

Who Incurs Environmental Clean-Up Costs - And Why - May Determine Deductibility

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Eric R. Fox

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Eric R. Fox and Michael F. Solomon

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Businesses that "inherit" environmental clean-up liabilities are in a less favorable position to be able to deduct their costs than those originally responsible.

Author: BY ERIC R. FOX AND MICHAEL F. SOLOMON

ERIC R. FOX and MICHAEL F. SOLOMON are partners in the Washington, D.C. law firm of Ivins, Phillips & Barker. Mr. Fox is editor-in-chief of The Journal of International Taxation. Mr. Solomon is a frequent contributor to The Journal.

1. Billions of dollars are likely to be spent in the coming years by American businesses to clean up environmental debris. Given the enormous size of this outlay, business clearly has a large stake in knowing to what extent such costs are deductible on the Federal, state, and local levels. There are two aspects to this issue. Are environmental clean-up costs deductible when the damage is attributable to the entity required to incur the clean-up expenses?
2. If the clean-up costs are otherwise deductible, is the deduction lost if ownership of the entity required to incur the cost has changed hands, or if its assets have been sold or transferred to a new owner? ¹

DEDUCTIBILITY OF EXPENSES

Generally, under Section 263(a)(1), no deduction is allowed for amounts paid for permanent improvements or betterments made to increase the value of property. ² The principal question here is whether that section is applicable to the cost of environmental clean-up projects. ³

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Reg. 1.263(a)-1(a) states, in part, that "no deduction shall be allowed for ... (1)[a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate, or ... (2) [a]ny amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made in the form of a deduction for depreciation, amortization, or depletion." Reg. 1.263(a)-1(b) provides that in general, "the amounts referred to in paragraph (a) of this section include 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 within the meaning of subparagraphs (1) and (2) of this paragraph. See section 162 and Reg. 1.162-4...."

This Regulation is at best ambiguous with respect to environmental clean-up costs. Paragraph (a)(2) is certainly not applicable, because no previous deduction will have been allowed with respect to the deterioration of affected land. On the other hand, the Service might well contend that the cost of the projects represents a permanent improvement or betterment made to increase the value of property within the meaning of paragraph (a)(1). The taxpayer's task here will be to convince a court that the projects are for incidental repairs and maintenance of property within the meaning of Section 162 and Reg. 1.162-4 (the reciprocal of Reg. 1.263(a)-1), rather than an addition to value or a substantial prolonging of life under Reg. 1.263(a)-1(b). Clearly, where there is no intent to adapt the land to a different use, clause (2) of Reg. 1.263(a)-1(b) will not be applicable.

The mere fact that land may be more valuable once clean-up has been completed, in the sense that it might not otherwise be usable, is certainly not determinative. If that were the case, most repairs would be nondeductible because something that works is invariably more valuable than something that does not. The test therefore must really be whether the asset on which the work is performed is more valuable after the work than it was before, assuming the asset was already in working condition. Thus, for example, replacing a building's broken windows is a repair, while removing a building's perfectly good single-pane windows and replacing them with double-pane thermal windows is a capital improvement.

Similarly, the fact that after a clean-up project has been completed, the land will be usable for a longer period than if it had not been cleaned up does not automatically mean the project costs are capital in nature. Clearly, an asset that is functional has a longer life than one that cannot be used. Again, this suggests that the before-and-after comparison should be made on the assumption that the item in

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question was in reasonably good working order before the work in question was performed. On this basis, environmental clean-up expenses are deductible repairs.

Plainfield-Union Water Co., 39 TC 333 *Plainfield-Union Water Co.* , articulates very clearly the standards suggested above. In this case, the taxpayer, a water company, cleaned some 7,400 feet of pipe and lined it with cement. This restored the pipe's original water-carrying capacity, which had been reduced by a process known as tuberculation (induced by the addition of a new supply of acidic water to the taxpayer's previously asphalt-lined pipes). The taxpayer capitalized \$5,000, representing the difference between the cost of new cement-lined pipe and new tarlined pipe. It deducted the remaining \$28,000 of the repair and lining costs, which the Service disallowed and capitalized. The Tax Court held for the water company, stating that an expenditure that returns property to the state it was in before the situation prompting the expenditure arose, and that does not make the relevant property more valuable, more useful, or longer-lived, is usually a deductible repair. A capital expenditure, in contrast, is generally one that results in a more permanent increment in the longevity, utility, or worth of the property. The court noted that any properly performed repair adds value as compared with the situation existing immediately prior to that repair. The court concluded, however, that 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. Comparing the period before tuberculation and after expenditure, the Tax Court concluded that the useful life of the water main was not increased by the cleaning and lining and that neither the strength nor the capacity of the main was enhanced.

