ways to approach this
issue.

1. Repair vs. Improvement

One common approach to distinguishing expenses from capital
expenditures is to determine whether the expenditure is in the
nature of a repair as opposed to an improvement of property. "Repairs" act merely to maintain property and not to increase its
value and therefore are generally deductible as ordinary expenses.
"Improvements," in contrast, generally increase the value of prop-
erty, or allow new and profitable uses of property, and must be
capitalized.

IRS regulations provide that "repairs" may immediately be
deducted as ordinary and necessary expenses, while long-term im-
provements to the property must be treated as non-deductible capi-
tal expenditures. IRS regulations implementing section 162 pro-
duce:

The cost of incidental repairs which neither materially add to
the value of the property nor appreciably prolong its life, but
keep it in an ordinarily efficient operating condition, may be
deducted as an expense. Repairs in the nature of replacements,

(1972).
90. Indopco, 503 U.S. at 79.
91. Id.
92. See Bittker & Lokken, supra note 61, at § 20.4.8.
to the extent that they arrest deterioration or appreciably prolong the life of the property, shall either be capitalized or depreciated in accordance with section 167 or charged against the depreciation reserve if such an account is kept.\footnote{93. Treas. Reg. § 1.162-4 (1960).}

Similarly, the regulations implementing section 263 imply a distinction between repairs and improvements. Treasury Regulation § 1.263(a)-1(b) provides in general that section 263 prohibits the deduction of

amounts paid or incurred (1) to add to the value or substantially prolong the useful life of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. Amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures \ldots \footnote{94. Id. § 1.263(a)-1(b).}

Since all repairs in some sense add to the long term value of property, drawing the line between deductible repairs and non-deductible improvements has been difficult. Courts have produced inconsistent and confusing rulings on this distinction, employing a variety of criteria, including: the magnitude of the expenditures, whether they produce a long term benefit, whether they increase the useful life of property, whether they adapt property to new uses, and, possibly, whether they are in response to an immediate and unplanned situation.\footnote{95. There is no clearly defined list of factors that are used to draw this distinction, and commentators analyze the factors in different ways. Compare Bittker & Lokken, supra note 66, at § 20.4.8 with Michael M. Megaard & Susan L. Megaard, IRS Explains Deductions for Environmental Cleanup Costs, 23 Tax'n For Lawyers 152 (1994); see also, Carringtion, supra, note 78.}

One line of cases strongly suggests treating expenses that are designed to maintain the property for its existing use or to return the property to a pre-existing condition should be treated as deductible repairs. \textit{Plainfield-Union Water Co. v. Commissioner}\footnote{96. 39 T.C. 333 (1962).} held, in part, that expenses should be deducted as repairs if the value of the property after the expenditure was the same as the value before the event requiring the expenditure—a "before and after" test. The taxpayer in \textit{Plainfield-Union} was a water company that cleaned existing cast iron pipes and lined them with cement to prevent
problems caused by the use of acidic water. The Tax Court allowed this expense to be deducted as a repair since it merely restored the original water carrying capacity of the pipes without resulting in any new or additional uses.97 The court noted that:

any properly performed repair adds value as compared with the situation immediately prior to the repair. The proper test is whether the expenditure materially enhances the value, use, life expectancy, strength, or capacity as compared with the status of the asset prior to the condition necessitating the expenditure.98

The court concluded that the activity was a repair since, among other things, it did not increase the value of the property as compared with its value prior to the existence of the “condition necessitating the expenditure.”99

Similarly, in Appeal of Illinois Merchants Trust Co.,100 the court applied this “before and after” or “restoration” principle. The case involved the deductibility of the costs of removing and replacing rotting wooden foundation piles at a warehouse located on a river. The Board of Tax Appeals held that these expenses were currently deductible, noting:

In determining whether an expenditure is a capital one or is chargeable against operating income, it is necessary to bear in mind the purpose for which the expenditure is made. To repair is to restore to a sound state or to mend, while a replacement connotes a substitution. A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property, nor does it appreciably prolong its life. It merely keeps the property in an operating condition over the probable useful life for the

97. Id. at 341.
98. Id. at 338.
99. The court, in conclusion, stated:

The useful life, strength, value, and capacity of the cleaned and lined water pipes were not increased by the expenditure in issue. Said expenditure did not make the relevant water main suitable for new or additional use. Said main continued to be used in the normal course of petitioner’s operations as a water company. Viewing the record as a whole, we hold that the cleaning and cement lining of the Maple Avenue main in 1957 was a repair, the cost of which is deductible under section 162(a).

Id. at 341.
100. 4 B.T.A. 103 (1926).
uses for which it was acquired. Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements or additions which prolong the life of the property, increase its value, or make it adaptable to a different use.\textsuperscript{101}

Other courts, rather than focusing on changes that occurred during the period of ownership by the taxpayer, have been more willing to allow the deduction of expenses used to remedy latent, pre-existing conditions if that remedy allows the property to be used for its original intended purpose. In \textit{American Bemberg Corp. v. Commissioner},\textsuperscript{102} the company owned a plant built on unstable land that had periodic cave-ins. The company spent over $900,000 filling underground cavities with grout and cement to prevent these cave-ins. The Tax Court stated that three factors were relevant in determining whether these expenditures were deductible repairs or capital improvements: (1) the purpose of the work; (2) the physical nature of the work; and (3) the effect of the work. The court found that the purpose of the work was to avoid disaster, rather than to improve or increase the original plant, and that nothing new had been created. The court noted that the fault had not been cured but that the immediate consequences of the fault had been remedied. Therefore, the court held that these expenses were deductible repairs rather than capital improvements.\textsuperscript{103}

Other lines of cases, however, suggest a greater willingness to find long term benefit from expenditures that allow the taxpayer to continue its current operations. In \textit{Wolfsen Land & Cattle Co. v. Commissioner},\textsuperscript{104} the Tax Court refused to allow the taxpayer to deduct as repairs the costs of "draglining" ditches in an irrigation system to clear them of sediment. The court noted that the effect of the activity was to restore their prior capacity, but nonetheless found that the costs should be capitalized since the expenses were part of a systematic plan to clear the irrigation canals and make them more efficient.\textsuperscript{105} The court noted that: "a cleaned ditch or reworked levee is of more value than is one in need of repair. A more efficient system renders the ranch more productive and valu-

\textsuperscript{101} \textit{Id.} at 106.
\textsuperscript{102} 10 T.C. 361 (1948), \textit{aff'd} 177 F.2d 200 (6th Cir. 1949).
\textsuperscript{103} \textit{Id.} at 377.
\textsuperscript{104} 72 T.C. 1 (1979).
\textsuperscript{105} \textit{Id.} at 12-13.
The court also relied on the fact that the expenses were of substantial magnitude. Rather than being "incidental repairs" the court held that they were "in the nature of capital 'replacement' expenditures which must be capitalized and amortized over their appropriate useful lives."107

A recent TAM also suggests that large and infrequent expenditures that are necessary to preserve existing operations must be capitalized.108 The situation involved expenditures by the owner of an offshore oil field to raise the level of storage tanks and construct a barrier wall to prevent the release of oil. The construction was necessary because existing tanks had subsided as a result of past oil and gas extraction.109 The taxpayer argued that the activity was a deductible repair since it merely allowed continued operation of the field. The IRS, however, relying largely on Wolfsen, held a large expenditure was not "incidental" and produced a long-term benefit to the taxpayer.

