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Federal Tax Treatment of Environmental Clean-up Costs: An Ever Changing Doctrine

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FEDERAL TAX TREATMENT OF ENVIRONMENTAL CLEAN-UP COSTS: AN EVER CHANGING DOCTRINE

by Joan M. Swartz[1]

I. INTRODUCTION

Over the past several decades, entities have been faced with an increasing myriad of federal and state environmental laws and regulations. It has become routine for these entities, small and large, to deal with environmental issues in the regular course of day-to-day operations. Managing environmental liabilities involves complicated issues regarding the necessity and scope of clean-up which can mean expenditures of hundreds of thousands of dollars. In the many instances where extensive study and/or clean-up is necessary, entities are searching for ways to reduce or mitigate the impact of clean-up costs. Some taxpayers have attempted to deduct environmental costs for federal income tax purposes to reduce the effect of these costs on the overall profitability of the business. This article analyses the federal income tax treatment of environmental-related costs.

II. RECENT DEVELOPMENTS

In recent years, the tax treatment of expenditures incurred to clean-up environmental contamination has become a subject of public debate. Initially, the Internal Revenue Service[2] adopted a restrictive approach to analyzing whether costs incurred for various environmental clean-up activities would be deductible for federal income tax purposes under Code Section 162. The Service generally required taxpayers to capitalize environmental costs under Code Section 162 based on the rationale that the clean-ups produced long-term benefits, disqualifying an immediate tax benefit to the taxpayer.[3]

More recently, however, the Service has shown a greater willingness to allow current deductions under certain circumstances. For example, in *Rev. Rul.* 94-38, the Service permitted a company to deduct the costs to remediate soil at its manufacturing plant which had become contaminated as a result of the company's own operations on-site.[4] The Service allowed the deductions as ordinary and necessary expenses,[5] because the company acquired the property in a clean condition and contaminated the property in the course of its business. With *Rev. Rul.* 94-38, the Service implied an adoption of a restoration principle. Under this principle, environmental costs which merely "restore" property to prior value, rather than enhancing it, are deductible as ordinary and necessary business expenses.[6]

The Service's application of the restoration principal since *Rev. Rul.* 94-38 has been less than consistent. This has caused both controversy and confusion among the taxpayers and their advisors. However, just recently, the Service issued *Notice* 97-7[7] providing a procedure whereby a taxpayer can submit a request for written guidance by the Service on the federal income tax treatment of environmental costs incurred by the taxpayer. The ruling procedure is designed by the Service to facilitate the resolution of the issue of current deductibility or capitalization of environmental costs over a period of years including future years in situations involving one environmental clean-up transaction. This procedure may be invoked during a two-year trial period beginning on the date that the proposed revenue procedure is finalized.[8] *Notice* 97-7, and the to be issued revenue procedure, is a breakthrough which will provide certainty on the tax treatment environmental clean-up costs under Sections 162 and 263 of the Internal Revenue Code (the "Code"). The *Notice* indicates that the ruling request may cover the treatment of costs incurred over a period of years including future and prior years (whether or not under examination).

Requests for guidance may involve continuing transactions. By continuing transactions, the Service means a series of events or transactions making up one environmental clean-up occurring over prior and future taxable

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[2] Referred to hereinafter as the "Service".

[3] *See, e.g.* TAM 9315004, (12/17/92).

[4] Rev. Rul. 94-38, 1994-1 C.B. 35 seems to signify a shift in the position of the Service.

[5] Section 162(a); Regs. §1.162-4 allows taxpayers to currently deduct the cost of incidental repairs that neither materially add to the value of the property nor appreciably prolong the life of the property.

[6] Rev. Rul. 94-38, 1994-1 C.B. 35.

[7] Notice 97-7, 1997-1 I.R.B. 8.