Slow deterioration. One line of argument taken by the Service in *Plainfield-Union* was that the cleaning and lining costs had to be capitalized because the expenditures were incurred to remedy a slowly evolving expected deterioration, a situation that certainly will be present in most environmental clean-up cases. The court emphatically rejected this contention. Citing several cases,⁴ the court specifically noted that a deduction is allowable even though the damage is not caused by a relatively sudden, unexpected, or unusual external factor.

In another similar case, *Midland Empire Packing Co.*, 14 TC 635 *Midland Empire Packing Co.* , the taxpayer operated a meat packing plant in Montana, adjacent to the Yellowstone River. Oil from an up-river refinery began seeping into *Midland Empire's* basement. Federal meat inspectors determined that the oil and its fumes represented a fire hazard and ordered *Midland Empire* to oilproof its basement

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or shut down the plant. As a result, the company spent \$5,000 to add concrete lining to the basement walls and floor, which it deducted. The IRS contended the expenditure was for a capital improvement.

The court approved the deduction, noting that the basement was not enlarged by the work and that the oil-proofing did not make it more desirable for the purpose for which the basement had been used through the years prior to the occurrence of the oil seepage. The expenditure did not add to the value or prolong the expected life of the property over what they were before the damage occurred, and the repairs merely served to keep the property in an operating condition over its probable useful life for the purpose for which it was used.

Not ordinary. As an alternative to arguing against deductibility on the grounds that the cost of the walls should have been capitalized, the IRS argued that while the expense may have been necessary, it was not ordinary in the taxpayer's particular business. Such an argument might again be made in connection with once-in-a-lifetime environmental clean-up expenses. This, too, the court found unpersuasive, and, quoting *Welch v. Helvering*, 12 AFTR 1456, 290 US 111, 78 L Ed 212, 3 USTC 1164 *Welch v. Helvering*, concluded that ""ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often... [T]he expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack.""

Three-factor test. *American Bemberg Corp.*, 10 TC 361 38 AFTR 758, 177 F2d 200, 49-2 USTC 9460 *American Bemberg Corp. aff'd*, is a particularly helpful case because it involves a very substantial repair expense deduction. *American Bemberg* manufactured rayon in a plant in Tennessee. The plant turned out to be situated on a geological fault that caused cave-ins of portions of the plant. To rectify this situation, the taxpayer incurred over \$900,000 of expense in 1941 and 1942 to fill in underground cavities with grout and cement. The Service disallowed the taxpayer's deduction, claiming the expense was incurred for permanent improvements or to restore property for which an allowance had been made.

The Tax Court found it appropriate to consider three factors in determining whether the costs were deductible or capital in nature-the purpose of the work done, the physical nature of the work, and the effect of the work for which the expenditures were made.

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1. The purpose of the work. The court noted that the expenditures were intended to avert a plant-wide disaster, and to avoid forced abandonment of the plant. The purpose was not to improve, better, extend, or increase the original plant, or to prolong its original useful life. Its continued operation was endangered; the purpose of the expenditures was to enable the taxpayer to continue the plant in operation not on any new or better scale, but on the same scale and, so far as possible, as efficiently as it had operated before. The purpose was not to rebuild or replace the plant in whole or in part, but to keep the same plant as it was and where it was.
2. The physical nature of the work. The court concluded that the drilling and grouting was not a work of construction, or the creating of anything new.
3. The effect of the work. The accomplishment of what was done forestalled imminent disaster and gave the taxpayer some assurance that major cave-ins would not occur in the future. On this basis, the court concluded that the expenditures fell into the "expense" class.

To the extent work involved in environmental clean-up projects appears to be analogous to that undertaken by American Bemberg-in that its purpose is merely to allow the taxpayer to continue the plant in operation not on any new or better scale, but on the same scale, its physical nature is not a work of construction, or the creating of anything new, and its effect is to forestall having to abandon the land that is being environmentally purified-the cost should be deductible.

Types of projects. While there is certainly favorable case law with respect to environmental clean-up projects, each taxpayer's chances of success in sustaining a deduction for environmental clean-up expenses will depend on the precise nature of each project involved. Deductibility is likely for projects involving testing land for the extent of pollution, excavating and hauling earth, and removing pollutants from the earth. At the other end of the spectrum would be projects involving the extensive installation of new equipment such as pipes, storage tanks, or emission-control equipment. Notwithstanding that these types of projects are designed only to prevent pollution rather than to enable a business to operate in a more efficient manner, the costs almost certainly would have to be capitalized for tax purposes as well as financial accounting purposes. For example, in *Woolrich Woolen Mills*, 7 AFTR 2d 1196, 289 F2d 444, 61-1 USTC 9397 *Woolrich Woolen Mills*, state law required the taxpayer to install a filtration plant to remove pollutants from water used in the manufacturing process prior to its discharge into public waters. The Third Circuit held this was a capital expense. The cost of lining ditches, however, to prevent seepage of pollution probably should qualify as a deductible expense under *Midland Empire*, and any expenditures incurred to close portions of any plant to future use should be deductible under Section 165 as a loss.