Courts have split on the issue of whether costs incurred to comply with government regulations must be deducted or capitalized. Some courts have held that such costs are deductible if they do not otherwise increase the value or useful life of property. In Midland Empire Packing Co. v. Commissioner,110 oil from a nearby refinery contaminated the basement of a meat packing company. Federal meat inspectors ordered Midland to oil proof its basement or shut down, and as a result, the company lined the walls and floors with concrete to prevent the contamination. The Tax Court allowed the company to deduct these expenditures since the petitioner "made the repair in question in order that it might continue to operate its plant."111 The court noted that lining the walls did not "increase the useful life of the building or make the building more valuable for any purpose than it had been before the oil had come into the basement."112

106. Id. at 17.
107. Id. at 18.
109. Although the taxpayer had not yet received any government order to undertake the construction, it had been informed that the facility would be "shut down" if the construction was not undertaken. Id.
110. 14 T.C. 635 (1950).
111. Id. at 642.
112. Id. at 639.
Other cases, however, have held that expenditures made to comply with government regulations must be capitalized even if the effect is merely to allow the taxpayer to continue its prior operations. In *Teitelbaum v. Commissioner*, the court required the taxpayer to capitalize the costs of converting its electrical system from D.C. to A.C. as required by city code. The court held that while this expenditure did not prolong the useful life of the building, it did make it more valuable by bringing the property into compliance with the law. Similarly, in *Blue Creek Coal v. Commissioner*, the IRS required a taxpayer to capitalize the costs of installing enclosed cabs on bulldozers as required by the Federal Mine, Health and Safety Administration. The expense did not increase the useful life of otherwise operational bulldozers, but did increase their value by bringing them into compliance with applicable law.

The case law also suggests that expenditures made to preserve a given use must be capitalized if it involves construction of equipment that itself constitutes a permanent addition. In *Woolrich Woolen Mills v. U.S.*, the court held that the costs of a filtration plant built under order of the state was a non-deductible capital improvement even though it did not add to productive capacity. Rather, the court reasoned that such a plant was a permanent addition having a useful life beyond the tax year. Similarly, in *Mt. Morris Drive-In Theatre Co. v. Commissioner*, the company sought to deduct the cost of a drainage system for an existing drive-in theater. The court held that these costs were not deductible as repairs since they involved the acquisition and construction of a new asset—the new drainage system. Additionally, the court noted that the costs were foreseeable at the time of the acquisition of the property.

A final possible analysis of several of the above cases suggests that expenses incurred in response to sudden or unplanned situ-

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113. 294 F.2d 541 (7th Cir. 1961), cert. denied, 368 U.S. 987 (1962).
115. See also *Hotel Sulgrave v. Commissioner*, 21 T.C. 619 (1954) (costs of installing sprinkler system in a building, required by city order, must be capitalized even though expense did not increase value of the property or prolong its useful life).
116. 289 F.2d 444 (3d Cir. 1961).
117. Id. at 449.
118. 25 T.C. 272 (1955), aff’d, 238 F.2d 85 (6th Cir. 1956).
119. Id. at 274–75.
120. Id. at 275.
ations to be treated as repairs.\textsuperscript{121} Plainfield-Union, Illinois Merchants Trust, and Midland Empire all, to some extent, involved responses to unplanned events or changed conditions that affected the function of existing equipment. In Plainfield-Union the taxpayer restored pipes damaged by water with increased acidity.\textsuperscript{122} Illinois Merchants Trust involved replacements of rotting piers. Midland Empire concerned expenses to protect property from newly discovered off-site contamination. In these cases, the court seemed to recognize that the taxpayer was responding to changed conditions, and was merely restoring equipment to its former function. In contrast, Wolfsen, Woolrich Woolen and Mt. Morris involved expenses that did not result from sudden or unexpected changes to capital equipment. They concerned either planned long term maintenance or responses to external government requirements.

2. INDOPCO and Future Benefits

The distinction between repair and improvement in part focuses on whether some future benefit results from the expenditure. In Indopco, Inc. v. Commissioner,\textsuperscript{123} the Supreme Court considered all benefits the business expenses produced in determining whether it was to be treated as an ordinary expense or capital expenditure. The case involved the deductibility of certain investment banking fees and attorney expenses a target company incurred in a friendly take-over. The Supreme Court noted that “deductions are exceptions to the norm of capitalization,” and held that the costs were capital expenditures.\textsuperscript{124}

In reaching this conclusion the Court largely focused on the long term benefit that the target company received by being acquired. In Indopco’s case, these benefits included the access to the acquiring company’s resources and the replacement of many shareholders by a single shareholder. The Court stated that

\footnotesize{\textsuperscript{121} Certain costs relating to accidental and unplanned events may be separately deductible under section 165. See infra text accompanying note 147.  
\textsuperscript{122} The court in Plainfield-Union, however, expressly held that deductions may be allowable even though the damage results from gradual, rather than sudden or unexpected, activities. Plainfield-Union v. Commissioner, 39 T.C. 333, 340 (1962).  
\textsuperscript{123} 503 U.S. 79 (1992).  
\textsuperscript{124} Id.
Although the mere presence of an incidental future benefit—"some future aspect"—may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization.\textsuperscript{125}

The Court held that the expenses could be capital expenditures although no tangible asset was created or improved.\textsuperscript{126} The Court distinguished \textit{Commissioner v. Lincoln Savings & Loan Assn.},\textsuperscript{127} which had required capitalization of expenses associated with a separate and distinct asset. The Court wrote:

\textit{Lincoln Savings} stands for the simple proposition that a taxpayer's expenditure that "serves to create or enhance . . . a separate and distinct" asset should be capitalized under § 263. It by no means follows, however, that \textit{only} expenditures that create or enhance separate and distinct assets are to be capitalized under § 263.\textsuperscript{128}

In 1994, the IRS issued Revenue Ruling 94-12 that purports to address the applicability of \textit{Indopco} to incidental repair expenses.\textsuperscript{129} Unfortunately, it does not. The Ruling curiously characterizes \textit{Indopco} as "clarifying" that the creation or enhancement of a separate and distinct asset is not a prerequisite to capitalization.\textsuperscript{130} The Ruling then simply states that "the \textit{Indopco} decision does not affect the treatment of the cost of incidental repairs under section 162 of the Code."\textsuperscript{131} That statement is to a certain extent true. What the Ruling does not address is the extent to which the Supreme Court's analysis in \textit{Indopco} affects the classification of whether an expense is an "incidental repair" based on an assessment of future benefits. The IRS in subsequent statements has continued to rely...

\textsuperscript{125} \textit{Id.} at 87.

\textsuperscript{126} \textit{Id.} at 86–87.

\textsuperscript{127} 403 U.S. 345 (1971).

\textsuperscript{128} \textit{Indopco}, 503 U.S. at 86–87. As discussed below, this quotation raises the specter that remediation expenses paid by former landowners or off-site generators might be treated as capital expenses notwithstanding the fact that they are not benefitting any specific asset that they own.

\textsuperscript{129} Rev. Rul. 94-12, 1994-1 C.B. 36.