[8] The procedure has not yet been finalized. An estimate by the Service is that the procedure will be final by the end of Summer 1997. In the meantime, the Service has issued Announcement 97-22, 1997-12 I.R.B. 47 (3/24/97) which allows any interested taxpayer the opportunity to make a presubmission request regarding a transaction and its deductibility.

years. Taxpayers may request a letter ruling that will cover all tax years in which costs are incurred under the transaction, even if they include years for which a return has been filed.[9] Special requirements apply to taxpayers under examination or before an appeals office. Environmental costs for purposes of the ruling request procedure include any costs associated with the assessment, mitigation, or remediation of environmental hazards on the taxpayer's property or the property of another. Taxpayers may not request guidance under this procedure if: (1) the entire environmental clean-up transaction is completed, and the time for filing returns with extensions for all years covering the transaction has expired; (2) the entire environmental clean-up transaction is a proposed transaction[10]; and (3) the identical environmental clean-up issue is in the taxpayer's return for an earlier period and the issue is currently in litigation in a case involving the taxpayer or related taxpayer.

Notice 97-7 is clearly an effort by the Service to clarify the confusion caused by its prior rulings on the issue of deductibility of environmental clean-up costs. In fact, *Notice* 97-7 provides that prior to issuing a letter ruling, the Service will have the proposed letter ruling reviewed by a member of its environmental clean-up costs specialization team. The review process should result in more consistent rulings.

III. GENERAL RULE

A. Ordinary and Necessary Repair vs. Long-term Improvement

Although the debate over the tax treatment of environmental remediation costs has only developed recently, it involves the long-standing tax accounting problem of whether an expenditure may be currently deducted as a repair, or alternatively must be capitalized as an improvement. Generally Code Section 162(a)[11] allows a taxpayer to deduct all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. By contrast, Code Section 263[12] requires that expenditures that materially add to the value of the property or appreciably prolong its useful life must be capitalized. Code Section 263(a)(1) provides that no deduction is allowed for capital improvements to property.[13] In addition, Code Section 263(a)(2) provides that no deduction is allowed for any amount expended in restoring property or making good the exhaustion of property for which an allowance is or has been made.[14]

Generally, an expenditure will be classified as a capital improvement rather than a currently deductible repair if it meets one of the three tests: (1) the expenditure increases the useful life of the property; (2) the expenditure adapts the property to a new or more productive use; or (3) the expenditure materially increases the value of the property.[15]

There are several tests for determining whether an expenditure is a currently deductible expense or capital expenditure, but the basic difference is one of degree, not kind, and thus a case-by-case analysis is required.[16] The reader should note that deductible expense treatment is the exception to the general rule of capitalization.[17]

B. Application of the General Rule

Rev. Rul. 94-38[18] provides a detailed analysis which is useful in understanding how Sections 162 and 263 relate to the facts in a particular case and affect the deductibility of environmental costs. *Rev. Rul.* 94-38 involved a corporation owning and operating a manufacturing plant. The soil and groundwater had been contaminated by the corporation's own disposal of hazardous waste. The corporation sought to remediate the site and establish a system for continued monitoring of groundwater for traces of hazardous chemicals. This action was necessary to comply with then applicable federal, state and local environmental requirements. To implement the clean-up, the company excavated the contaminated soil, transported it to a waste disposal facility and back-filled the excavated area with clean soil. Soil remediation activities took over two years to complete. The corporation also constructed a groundwater treatment facility including wells, pipes, pumps and other equipment to extract, treat and monitor the contaminated groundwater. The construction of the groundwater treatment and monitoring facility began at about the same time as the soil remediation, but was planned to remain in operation for approximately 12 years to insure the elimination of hazardous chemicals.

The company argued that the overall effect of the soil remediation and groundwater treatment program was to

[9] Ordinarily, the Service limits letter rulings on income tax issues only to prospective transactions or completed transactions if the request is made before the return is filed. *But see* Rev. Proc. 97-1, 1997-1 I.R.B. 11 (1/6/97) which provides a procedure for review of proposed transactions in this situation.

[10] Rev. Proc. 97-1, 1997-1 I.R.B. 11 (1/6/97) is applicable, a letter ruling is available under certain conditions set out therein.

[11] §162(a); Regs. §1.162-4.

[12] §263(a); Regs. §263(a)(1) states no deduction shall be allowed for any amount paid out for new buildings or for the permanent improvement or betterments made to increase the value of any property.

[13] *Id.*

[14] §263(a); Regs. §163(a)(2).