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Cost of clean-up. The favorable cases above have been cited with approval in several later Tax Court decisions, ⁵ including *R.R. Hensler, Inc.*, 73 TC 168 *R.R. Hensler, Inc.* . In *Hensler*, which is not directly on point, the court stated that the size of the amounts should not be controlling. This may become the primary issue in most environmental clean-up cases.

The amounts to be expended by most companies in connection with environmental clean-up projects are likely to be significantly more than "large," particularly for chemical plants, oil refineries, and any business activity heavily dependent on the use of chemicals or petroleum products. The IRS can be expected to argue that under no circumstances can expenditures of the magnitude expected to be involved in these cases be incidental repairs, regardless of the fact that the costs of a much smaller scale project might so qualify. See, for example, *Wolfsen Land & Cattle Co.*, 72 TC 1 *Wolfsen Land & Cattle Co.* , a somewhat anomalous case in that the IRS argued that sizable expenditures to restore an irrigation system to its original condition were deductible, whereas the taxpayer wanted the amounts in issue to be capitalized and depreciated. The Service would no doubt try to rely on *Wolfsen*, even though it lost that case. *Wolfsen*, however, can be distinguished on the grounds that the restoration project was found to create a separate wasting asset of independent value because the same activity had to be repeated at regular and determinable intervals, namely five, ten, or 30 years, depending on the portion of the irrigation system involved. ⁶

Disputes likely. Notwithstanding what is clearly favorable case law, both the magnitude and the novelty of the issue under consideration make controversy a distinct likelihood. If there is one common thread in all of the cases, however, it is the determination by courts generally that costs incurred to place property back in the state that existed before the occurrence of the event that necessitated the expenditure are ordinarily deductible expenses. While it is possible to conceive of factual situations where environmental clean-up costs accomplish this result but also produce other benefits, ⁷ some significant portion of these costs must nevertheless fall within the general rule of deductibility.

POST-ACQUISITION CLEAN-UP EXPENSES

Assuming, as a general rule, that environmental clean-up costs are deductible, a company acquiring a business with contingent liabilities for such expenses nonetheless must be extremely concerned about deductibility. As a general rule, the payment of contingent liabilities assumed in connection with a purchase of assets does not give rise to a deductible expense, but must be capitalized as part of the cost of the acquired assets. Thus, in *David R. Webb Co.*, 77 TC 1134 52 AFTR 2d 83-5104, 708 F2d 1254, 4 EBC 1769, 83-1 USTC 9384 *David R. Webb Co.aff'd* , the court stated that such payments of the

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obligation of a previous owner are capital expenses when paid, regardless of how the previous owner would have been able to treat them.

To the extent any taxpayer assumes any other company's contingent liabilities relating to environmental clean-up costs, there would be a substantial risk that these liabilities would not generate deductible expenses but would be treated as a cost of the assets acquired, recoverable only through, and to the extent of, allowable depreciation or amortization. The basis of such assets would be adjusted as the environmental expenses were incurred. Depending on the magnitude of these expenses, and given the mechanical application of Section 1060, a substantial portion of this cost might be attributable to non-amortizable goodwill.⁸

The risk of losing a deduction for environmental clean-up expenses is not limited to the case of purchased assets. Companies incorporating a sole proprietorship or forming joint ventures also must face this risk because, in the Section 351 context, the Tax Court has held in *Gaines*, TC Memo 1982-731, PH TCM 82731, 45 CCH TCM 363 *Gaines* (a decision based squarely on *Webb*), that a corporation is not entitled to deduct the otherwise deductible expenses assumed from a predecessor partnership.⁹

While companies acquiring stock (without making a Section 338 election) will generally not be affected by *Webb* or *Gaines*, the potential enormity of environmental clean-up expenses requires such taxpayers to look closely at the Section 382 rules and consolidated return Regulations relating to the deductibility of built-in losses.¹⁰

Indemnification clauses. Finally, there are significant tax issues presented by indemnification clauses in contracts involving the sale of stock or assets, where such indemnification is for clean-up costs necessitated by environmental damage incurred up to the time of sale. Generally, payments made under such clauses relate back to the original sales transaction. Therefore, a payment made by an indemnifying party to the indemnitee would be a reduction in the original purchase price paid by the purchasing party. In an asset transaction, the purchasing party would reduce the basis of the assets purchased, and in a stock transaction the purchasing party would reduce its stock basis.¹¹