\textsuperscript{130} \textit{Id.}

\textsuperscript{131} \textit{Id.} at 37.
on an assessment of long-term benefits in characterizing an item as a capital expenditure.\textsuperscript{132}

3. Plans for Rehabilitation

An expenditure may independently be classified as a capital expenditure if it is part of a general plan of rehabilitation of property. Under the plan of rehabilitation doctrine, costs incurred as part of some overall scheme to repair or rehabilitate property must be capitalized even if the individual expenditure, in the absence of such a scheme, would have been deductible.\textsuperscript{133}

In \textit{U.S. v. Wehrli},\textsuperscript{134} the court noted that determining whether an expenditure is made as part of a plan of rehabilitation requires:

A realistic appraisal of all the surrounding facts and circumstances, including, but not limited to, the purpose, nature, extent, and value of the work done, e.g., whether the work was done to suit the needs of the incoming tenant, or to adapt the property to a different use, or . . . whether what was done resulted in any appreciable enhancement of the property’s value.\textsuperscript{135}

In \textit{Mountain Fuel Supply Co. v. United States},\textsuperscript{136} the court used the plan of rehabilitation doctrine to require capitalization of expenditures for the repair and restoration of an in-place pipeline. The taxpayer had deducted expenses related to restoring gas lines including the costs of digging, removing, repairing, and returning the pipes to the ground. The court found that the expenses should

\textsuperscript{132} The IRS in a subsequent Technical Advice Memorandum relied on Revenue Ruling 94-12 for the proposition that \textit{Indopco} did not affect the treatment of incidental repairs. Curiously, in that opinion, Tech. Adv. Mem. 94-24-002 (February 9, 1994), the IRS relied on \textit{Wolfsen} to conclude that large maintenance expenses necessary to allow the taxpayer to continue its operations must be capitalized since the expenses conferred significant long-term benefits. \textit{See supra} text accompanying note 108.

\textsuperscript{133} In \textit{Stoeltzing v Commissioner}, 266 F.2d 374, 376–77 (3d Cir. 1959), the court relied on the plan of rehabilitation doctrine to hold that costs incurred to renovate an old building must be capitalized even though individual items might have been deductible.

\textsuperscript{134} 400 F.2d 686 (10th Cir. 1968).

\textsuperscript{135} \textit{See California Casket Co. v Commissioner}, 19 T.C. 32, 37–38 (1952) (expenditures for remodeling old warehouse must be capitalized since taxpayer had an express intention and purpose of completely renovating and altering property). \textit{See also Mt. Morris Drive-In Theatre v. Commissioner}, 25 T.C. 272 (1955), \textit{aff’d}, 238 F.2d 85 (6th Cir. 1956), \textit{see supra} text accompanying note 118.

\textsuperscript{136} 449 F.2d 816 (10th Cir. 1971), \textit{cert. denied}, 405 U.S. 989 (1972).
appropriately be capitalized since, in addition to increasing capacity and longevity associated with the new pipe, the restoration was part of an overall plan of rehabilitation that was "well defined in scope and . . . of considerable significance in view of the [taxpayer's] overall operations."\(1\)

The plan of rehabilitation doctrine raises a number of particular issues. First, application of the doctrine requires inquiry into the "intent" of the taxpayer. The taxpayer must capitalize deductible expenses if it has formed some plan or scheme for rehabilitation. Second, the timing of expenses may affect whether they are characterized as part of a plan of rehabilitation. Expenses occurring shortly before or after sale of property that remedy conditions are more likely to be characterized as being part of a plan of rehabilitation. Finally, cases such as Wolfsen suggest that where a taxpayer foregoes annual maintenance in favor of periodic but infrequent renovation of property, its renovation expenses may be viewed as part of a plan of rehabilitation and therefore capital expenses.

4. Assumption of Liabilities

Special tax issues arise when, as part of a "taxable acquisition" of an asset a buyer assumes the liabilities of a seller.\(138\) In general, the assumed liability is treated as part of the cost of the acquisition, and the buyer's purchase price is considered to have included the value of the assumed liability. Payments on these liabilities generally may not be deducted but must be used to adjust the basis in the acquired asset.

These rules are relatively clear when applied to the assumption of fixed and determined liabilities. In such cases, the buyer generally will be required to treat the value of the assumed fixed liabilities as part of its purchase price. As such, the buyer cannot deduct payment on these liabilities; rather the payment will be reflected

\(1\) Id. at 821-22.

\(138\) A company's acquisition of the assets of another company will normally be treated as a taxable event. However, in TAM 95-212-35 (October 30, 1995), the IRS recently held that contingent environmental liabilities assumed by the newly formed subsidiary in a section 351 exchange are not taxable liabilities. The IRS also held that the new liabilities of the subsidiary would be treated in the same manner as if they were owned by the parent.
by a higher cost basis in the acquired asset. This may be the case even if the owner of the asset had made the expenditure. The seller generally must include the value of the fixed liabilities as part of the sale price.

Far less clear is the treatment of the assumption of contingent liabilities that are either uncertain in amount, or which may never require payment. In general, however, it is likely that buyers that assume contingent liabilities will be required to capitalize, as an adjustment to basis, the money paid to satisfy those liabilities. In David R. Webb Co. v. Commissioner, for example, a pension-type liability was assumed in connection with the purchase of assets of an operating business. The Court of Appeals held that payments to a widow, made as a result of a liability assumed as

140. See Hyde v. Commissioner, 64 T.C. 300 (1975).
141. See Treas. Reg. § 1.338(b)(10)-1(f)(5) (1995) (calculation of deemed sales price for stock acquisition treated as asset purchase); Temp. Treas. Reg. § 1.1060-1T(c) (calculation of amount realized in case of asset purchase). When the buyer assumes the liability, this will generally be treated as payment of the seller’s liability. To the extent that payment of the liability is otherwise deductible, the seller may be able to take an offsetting deduction for the value of the assumed liability. See Commercial Sec. Bank v. Commissioner, 77 T.C. 145 (1981).

For example, assume a seller has an asset worth $500 and a fixed liability of $100. If the buyer pays $500 for the asset and assumes the liability, the seller generally will be treated as having received consideration of $600 in the transaction, but may be able to claim a $100 deduction for payment of the liability.

142. The definition of a “contingent liability” is not clear. There is no specific definition applicable in the case of an actual asset sale under Treas. Reg. 1060. In the case of a deemed asset sale under section 338, the regulations simply provide that a contingent liability is one that is not fixed and determinable. Treas. Reg. § 1.338(b)-3T(b)(1) (1995).
143. Although this is the most likely treatment of payments made to satisfy contingent liabilities, it is not the only possibility. Some commentators have suggested that the value of a contingent liability could be assessed at time of sale and the basis adjusted at that time to reflect this projected value or, alternatively, that subsequent payments to satisfy an assumed contingent liability could simply be deducted at the time of payment. See, e.g., Report on the Federal Income Tax Treatment of Contingent Liabilities in Taxable Asset Acquisition Transactions (N.Y. State Bar Ass’n Tax Section), TAX NOTES 883 (Nov. 19, 1990).

Neither section 1060 nor section 338(b)(10) deal directly with the treatment of the assumption of contingent liabilities. See I.R.C. § 1060 (1994); see I.R.C. § 338(b)(10) (1994). Regulations implementing section 338 (stock acquisition treated as asset acquisition) provide that the seller must make an “accounting” when contingent liabilities become fixed. At this point, the seller may be required to adjust the amount realized on sale of the asset to reflect the new fixed value of the contingent liability. Similarly, such an accounting should require an increase in basis to the buyer. See Treas. Reg. § 1.338(b)(10)-1(f)(2) (1995); Temp. Treas. Reg. 1.338(b)-3T(h)(1)(i) (1995). See Ellen H. De Mont, Tax Treatment of Contingent Liabilities: The Need for Reform, 28 U. RICH. L. REV. 113 (1994).
144. 77 T.C. 1134 (1981), aff’d, 708 F.2d 1254 (7th Cir. 1983).
part of the transaction, were capital expenditures that must be used to adjust the basis in the asset.  

5. Casualty Losses

Finally, in some cases, expenses that might otherwise be capitalized may be deducted if treated as casualty losses. Section 165 of the Code allows a current deduction for certain losses that are not compensated by insurance or otherwise. These deductions are limited, however, to losses that are "evidenced by closed and completed transactions, fixed by identifiable events, and . . . actually sustained during the taxable year." In order to obtain a deduction, a party generally must suffer some sudden loss and not a gradual deterioration.