[15] *See* Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333 (1962), *non-acq.*, 1964-2 C.B. 8.

[16] Welch v. Helvering, 290 U.S. 111 (1933).

[17] *See* INDOPCO Inc. v. Commissioner, 503 U.S. 79 (1992).

[18] 1994-1 C.B. 35.

restore the land to essentially the same physical condition that existed prior to the contamination.[19] Indeed, during and after the remediation and treatment the company continued to operate the plant in the same manner as it did prior to the clean-up, except that all disposal of hazardous chemicals was now in compliance with applicable law.

Based on these facts, the corporation sought to deduct all the costs of remediation as ordinary and necessary repairs. It argued that the appropriate test for determining whether the expenditures increased the value of property is to compare the status of the asset after the expenditure with the status of the asset before the condition arose that necessitated the expenditure.

The Service has acknowledged that even though a taxpayer may incur an expense only once in the life of its business, the expense may qualify as an ordinary and necessary expense if it is helpful in the carrying on of the business, commonly and frequently incurred in the type of business conducted by the taxpayer, and not a capital expenditure.[20]

In determining whether a current deduction or capitalization is the appropriate tax treatment for any particular expenditure, it is important to consider the extent to which the expenditure will produce significant future benefits.[21] Applying this criteria, the Service held in *Rev. Rul.* 94-38 that the groundwater treatment facility constructed by company had a useful life substantially beyond the taxable year in which that treatment facility was constructed. Thus, the cost of constructing the treatment facility was a capital expenditure under Code Section 263.[22] The company therefore required capitalization of both the direct cost of the treatment facility and the allocable share of the indirect costs incurred in constructing the groundwater treatment facility.

In contrast, the Service held that remediation expenditures and on-going groundwater treatment expenditures (i.e. the groundwater treatment expenditures other than the expenditures to construct the treatment facility) merely restored the company's soil and groundwater to the condition before they were contaminated by the manufacturing operation. The Service reasoned that these activities did not produce permanent improvements to the land within the scope of Code Section 263, or otherwise provide a significant future benefit. The Service also reasoned that these activities did not increase the value of or prolong the useful life of the land, nor did they adapt the land to a new or different use. As such, the soil remediation and on-going groundwater treatment expenditures were deemed ordinary and necessary business expenses within the scope of Code Section 162. The Service viewed these expenditures as appropriate and helpful in carrying out the company's business, and commonly required in such business.[23]

C. Future Benefit

One of the essential questions in determining whether an expenditure qualifies for a current deduction or must be capitalized is whether the taxpayer realizes benefits beyond the year in which the expenditure is incurred. This principle was enumerated by the United States Supreme Court in *INDOPCO, Inc. v. Commissioner*.[24] In that case, the high court held that expenses such as investment banking, legal and other costs incurred in connection with a friendly corporate acquisition were required to be capitalized. The Court reasoned that the taxpayer would realize significant benefits beyond the taxable year of the transaction. This case is cited by the Service for the proposition that costs that create future substantial future benefits must be capitalized.[25]

Rev. Rul. 94-38 is a good example of the application of this principle. The Service analyzed the type of costs, and divided them depending upon whether the benefits produced by the expenditure extended beyond the year in which the expense was incurred. For example, in *Rev. Rul.* 94-38 the groundwater treatment facilities were found to have a useful life substantially beyond the taxable year in which constructed. Thus, the costs of construction were deemed capital expenditures under Code Section 263(a).[26] By contrast, the soil remediation expenditures and on-going groundwater treatment expenditures did not produce permanent improvement to the land. The Service deemed the soil remediation and on-going groundwater treatment expenditures as activities which did not result in improvements that increased the value of the property, but merely restored the soil and groundwater to their approximate condition before they were contaminated by the taxpayer's

[19]Rev. Rul. 94-38.

[20]The Service cites the following authorities for its position: *Internal Revenue Service v. Tellier*, 383 U.S. 687 (1966); *Deputy v. duPont*, 308 U.S. 488 (1940); *Welch v. Helvering*, 290 U.S. 111 (1933).

[21]*See INDOPCO*, 503 U.S. at 79.

[22]§263(a); §1.263(a)(1).