The real tax issue presented by indemnification clauses of this type exists with respect to the actual payment of the clean-up expenses. In an asset transaction, as noted previously, payments satisfying an assumed liability are nondeductible capital expenses. Thus, the purchasing entity can increase its asset basis by its performance of the obligations assumed, but will have such increase in basis offset by and to the extent of any indemnification payment received. Neither party obtains a deduction for the expenses

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incurred in the clean-up operation, and the only tax effect of the clean-up payments is the reduction in gain or increased loss realized by the selling party by reason of its indemnification payment.¹²

In a stock sale (assuming that no Section 338 election is made), however, the tax effects may be more dramatic. Assuming the indemnification payment is made between the purchasing and selling parties, each such party would adjust the gain or loss and basis of the stock sold and acquired. The subsidiary incurring the clean-up expense would continue to be able to deduct its expense. Thus, the expense deduction is effectively given tax effect, and the stock transaction is adjusted between buyer and seller to offset the buyer's reduced purchase price by the seller's reduced gain (or increased loss). In such a case, of course, the seller should clearly provide that any indemnity payment will be on a basis that reflects the tax benefit received by the transferred subsidiary. Where the indemnification payment is between the selling shareholder and the transferred subsidiary, the tax rules are less clear, but arguably should produce a result comparable to the situation where the payment is between buyer and seller. Of course, there are other issues that affect the consequences of making these indemnification payments (i.e., the timing of the increase and decrease in basis; the effects of Section 461(h) on such election), and these issues must be addressed when negotiating and agreeing to any contract provisions involving indemnifications of this type.

CONCLUSION

Environmental clean-up requirements can be expected to generate billions of dollars of business expenses in coming years. Given the potential revenue loss involved, litigation may be necessary in certain situations. Under current law, taxpayers can feel reasonably assured that a substantial portion of their environmental clean-up costs are deductible. Companies that have acquired assets or the stock of corporations subject to environmental clean-up liabilities are in a more precarious position, and no company should make an acquisition without thoroughly exploring the treatment of environmental clean-up liabilities.

1

This article does not address the treatment of expenses incurred to prevent future problems, the implication of the economic performance standards for environmental clean-up situations (such as strip-mining reclamation), or specifically legislated rules (such as nuclear decommissioning expenses in Section 468A).

2

The fact that no separate asset is created does not assure deductibility. It is still necessary to consider

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whether the expenditure results in a "not insignificant future benefit that is more than merely incidental." *National Starch & Chemical Corp.*, 66 AFTR 2d 90-5844, 918 F2d 426, 90-2 USTC 50571 *cert. granted*. See generally Schewe, Lipton and Freeman, "How to Establish Deductions for Friendly Takeover Costs by Limiting *National Starch*," .

3

The uniform capitalization rules of Section 263A do not generally convert an otherwise deductible repair expense into a capital expenditure. See Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at page 510. This article does not address the application of Section 263A to those expenditures that are not repair costs or those that do relate to the manufacture, remanufacture, or production of property.

4

Kansas City Southern Ry. Co., 43 AFTR 1025, 125 Ct Cl 287, 112 F Supp 164, 53-1 USTC 9416 ; *Collingwood*, 20 TC 937 ; *Farmers Creamery Co. of Fredericksburg, Va.*, 14 TC 879 ; and *Buckland*, 35 AFTR 161, 66 F Supp 681, 46-1 USTC 9273 .

5

See, e.g., *Munroe Land Co.*, TC Memo 1966-2, PH TCM 66002, 25 CCH TCM 3 ; *Oberman Mfg. Co.*, 47 TC 471 *acq.*

6

See also *Southern Pacific Transportation Co.*, 75 TC 497.

7

As an example, tanks may be installed to collect future pollutants at the same time that prior pollutants are being extracted from the property. The portion of the clean-up cost attributable to the tanks would be a nondeductible capital expenditure.

8

H.R. 3035, recently introduced by House Ways and Means Chairman Dan Rostenkowski (D-Ill.), would allow the cost of these previously unamortized intangibles to be recovered over 14 years.

9

Legislative efforts currently underway, however, are intent on clarifying this position to allow a deduction to the transferee.

10

See, generally, Section 382(h) and Reg. 1.1502-15.

11

Arrowsmith, 42 AFTR 649, 344 US 6, 97 L Ed 6, 52-2 USTC 9527 ; *Bradford*, 49 AFTR 1358, 233 F2d

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935, 56-1 USTC 9552 ; Freedom Newspapers, Inc., TC Memo 1977-428, PH TCM 77428, 36 CCH TCM 1749 ; Federal Bulk Carriers, 66 TC 283 ; Wener, 24 TC 529 .

12

The selling party may be able to preserve a deduction for the environmental clean-up costs if it retains the liability to perform the clean-up, rather than transferring this liability to the purchasing party together with indemnification. See, e.g., Rev. Rul. 67-12, 1967-1 CB 29.

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