IV. PRIOR STATEMENTS OF THE IRS ON DEDUCTIBILITY OF ENVIRONMENTAL REMEDIATION EXPENDITURES

In 1992 and 1993, the IRS issued several TAMs that dealt with the deductibility of certain expenses from remediation of environmental problems. These TAMs took an expansive view of the long term benefits of environmental remediation and strongly suggested that most remediation costs of hazardous substances would be classified as capital expenditures. In 1994, however, the IRS made a remarkable about-face. In Revenue Ruling 94-38, the IRS issued an opinion holding that certain costs of remediating contaminated soil could be deducted. The Ruling was based on a simplistic analysis of the reasons for and consequences of environmental remediation activities. It suggested that in other contexts, the IRS would be likely to hold that remediation costs would be deductible as ordinary expenses. In 1995, however, the IRS seemed to reverse course once again. A new TAM strongly suggests that

145. Id. at 1137.
147. Treas. Reg. § 1.165-1(b) (as amended in 1977).
148. See, e.g., Fay v. Helvering, 120 F.2d 253 (2d Cir. 1941); Rev. Rul. 72-592, 1972-2 C.B. 101 (casualty loss must be sudden, unexpected, and unusual).
149. Technical Advice Memoranda (TAM) are published by the IRS to resolve disputed tax claims, but, like other private rulings, TAMs may not be used or cited as precedent. I.R.C. § 6110(j)(3) (1988).
the IRS believes that most remediation expenditures must be capitalized.\footnote{150}

A. Pre-1995 Technical Advice Memoranda


In December 1992, the IRS issued a TAM holding that the costs associated with a plan to remediate soil and equipment contaminated with polychlorinated biphenyls ("PCBs") were capital expenditures.\footnote{151} The taxpayer's property had been contaminated with PCBs from past operation of equipment, and from past efforts to remove and dispose of the PCBs. The Environmental Protection Agency instituted an enforcement action alleging violation of several statutes including RCRA and the Toxic Substances Control Act ("TSCA"),\footnote{152} and, in settlement of the action, the taxpayer agreed to an extensive plan to investigate and remediate PCB contamination on the taxpayer's property. The taxpayer had treated as current expenses all of the costs of remediation, except for the costs of equipment and groundwater monitoring wells.

The IRS held that the soil cleanup costs were capital expenditures.\footnote{153} This conclusion was based on two factors. First, the opinion held that the costs constituted "replacements and betterments", and not "incidental" repairs.\footnote{154} Relying largely on Wolfsen Land and Cattle Co.,\footnote{155} the IRS found that the expenditures resulted from the taxpayer's decision to forego regular maintenance, that they were made as part of a systematic plan, and that they would result in the property being more valuable. The opinion specifically declined to follow the analysis in Plainfield-Union Water Co. and strongly implied that the logic of Plainfield-Union had

\footnotesize{\begin{itemize}
\item[150.] See infra part IV.C.
\item[152.] See supra note 9.
\item[153.] The opinion also addressed the issue of whether legal fees, oversight, and environmental audit costs are deductible. The opinion held that legal fees, incurred to defend against actions by the government and private parties, were deductible expenses. Oversight fees, incurred to monitor implementation of the PCB removal plan, were held to be capital expenses. A recent TAM makes the continuing validity of this conclusion questionable. See infra note 161.
\item[155.] See supra text accompanying note 104.
\end{itemize}}
been repudiated by Wolfsen.\textsuperscript{156} Second, the opinion relied on the fact that the remediation was part of an overall plan for rehabilitation of the property.\textsuperscript{157}


In 1992, the IRS issued TAM 92-40-004, which addressed the deductibility of expenses to remove asbestos insulation.\textsuperscript{158} In this case, the taxpayer removed and replaced asbestos insulation in certain manufacturing equipment. The taxpayer was concerned about federal and state requirements relating to worker exposure to asbestos. Rather than institute a program to monitor and encapsulate any friable asbestos insulation, the taxpayer elected to replace existing asbestos insulation with new insulation that was less efficient.\textsuperscript{159}

The taxpayer argued that the costs of asbestos removal should be treated as deductible repairs since (1) the cost of the replacement, although large, was minor in comparison to the facility's overall repair and maintenance costs, (2) the expenditures did not add value or prolong the life of the equipment but merely restored the property to its original value and function, and (3) the expenditures did not involve the types of expenditures typically treated as capital since they did not create new units or components, and were not part of a plan of rehabilitation.\textsuperscript{160}

The IRS held, however, that the expenditures were not repairs but capital expenditures. The IRS relied on several factors: long-term benefits to the company from reduced monitoring and maintenance costs, safer working conditions, reduced risk of liability for owners and investors, increased marketability, permanence of the improvement and the fact that the property now met local requirements that allowed the business to continue in operation. In the TAM, the IRS distinguished \textit{Plainfield-Union}. In this case, the IRS held that: one, there was no way to value the property prior to the condition giving rise to the need for the repair; and two, there was no decrease in efficiency as a result of the deterioration that was being repaired. The IRS also noted that any increase in

\textsuperscript{156} Tech. Adv. Mem. 92-15-004 (Dec. 17, 1992); \textit{see also supra} part III.B.1.
\textsuperscript{157} \textit{See supra} part III.B.
\textsuperscript{159} \textit{Id}.
the value of the property resulted from "subjective factors" (such as safer working conditions and increased marketability) that are "not compatible with the objective measurement articulated in Plainfield-Union."\textsuperscript{161}


TAM 94-11-002 dealt with expenses for the complete removal of asbestos installation and the encapsulation of other friable asbestos installation.\textsuperscript{162} In order to obtain a bank loan, the taxpayer was required by the lender to remove or encapsulate asbestos containing materials in the warehouse. The IRS held that the costs of complete removal of the asbestos was a capital expenditure. According to the IRS, the complete removal produced long-term improvements since it: one, permanently eliminated health risks to workers and potential lessees; two, made the property "more attractive" to potential buyers, investors, lenders and customers; three, expanded the useable area available to the taxpayer; and four, adapted the property to a "new and different" use by allowing the taxpayer to convert portions of its property into garage and office space.\textsuperscript{163}

In contrast, the IRS held that the costs associated with encapsulation of asbestos were deductible repairs. Since these expenses did not permanently remove the asbestos problem but merely addressed certain limited problem areas where asbestos insulation was damaged or punctured, these expenses were in the nature of "incidental repairs."\textsuperscript{164}

B. Revenue Ruling 94-38

In 1994, the IRS issued Revenue Ruling 94-38.\textsuperscript{165} At issue were the costs incurred by a manufacturing facility in remediating soil and groundwater contamination on its property. When purchased by the taxpayer, the property was allegedly uncontaminated,

\begin{footnotes}
\item[163] Id.
\item[164] Id.
\item[165] Rev. Rul. 94-38, 1994-1 C.B. 35.
\end{footnotes}
but in over twenty years of operations the taxpayer had discharged and buried wastes on portions of its land.

In 1993, in order to comply with “presently applicable and reasonably anticipated federal, state and local environmental requirements,” the taxpayer began a remediation project that involved removal and off-site disposal of contaminated soil and installation of groundwater monitoring and treatment systems. The IRS claimed the effect of the remediation was to “restore [the] land to essentially the same physical condition that existed prior to the contamination.” The IRS also noted that the taxpayer during and after the remediation would use the land and operate the plant in the same manner as it did prior to the cleanup. The only change the IRS observed was that the taxpayer would now operate its facility “in compliance with environmental requirements.”