[23]Revenue Ruling 94-38 was viewed as modification of Revenue Ruling 88-57, 1988-2 C.B. 36, to the extent it implied that the value test applied by the Tax Court in *Plainfield-Union* cannot be an appropriate test in any case other than one in which there was sudden and unanticipated damage to an asset.

[24]*INDOPCO*, 503 U.S. at 79.

[25]More recent developments indicate the Service may be adopting a more narrow view of *INDOPCO*. *See, Capitalization and Future Benefits: Defining the Scope of INDOPCO, Inc. v. Commissioner*, 36 Tax Management Memo 159 (5/29/95).

[26]Rev. Rul. 94-38.

manufacturing operation.[27]

D. Value, Use, Life Expectancy and Capacity

The underpinnings for *Rev. Rul.* 94-38 are set out in *Plainfield-Union Water Co. v. Commissioner*,[28] it is useful to examine the case in order to understand the Service's reasoning. In *Plainfield-Union*, the taxpayer, a water utility, incurred costs to clean and install cement linings in 600 feet of water pipe. The water main, installed in 1910 with tar lining, had been designed to carry well water. Due to changes in the nature of the use of the water main, cleaning and re-lining was necessary. The Service contended that the expenditures should have been capitalized because they increased the value of the pipe. The Court rejected the Service's contention, explaining that any properly performed repair adds value as compared with the situation existing immediately prior to the repair. The Court upheld the deduction of the expenses, explaining that the proper test was whether the expenditure materially enhanced the value, use, life expectancy, strength or capacity of the asset as compared with the status of the asset "prior to the condition necessitating the expenditure."[29] Other taxpayers have attempted to rely on the reasoning in *Plainfield-Union* to justify current deduction of environmental expenses as ordinary and necessary expense to no avail.[30] For example, in Technical Advice Memorandum 9240004[31] the taxpayer owned a manufacturing plant in which the equipment was insulated with asbestos containing materials. In response to government regulation, the taxpayer removed all asbestos containing materials and replaced them with alternative forms of insulation. The replacement insulation was less thermally efficient than the asbestos containing insulation removed from the site. The taxpayer argued, based on *Plainfield-Union*, that to determine whether the value was increased by the expenditure, the proper comparison was not to the value of the property immediately before the expenditure, but rather to the value of the property before the existence of the condition necessitating the expenditure.

The Service rejected the taxpayer's arguments. The Service stated that by removing the asbestos containing materials from its plant, the taxpayer had increased the value of its property since it was now in compliance with government regulations. Section 263 required the capitalization of any cost associated with permanent improvements or betterments. The Service distinguished a "repair" as something not a permanent cure but only a remedy for immediate consequences,[32] finding that the cost to remove or replace the asbestos containing materials should be capitalized. The Service concentrated on the fact that the asbestos abatement program made the taxpayer's plant more valuable by reducing or eliminating the human health risk posed by asbestos containing insulation. The effect of TAM 9240004 has been to limit the use of *Plainfield-Union* to facts where the expenditure was necessitated by the progressive deterioration of the property.[33]

Another Technical Advice Memorandum issued by the Service in 1994 produced more favorable results for taxpayers regarding asbestos management. In TAM 9411002 the taxpayer engaged in the sale of rental warehouse space. Its warehouse facility consisted of a warehouse building and boiler house containing old heating equipment. In order to secure financing for expansion, the taxpayer was required to abate asbestos from the warehouse and boiler house. The taxpayer removed the boilers and tanks contaminated by asbestos, cleared the boiler house of all other asbestos containing materials, and repaired damaged asbestos insulation in the warehouse. The taxpayer retained an asbestos contractor to encapsulate certain damaged areas and abate the insulation too damaged to be rewrapped. After all asbestos work was completed, the taxpayer converted the boiler room into a garage and office space, and rented the office space to a tenant.[34]

The taxpayer deducted the costs incurred in the asbestos abatement activities in the warehouse and boiler house as ordinary and necessary business expense, relying on *Plainfield-Union* for its position that the removal of asbestos containing materials did not increase the value of the property. The TAM found that the taxpayer's clean-up expenditures increased the value, the use, and the capacity of the property as compared to its original condition because the expenditures permanently eliminated the

[27] *Id.*

[28] 39 T.C. 333.