Based on these facts, the Revenue Ruling held that most costs of the remediation were currently deductible as ordinary expenses. In a brief analysis, the ruling held that the remediation did not produce any permanent improvements to the land. Citing Plainfield-Union Water Co., the IRS stated that the relevant test for determining whether or not an expense was a permanent improvement was to compare the status of the asset before the expense with the condition of the asset before the event requiring the expenditure. According to the IRS, the “soil remediation and ongoing groundwater treatment expenditures do not result in improvements that increase the value of [the taxpayer’s] property because [the taxpayer] has merely restored its soil and groundwater to their approximate condition before they were contaminated by X’s manufacturing operations.” The Revenue Ruling held, however, that the groundwater treatment facilities constructed as part of the remediation had useful lives beyond the year in which they were constructed, and were thus properly classified as expenses that should be subject to the mandatory capitalization requirements of section 263A.

166. Id.
167. Id.
168. Id.
169. Id. at 36.
In September 1995 the IRS issued a memorandum that casts further doubt on the deductibility of cleanup costs. TAM 95-410-05 implies that most costs associated with the cleanup of property contaminated prior to purchase by the taxpayer must be capitalized.\textsuperscript{170} This TAM is difficult to interpret because the facts of the case are so unclear.\textsuperscript{171} Apparently a corporate predecessor of the taxpayer purchased undeveloped property that was used as a site for the disposal of industrial wastes. The property may or may not have been contaminated at the time of the purchase. Several years after the purchase, the taxpayer donated the property to a county government and took a charitable deduction for the donation based on the fair market value of the property. After the county discovered that the property was contaminated, it reconveyed the property to the taxpayer for one dollar. The taxpayer recorded a new basis in the property of one dollar and did not recapture or otherwise take back income for any portion of the charitable deduction it had previously taken. The property was subsequently investigated by state and federal environmental officials and listed on the National Priorities List under CERCLA. The taxpayer entered into a Consent Decree with the Environmental Protection Agency and agreed to perform a “Remedial Investigation/Feasibility Study” (“RI/FS”) that, among other things, involved an investigation into the extent of contamination and the development of plans for the cleanup of the property.

Although the taxpayer had not yet incurred any costs for actual remediation of the site, the taxpayer had incurred three classes of expenditures: (1) costs to an environmental consultant for investigation of the site and performance of the RI/FS, (2) legal fees related to negotiation and drafting of the Consent Decree, and 3) fees paid to consultants for lobbying, public relations and some engineering efforts. Based in large part on Revenue Ruling 94-38, the taxpayer claimed each of these classes of expenditures as a current deduction. Stating that capitalization was the norm, the IRS rejected all of the claimed deductions holding that the taxpayer had not met its burden of proof.

\textsuperscript{171} See infra Author's Note following Conclusion.
What emerges from the analysis of the TAM is that the IRS is narrowly reading Revenue Ruling 94-38. The TAM suggests that the IRS will allow the current deduction of cleanup expenditures under the logic of 94-38 only if the taxpayer: acquired uncontaminated property; contaminated the property during his or her period of ownership; expended money to restore the property during its period of ownership; and restored the property to the uncontaminated condition that existed at the time it was acquired by the taxpayer. In the TAM the IRS concluded that because the taxpayer's expenditures involved remediation of contamination that existed prior to its re-acquisition from the county, the expenses were not deductible.172

The IRS appears to state that costs associated with the cleanup of preexisting contamination must be capitalized. In a terse and "lightly" reasoned paragraph, the IRS discusses the argument that the hazardous waste site assessments costs may be deductible since they relate to the subsequent cleanup of the site.173 The TAM states:

Because we have concluded that the analysis in Rev. Rul. 94-38 does not apply to the Taxpayer, the actual cleanup costs, when incurred, may be capitalizable improvements under section 263. For costs incurred after December 31, 1986, section 263A requires taxpayers to capitalize direct and certain indirect costs associated with the production, including improvement of property. See section 263A(g)(1) (emphasis added).174

Note that there is no discussion of the significance of future benefits and no discussion of case law such as American Bem-

172. It is unclear from the opinion whether use of the site as a disposal site began before or after it was originally acquired by its corporate predecessor. If the contamination began after the original acquisition, it is unclear whether the taxpayer could have successfully relied on Revenue Ruling 94-38 if the reconveyance from the county had been in the form of a rescission of the donation or if the taxpayer had revised its earlier taxes to take back the value of the deduction.

173. In the TAM, the IRS specifically considered, and rejected, arguments that each of the three classes of expenditures should be capitalized. Surprisingly, the TAM rejected arguments that expenses incurred to avoid litigation may be capitalized. Although legal fees are frequently deductible as ordinary and necessary business expenses, the IRS implied that attorney's fees incurred to facilitate a remediation must be capitalized. Since there was documentation that the legal fees were incurred to negotiate and draft the Consent Decree with the EPA, the IRS presumably concluded that such expenditures were not deductible.

The TAM informs the taxpayer that cleanup costs are to be capitalized because they may be capitalizable, and the taxpayer has not met its burden of proof to demonstrate otherwise. What one is to make of this oddly written and reasoned TAM is unclear. The implications of the TAM are further confused by the fact that it is difficult to discern the weight that should be accorded to the TAM since, among other things, a TAM, unlike a Revenue Ruling, has no precedential value. The implications of the TAM are further confused by the fact that it is difficult to discern the weight that should be accorded to the TAM since, among other things, a TAM, unlike a Revenue Ruling, has no precedential value.176

V. Application

Given the limited logic and inconsistencies in past IRS statements, appropriate tax treatment of many remediation costs remains uncertain. Remediation expenses can be incurred for a variety of different reasons and thus require a variety of different responses. In many of the most common situations in which taxpayers incur expenses, the inconsistent case law and varying rationales for classification of expenses make it difficult to determine how remediation expenses should be classified. The following section analyzes how remediation expenses might be treated when incurred in a variety of common situations.

A. Remediation of Contaminated Property by the Current Landowner

1. Remediation of Contamination Caused by the Taxpayer

In many cases, federal and state law may require landowners to remediate contamination of their property caused by the taxpayer’s activities. If nothing else, Revenue Ruling 94-38 clarifies that many of these expenses incurred to remediate contamination caused by the taxpayer will be treated as ordinary expenses.178

175. 10 T.C. 361 (1948), aff’d, 177 F.2d 200 (6th Cir. 1994).
177. See supra part II.A.1.
178. Although not discussed in Revenue Ruling 94-38, the certainty of the conclusion may be suspect if the remediation involves cleanup of pre-existing contamination or the reduction of pollutants to levels below those existing at the time of purchase of the
Thus, expenses incurred for investigating and planning remediation activities and the costs of removal and disposal of contaminated soil should be deductible as ordinary expenses in the year in which economic performance occurs. Only expenditures made to construct physical structures that last beyond the taxable year (such as groundwater monitoring wells or pumping equipment) will be treated as capital expenditures.

Under the logic of the Ruling, it seems irrelevant whether the taxpayer incurred these costs in response to a government order or voluntarily undertook the remediation to avoid future liability or prepare the property for sale. The Ruling seems concerned only with the facts that the taxpayer was restoring the property to its preexisting condition and that the taxpayer was continuing to use the property for the same purposes.

If the remediation expenses are made to clean up an immediate spill of environmental pollutants, a much stronger argument can be made that the expenses are a casualty loss to be treated under the rules of section 165. This may be warranted if the liability is confined to a discrete spill event for which the scope of liability can be fixed and expenses for remediation incurred in the same tax year as the event.

2. Remediation of Preexisting Contamination

If a taxpayer remediates contamination that existed at the time of the property’s purchase, neither Revenue Ruling 94-33 nor TAM 95-410-05 provide clear guidance on how the IRS will treat remediation costs. Among other factors, the reasons the taxpayer incurred the expenses, the timing of when they were incurred and even the extent of the remediation may affect their tax treatment. The situation is even more complicated if the taxpayer does not directly pay for the remediation but rather reimburses remediation expenses incurred by other parties, such as the prior owners or off-site generators liable under CERCLA, or has increased its costs by waiving possible claims against a former owner.

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property. In such cases, it is possible to conclude that the taxpayer is not simply repairing but rather improving property and adapting it to new uses.

179. See supra text accompanying note 146.
a. Remediation Expenses Directly Incurred by Taxpayer

If the taxpayer directly incurs costs to remediate preexisting contamination, the situation differs markedly from the situation analyzed in Revenue Ruling 94-38. To the extent that the remediation merely allows the taxpayer to continue operation of the facility in the same manner as it had prior to the remediation, it is possible to argue that Revenue Ruling 94-38 allows such maintenance expenses to be treated as ordinary repairs. American Bemberg is particularly relevant for this conclusion. In that case, payments to fill in preexisting underground caverns that were causing surface subsidence were allowed as repairs, in part because they merely allowed continuation of the existing use.

TAM 95-410-05, of course, expressly rejects application of Revenue Ruling 94-38 in this context and strongly implies that costs must be capitalized. The limited logic employed by the IRS in TAM 95-410-05 and in the non-precedential status of TAMs suggest, however, that the IRS may reconsider this issue in the future.

There are many legitimate reasons to think that costs for remediation of preexisting contamination must be capitalized. When a taxpayer cleans up contamination that existed at the time of purchase, the taxpayer is not simply restoring its own property to some preexisting condition. Rather, the taxpayer is actually improving the property's condition, which existed at the time of purchase. Thus, such expenses might be considered improvements subject to the normal rule of capitalization.

The situation is even more complicated if the remediation results in attainment of pollutant levels that allow the property to be used for new purposes. This would be the case if industrial property were cleaned to levels that allow its use for residential purposes. In such a case, it is far more likely that the expenses could be treated as "permanent improvements or betterments made to increase the value of any property or estate" under section 263.

180. See supra text accompanying note 102.
Additionally, if the remediation is taken as part of an overall plan to address environmental problems at the site, it is possible that these expenses would be treated as capital expenditures even if they would have been deductible as ordinary expenses by the prior owner. Any cleanup undertaken by a buyer shortly after the purchase, will raise questions as to whether the cleanup was part of a plan of rehabilitation. If the remediation were considered part of a plan of remediation, the expenses would presumably be capitalized by an adjustment to basis even if the same expenses, incurred in a situation that was not part of such a plan, might otherwise be deductible. Similarly, remediation undertaken by a seller before sale to increase the marketability of the property could also be viewed as a capital expense under the plan of rehabilitation doctrine. As noted above, determination of whether there is a plan of rehabilitation is a fact specific inquiry made on a case-by-case basis.

b. Consideration of Remediation Expenses in the Purchase Price: Waiver of Claims Against the Former Owner

It is not uncommon to identify environmental contamination during an environmental audit and for the cleanup to be negotiated as part of the transaction. To the extent that the negotiations result in the buyer undertaking the remediation, those costs would likely be treated as a part of the purchase price that must be added to basis rather than deducted.

The buyer and seller may choose to negotiate a limitation on the assertion of future claims against the seller for remediation expenses incurred by the buyer after sale. These limitations will apply even to claims arising from contamination that existed prior to sale. In some cases, a purchaser may simply waive any CERCLA or other claim it might have against a former owner. In other cases, through caps on the total amount of money for which a seller may be liable or through time limits on the assertion of claims, a purchaser may limit the amount of money that it might otherwise have recovered from the seller. In exchange for an agreement to limit

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183. See supra part III.B.
184. Id.
possible claims against the seller, the purchaser presumably will pay a reduced price for the asset.\footnote{185}

Through such limitations, the purchaser is, in effect, assuming the contingent liability of the seller. Thus, the purchaser’s increased remediation expenses might be viewed as a cost incurred as part of the purchase of the property. Under case law dealing with assumed contingent liabilities, such costs might be treated as capital items that must be reflected in the basis of the property rather than a deductible maintenance expense.\footnote{186}

This issue is further complicated by the fact that the current landowner may be jointly and severally liable with the former landowner. In such a case, it might be argued that remediation expenses paid by the purchaser are not an assumed contingent liability since the purchaser, as current landowner, has the potential liability even in the absence of the agreement.

c. Payments to PRPs Under CERCLA

In some cases, a landowner might be required to reimburse other PRPs that clean up the taxpayer’s property.\footnote{187} These reimbursement expenses would likely be treated as ordinary expenses to the extent that they would have been treated as such if incurred directly by the taxpayer. As with direct expenses, they may simply restore the condition of the taxpayer’s property. Also, as noted above, the analysis in Revenue Ruling 94-38 does not seem to

\footnote{185. In some cases, a purchaser may, as part of the negotiated sale of an asset, agree not only to waive any claim that the purchaser had against the seller, but also to indemnify the seller for any environmental cleanup costs which the seller may incur after sale. In most cases, this indemnification will apply to costs incurred to remediate contamination caused by the buyer after the sale, but in some cases the purchaser may agree to indemnify the former owner for all costs incurred for contamination that existed even prior to sale. Such an agreement might be reached where the seller wishes the equivalent of an “as is” transaction in which, after sale, the seller has minimized its potential liability at the site. Such an indemnification agreement could easily be treated as an assumption by the purchaser of seller's contingent environmental liabilities. Thus, expenditures by the purchaser to reimburse the seller for its subsequently incurred cleanup costs could be treated as part of the cost of purchasing the property and thus require capitalization, rather than deduction, of the expenses paid to the former landowner.}

\footnote{186. See supra part III.B.3.4.}

\footnote{187. Under CERCLA, hazardous waste generators may be required to undertake a cleanup at property they do not own, but at which they disposed of hazardous substances. 42 U.S.C. 9607(a)(3) (1988). In such cases, they may seek to recover some of these costs under CERCLA from the current landowner.
depend on whether the costs were incurred voluntarily or through government compulsion.

Payments to PRPs under CERCLA are not made as a result of any express assumption of liability at the time of sale. Thus, curiously, costs made by a landowner to reimburse former owners as a result of a CERCLA cost recovery action are more likely to be treated as deductible expenses than costs incurred as a result of an indemnification agreement or limitation on recovery negotiated at the time of sale.

B. Remedial Expenses Incurred by a Former Landowner

A previous landowner might currently be liable for the cost of remediation of property in a number of ways. The former owner may have incurred liability as part of the sale of the property if, for example, the former owner agreed to indemnify the purchaser for environmental liabilities. Additionally, the former owner may be liable as a PRP under CERCLA or comparable state statute.

1. Expenses Incurred Pursuant to an Indemnification Agreement

Indemnification agreements negotiated as part of the sale of real property frequently require the former owner to indemnify the purchaser for costs incurred as part of the cleanup of the property. In most cases, this indemnification is limited to expenses incurred in remediating contamination that existed at the time of sale. Depending on the existing liability of the former owner under federal or state law, such an indemnification can result in the seller either retaining preexisting liability or incurring new liability. In either case, the buyer presumably paid more for an asset in exchange for the prospective indemnification by the seller.

If payments under an indemnification agreement are viewed as the seller simply satisfying its preexisting liability, then it is unlikely that they would constitute an element of the sales price of the property or reflect any assumption of liability as part of the sale. Nonetheless, the payment of retained liabilities still raises difficult questions. Assuming the remediation expenses would have been deductible if incurred when the seller owned the property, it is likely they would be treated as an ordinary deductible expense.
when subsequently incurred. If, however, the expense would have been capitalized as an improvement if made when the seller owned the property, it is questionable whether it would similarly be capitalized if made when the seller no longer owns the property. The expense could be viewed as an ordinary deductible business expense since the taxpayer is not obtaining a long-term benefit to an identifiable asset. Alternatively, these payments might be capitalized and either (1) be treated as a capital loss available to offset current capital gain, or (2) result in recalculation of the adjusted gain or loss on the asset.