[29] 39 T.C. at 338.

[30] *See* TAM 9240004, (6/29/92); TAM 9315004, *and* TAM 9411002, (11/19/93).

[31] TAM 9240004.

[32] *See also* Overman Manufacturing Co. v. Commissioner, 47 T.C. 471 (1967), *acq.* 1967-2 C.B. 3 *and* Niagara Mohawk Power Corp. v. United States, 558 F.2d 1379 (Ct. Cl. 1977).

[33] There is a breadth of authority which support this notion: Teitelbaum v. Commissioner, 294 F.2d 541 (7th Cir. 1961), *cert. denied*, 368 U.S. 987 (1962)(cost of converting buildings electrical system from DC to AC to comply with city ordinance must be capitalized); RKO Theatres, Inc. v. United States, 163 F.Supp. 598 (Ct. Cl. 1958)(cost of installing new exit from fire escapes to comply with city regulations must be capitalized); Hotel Sugrave, Inc. v. Commissioner, 21 T.C. 619 (1954)(cost of installing sprinkler system to comply with order of city building department must be capitalized); Deaven v. Commissioner, 6 T.C.M. (CCH) 1344 (1947)(cost of converting from oil heat to coal heat because war time oil conservation laws must be capitalized).

[34] TAM 9411002.

health risk posed by the asbestos; made the property more attractive to potential buyers, investors, lenders and customers; and enhanced property usefulness and capacity by creating new office space.[35] The Service rejected the *Plainfield-Union* argument, finding that since asbestos was present at the time the taxpayer purchased the property, the asbestos removal costs did not merely return the property to the state it was in before the condition necessitating the expenditures arose.

The Service, however, did allow the taxpayer to deduct as ordinary and necessary expenses all costs of encapsulating asbestos containing materials. The TAM provided that these costs were deductible as incidental repair costs because they neither increased the value of the taxpayer's property nor substantially prolonged its useful life. For example, the wrapping of the pipe insulation reduced, but did not eliminate, the threat of exposure to airborne asbestos fibers. Furthermore, the taxpayer had a continuing obligation to monitor asbestos containing materials and re-encapsulate or remove insulation if it became damaged. For these reasons, the Service believed that encapsulation expenditures did not enable the taxpayer to prolong the life of or expand the facility.[36]

E. Restoration Principle

The restoration principle enunciated in *Rev. Rul.* 94-38 and grounded in *Plainfield-Union* was the focus of several more recent rulings. In Technical Advice Memorandum 9541005[37], the taxpayer, a consolidated group of corporations, purchased land initially used for farming and later used as a site for disposal of industrial waste. The land was donated to the County planning to use it for a recreational park. Upon discovery of the contamination, the County re-deeded the land back to the donor for $1.00. The donor recorded the property as having a $1.00 tax basis and did not recapture or adjust for the charitable contribution deduction it had taken.[38] The donor company entered into a consent order with the Environmental Protection Agency[39] for the purpose of completing a Remedial Investigation and Feasibility Study to determine the extent of the contamination and to recommend action necessary to remedy the condition. Numerous expenses were incurred by the company, including consulting and engineering fees and legal expenses related to the negotiation and drafting of an EPA consent order spelling out the remediation requirements.

In TAM 9541005, the Service concluded that the theory of deductibility under *Rev. Rul.* 94-38 applies only to cases where the environmental remediation expenditures restore contaminated property to a previous uncontaminated condition. The Service interpreted the restoration principle rigidly, applying it solely to situations where a taxpayer acquires property in a clean condition, contaminates the property in the course of its own regular business operations, and incurs costs to restore the property to its former condition. This requirement was not satisfied because the donor (a subsidiary of the former owner) acquired the property in a contaminated condition when it re-acquired it from the County for $1.00. The Service held, without significant discussion, that the taxpayer's expenditures were not incurred in the ordinary course of its business. It came to this conclusion despite the fact that the contamination occurred during the taxpayer's regular business operations.