An indemnification by seller, even with respect to preexisting contamination, could result in the seller incurring new liabilities.\textsuperscript{188} This is, curiously, the reverse of the typical assumption of contingent liabilities issues. In such a case the seller is assuming contingent liabilities of the buyer. It is quite possible that a seller who received a higher sales price as a result of such an indemnification agreement might be required to treat payments under that agreement as a part of the sale. The payments therefore would be capital expenses and the seller would presumably have to readjust the gain or loss on the sale to reflect those payments.\textsuperscript{189}

2. Remedial Expenses Incurred as a PRP

If a former landowner is obligated to pay the remediation expenses of other PRPs, it is likely that the expenses will be treated in the same manner as expenses incurred by any other off-site generator.\textsuperscript{190} Certainly, there is no long-term benefit to a particular capital asset. If the liability is not incurred or retained as part of the sale of the property, it need not require treatment as a capital loss associated with the transaction.

\textsuperscript{188} Not all prior owners of land are potentially liable under CERCLA. Prior owners are liable under CERCLA only if they owned the land "at the time of disposal." The scope of this liability is somewhat uncertain, see supra discussion in note 17, but it is not uncommon for sellers to agree to indemnify buyers for preexisting contamination even if the seller would otherwise be liable after sale.

\textsuperscript{189} See Arrowsmith v. Commissioner, 344 U.S. 6 (1952), Bradford v. Commissioner, 233 F.2d 935 (6th Cir. 1956); Fox & Solomon, supra note 2.

\textsuperscript{190} See infra text accompanying note 196.
C. Remedial Expenses Incurred by Off-Site Generators

A business may incur environmental remediation expenses under CERCLA or comparable state laws to cleanup property to which it sent its waste. In such cases, it can be argued that these costs are business expenses deductible at the time of "economic performance." Payments for remediation of property not owned by the taxpayer does not result in any long-term benefit to a particular asset of the taxpayer. Other benefits identified in the TAMs, such as reduced long term maintenance, increased marketability or reduced tort liability, are also not clearly present.

There are, however, arguments suggesting that all or part of the off-site expenses should be treated as capital expenses in the year economic performance occurs. First, the IRS could argue that the generator receives a long-term benefit by avoiding additional liability to the government and private parties, thereby increasing the marketability and value of a company. This argument is substantially stronger if the off-site generator enters into a settlement agreement in which it receives contribution protection from suits by third-parties and a covenant not to sue by the government. In such a case it is even clearer that payments made result in some long-term benefit.

If the IRS did wish to pursue that argument, there still remains the fact that there is no specific asset against which to capitalize the expenses. Yet taxpayers may be required to capitalize expenses even when there is no underlying tangible asset to which the expenses can be applied. This is in its most frightening form since the Court held no specific, tangible asset need be identified in order to classify an expenditure as a capital expense. Thus, it is possible that generators could be required to capitalize remediation expenses but not be allowed to recover those expenses through amortization or depreciation.

191. See supra note 47 and accompanying text.
192. See supra part IV.A.1.
196. Id. at 86–87.
197. It is possible, but not certain, that the provisions of I.R.C. § 197 would allow
Additionally, even if the off-site expenses were generally viewed as ordinary expenses, there is some question as to whether that portion of the payment made to construct permanent equipment or improvements should be treated as capital expenses. In Revenue Ruling 94-38, the IRS determined that such equipment must be capitalized, though other expenses could be deducted as ordinary income.

This creates obvious problems. Parties who have incurred costs in settling CERCLA liability must have information about the ultimate use of those funds to determine proper treatment of their expenses. Presumably the taxpayer must capitalize that portion of its remediation expenses that reflect the percentage of cleanup expenses devoted to construction of permanent improvements. Although payment to an approved qualified settlement fund may ensure that economic performance has occurred, payment to such an account does not determine whether the expense should be treated as ordinary or capital expenses.

VI. RECOMMENDATIONS FOR REFORM

It is obvious that the issue of deductibility of remediation expenses remains uncertain. It is almost impossible to make a rational assessment of the tax classification of remediation expenses. The same expenses incurred by different parties may have different tax treatment; expenses incurred as a result of different obligations may have different tax treatment; and the tax treatment may vary depending on the type of cleanup technology that is selected.

This situation creates practical and policy problems. First, the current state of the law makes it virtually impossible to make reasonable determinations about the tax treatment of most common remediation expenses, and the rulings of the IRS and the courts have not provided a consistent basis on which to resolve the issue. Part of the problem lies in the basic elements of tax analysis. Classification of capital and ordinary expenses is inherently difficult,
and many expenses can legitimately be analyzed in different ways to reach conflicting results as seen in *Plainfield-Union* and *Wolfsen*.

Second, the general principles and policies that normally provide guidance in drawing the necessary distinctions simply may not be appropriate in determining the classification of remediation expenses. We may be asking the wrong questions if the issue boils down to whether cleaning up dirt is more like a repair or improvement. For example, payments by a former owner to remediate property may be deductible if imposed through CERCLA but capitalized if imposed through an indemnification agreement. Cleanup by a taxpayer that allows it to continue use of its property for industrial purposes are more likely to be deductible than cleanups to levels that allow future use as residential property. The inquiry into such subtle distinctions promotes uncertainty, increases the costs of analyzing and complying with tax requirements, and ultimately benefits no one.

Third, the IRS’s approach of issuing piecemeal rulings and TAMs is making a bad situation worse. The TAMs and Revenue Rulings are inconsistent and the strained logic that they employ may have the effect of distorting the law in other areas.

Fourth, the tax treatment of cleanup expenses may perversely influence the types of remediation that are undertaken. Revenue Ruling 94-38,201 for example, holds that, in some cases, expenses for permanent improvements such as pumps and wells must be capitalized whereas remediation expenses that do not involve such construction may be deducted as ordinary expenses. Such a ruling might give tax advantages to incineration or off-site disposal of wastes where on-site “pump and treat” or construction and maintenance of impermeable covers may be preferable. Typically, selection of an appropriate remedial plan involves balancing a variety of technical and environmental facts; it seems inappropriate to have tax consequences influence the decision.

Finally, tax rules may actually discourage remediation if, for example, the plan of rehabilitation doctrine were to penalize landowners that remediate property immediately before or after a sale.

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It is time to adopt a clear and consistent rule that resolves the tax treatment of remediation expenses. Such a rule should ideally be easy to apply, consistent in its treatment of remediation expenses, generally consistent with existing tax law on deductions and, at a minimum, eliminate tax considerations from selection of remediation objectives and techniques. A rule that promoted environmentally responsible efforts should also be a national objective.

Most of these objectives can be attained by adoption of a relatively simple approach to tax treatment of remediation expenses. 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 a provision 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.

In addition to a general standard of compliance with federal and state environmental laws, such a provision should specifically provide that remediation expenses are deductible if these costs:

1. would be recoverable under section 107(a)(4)(B) of CERCLA,
2. are incurred to comply with corrective action obligations under section 3004(u), 3008(h) of RCRA,
3. are incurred to comply with the corrective action obligations applicable to Underground Storage Tanks under section 9003 of RCRA, or
4. are incurred for remediation of petroleum, hazardous substances or hazardous wastes under state laws comparable to CERCLA or RCRA.

Expenses that do not meet these criteria would be judged under the general approach currently being developed by the IRS. Most re-

202. Several industry and tax groups have submitted comments to the IRS on this issue that, not surprisingly, suggest that most hazardous waste cleanup costs should be immediately deductible. See Comments of the Tax Executives Institute, Inc. On the Proper Income Tax Treatment of Environmental Remediation Expenditures Submitted to the Internal Revenue Service, Tax Notes Today (June 23, 1993); Comments of Coopers & Lybrand, Tax Notes Today (June 22, 1993).
mediation expenses that are incurred in an environmentally appropriate manner would, however, qualify for treatment as ordinary expenses.

The advantages of such an approach are straightforward:

(1) This approach would provide certainty and consistency to the tax treatment of remediation expenses. The rule would adopt by reference an established body of law that would determine whether an expense is deductible. If an expense for remediation of a hazardous substance is incurred in a manner that is consistent with the national contingency plan under CERCLA, it would be deductible. If a party incurred costs pursuant to a corrective action order it would be deductible.

(2) Selection of a cleanup standard and technique would not be influenced by tax considerations. The tax treatment of expenses for off-site disposal of wastes would be the same as for on-site treatment and containment. Decisions would be made exclusively with regard to the requirements of applicable environmental statutes.

(3) The tax treatment of comparable remediation expenses would be the same regardless of who incurred the costs or the circumstances in which they incurred the costs. Thus, remediation expenses of an off-site generator or a current owner of property would be treated the same for tax purposes. This approach would eliminate possible distinctions in tax treatment between payments made under indemnification agreements as opposed to payments made following CERCLA contribution or cost recovery actions. It would also eliminate possible different treatment of cleanup expenses that might be characterized as part of a plan of rehabilitation.

Additionally, the Emerging Issues Task Force ("EITF") of the Financial Accounting Standards Board had previously issued recommendations that provided for the deduction of most remediation costs. See Capitalization of Costs to Treat Environmental Contamination, EITF Bulletin 90-8 (Emerging Issues Task Force, Fin. Accounting Standards Bd., May 31, 1990); Accounting for the Cost of Asbestos Removal, EITF Bulletin No. 89-13 (Oct. 26, 1989). EITF Bulletin 90-8, for example, recommends that environmental contamination treatment costs should be treated as ordinary expense items unless (1) the costs extend the life, increase the capacity, or improve the safety or efficiency of property owned by the company, (2) the costs mitigate or prevent environmental contamination that has yet to occur and that otherwise may result from future operations or activities or (3) the costs are incurred in preparation for the sale of property currently held for sale.
(4) Taxpayers would have an incentive to undertake remediation in an environmentally appropriate manner in order to ensure that the costs will be treated as ordinary expenses.

(5) Comprehensive treatment of this issue through regulation or amendment could avoid the IRS’s current approach of attempting to address the unique issues associated with environmental remediation by reference to existing regulations and analysis that is simply inappropriate.

The disadvantages of the approach are also straightforward:

(1) This approach allows immediate deduction of certain expenses that would be treated as capital expenditures under existing IRS rulings.\textsuperscript{203} The immediate deduction of these expenses would reduce the amount of tax revenue received by the government. As a practical matter, such a rule would probably have little actual impact on revenues. Given the current state of uncertainty and vacillations by the IRS, most taxpayers may be confused, but they are also probably deducting most remediation expenses.\textsuperscript{204} The primary impact would be from deduction of expenses for permanent equipment that is probably now being amortized by most taxpayers.

(2) The rule is not completely certain and consistent. There is considerable confusion, for example, about the elements necessary to ensure that a cleanup of hazardous substances is consistent with the NCP.

(3) It may require the IRS to determine whether a cleanup is consistent with environmental requirements before deciding whether an expense is deductible.

(4) It may also require the IRS to determine which State laws are comparable to CERCLA and RCRA. Although this is a concern, the IRS in other contexts is required to assess whether taxpayer expenses satisfy other legal requirements. Additionally, under the current approach, the IRS needs to evaluate existing environmental requirements if only to ascertain whether a remediation adapts property to a new use.

\textsuperscript{203} For example, the groundwater equipment that must be capitalized under Revenue Ruling 94-38, 1994-1 C.B. 35, would be deductible under this proposed approach.

\textsuperscript{204} See Comments of the Tax Executives Institute, supra note 201.
(5) The approach does not resolve all issues relating to environmental expenses. The asbestos TAMs, for example, involved expenses that were probably not covered by the proposal. The tax treatment of a vast amount of expenses would be covered by the proposal, and any expenses not addressed by the proposal would simply be analyzed under the same approach that is currently used.

Questions might exist as to the authority of the IRS to adopt such a regulation. Although the IRS has broad rulemaking authority to adopt necessary regulations, there would certainly be some question as to whether such a generic regulation is consistent with the Code. Section 162(a), however, authorizes the deduction of "ordinary and necessary business expenses." Given the inherent ambiguities in the classification of remediation expenses and the apparent willingness of the IRS to conclude that remediation of property has limited long-term benefits to the taxpayer, such a rule is justifiable. Although not free from doubt, such a rule could be seen as promoting a fundamental objective of the Code—matching tax treatment of expenses to the year in which the benefit occurs.

In fact there may be only two objections by the IRS to the adoption of such a regulation. First, to the extent that the regulation would authorize the immediate deduction of physical equipment with useful lives that extend beyond the taxable year, the rule might be seen as inconsistent with § 263A. However, it seems at best ambiguous as to whether construction of physical equipment as part of a remediation program necessarily constitutes "production" of property in a trade or business.

Second, the rule gives special tax treatment to expenses incurred in compliance with certain environmental statutes. Since the

205. I.R.C. § 7805 (1994) authorizes the IRS to "prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue."


209. At worst, the IRS could authorize deduction of all other expenses and require amortization of physical equipment.
IRS should be making tax, and not environmental policy, this distinction may seem anomalous. The effect of the regulation, however, would be to create a “safe harbor” for those taxpayers who incur expenses in compliance with the statutes. Other taxpayers would simply be required to justify deductions under traditional tax theories. Given the advantages of certainty in the tax treatment of these expenses, the regulation seems justifiable independent of any environmental advantages.

Nothing, of course, prevents Congress from amending the Internal Revenue Code to adopt such a provision. Certainly the Code is littered with special provisions, including, for example, section 468, that gives special treatment to payments to reserve funds for remediation by solid waste management facilities.210

Consistency, certainty and appropriate environmental remediation seem ample justifications for a clarifying amendment.

Evaluation of this proposal ultimately requires a comparison with the status quo. Given the problems with the current approach, the proposal with its limitations may be preferable.

VII. Conclusion

Enormous amounts of money are spent annually in the United States on remediation of environmental contamination. Despite the magnitude of these expenses, the IRS has not yet been able to develop a consistent and logical approach for determining whether the expenses are ordinary or capital expenditures. Indeed, there are inherent problems in classifying environmental remediation expenses under traditional approaches that distinguish ordinary from capital expenses. In addition, the IRS has advanced differing and inconsistent approaches in various rulings it has issued. The uncertain state of the law is producing both bad tax and bad environmental policy. It is time for the IRS or Congress to resolve this problem by adopting provisions that ensure consistent, simple and environmentally beneficial treatment of remediation expenses.

Author's Note

The IRS recently revoked and reversed TAM 95-410-05. See 96 Tax Notes Today 13-3 (Jan. 19, 1996). Concluding that the contamination was solely the result of the Taxpayer's activities, the IRS held that Taxpayer's costs were deductible under the logic of Rev. Rul. 94-38. The status of expenditures to clean up pre-existing contamination remains uncertain. See supra part IV.C.