TAM 9541005 has been widely criticized by practitioners.[40] The Service's position that deductions may be taken only if the taxpayer contaminates the property itself is poor public policy. Also, the break in taxpayer's ownership for a brief period did not justify disassociating the taxpayer from the contaminating acts.

In the subsequent TAM 9627002,[41] the Service revoked TAM 9541005 and issued a new ruling that allows the deduction of such costs under these conditions. This reversal may indicate new flexibility in applying *Rev. Rul.* 94-38. The revised TAM 9627002 explains that environmental assessment costs are deductible under the theory of *Rev. Rul.* 94-38, notwithstanding the break in ownership of the property. The Service based its finding on the fact that the same taxpayer contaminated the property and incurred the environmental costs, holding that the interim break in ownership should not operate to disallow a deduction under the general principles of Code Section 162. The Service determined that the costs were deductible because they did not create or enhance an asset, nor did they produce a long-term benefit. The Service noted in TAM 9627002 that the contamination of land and the taxpayer's liability for remediation were unchanged during the break in ownership based on generally accepted interpretations of Comprehensive Environmental Response, Compensation and Liability Act of 1980.[42]

The Service also explained that its holding in TAM 9541005 that assessment costs were not incurred in the ordinary course of the taxpayer's business was based, in a large part, on a perceived

[35] *Id.*

[36] *Id.*

[37] TAM 9541005, (10/13/95).

[38] The land was eventually classified as a Superfund site under the provisions of the Comprehensive and Environmental Response, Compensation and Liability Act of 1980, 42 U.S.C. §9601 *et seq.*

[39] Hereafter referred to as "EPA".

[40] *See, e.g., Tax Treatment of Environmental Clean-up Costs: The Debate Continues*, 37 TAX MANAGEMENT MEMO 131 (1996) *and* Rubin, Witt and Rosefsky, *Tax Treatment of Environmental Clean-up Costs*, NYU 54TH INSTITUTE ON FED. TAX, §11 (1996).

[41] TAM 9627002, (7/5/96).

[42] 42 U.S.C. §9607 clearly states that present and past owners are within a class of liable persons for environmental hazards created on property, whether or not the past owners retain an interest in the property.

absence of proof regarding the amount and purpose of the costs. The District Director, in its request for reconsideration, advised the National Office that it did not dispute the amount and purpose of the cost.

The Service's change in heart may be based on the narrow issue of ownership. However, the revocation of TAM 9541005 may also indicate a greater willingness by the Service to apply *Rev. Rul.* 94-38 in a broader manner.

F. Extension of the Restoration Principle

The Service's position that the break in ownership should not affect the deductibility of clean-up and associated costs is in keeping with another authority, *Rev. Rul.* 95-74.[43] In that controversy, the Service held that a subsidiary which receives contaminated property in a Code Section 351[44] exchange stands in the shoes of the parent for purposes of determining whether clean-up costs should be capitalized. In *Rev. Rul.* 95-74 a parent corporation formed a subsidiary, and transferred to the subsidiary substantially all the assets of a manufacturing business in exchange for all the subsidiary's stock. The transferred land had been bought by the parent in clean condition and was contaminated by the parent's manufacturing operation. Before the Code Section 351 transfer, the parent did not take any steps to cure the contamination, nor had the parent deducted or capitalized any environmental clean-up costs. The subsidiary assumed all the environmental liabilities of the manufacturing business, including its liabilities for potential soil and groundwater contamination. The subsidiary also incurred the cost to remediate the contamination of the transferred land. Under the principles discussed in this article, part of the costs would have been deductible as ordinary and necessary business expense, and part of the cost would have been required to be capitalized by the parent, if the parent had not transferred the property to the subsidiary. The Service determined that the subsidiary stood in the parent's shoes with regard to environmental liability, allowing the subsidiary to deduct some costs and requiring it to capitalize other costs.

In rendering *Rev. Rul.* 95-74 the Service refused to follow an Eighth Circuit decision with similar facts, *Holdcroft Transportation Co. v. Commissioner*.[45] The Court held in that case that transferor's liabilities, after a transfer under the predecessor to Code §351, were not deductible by transferee even though they would have been deductible by the transferor. The Court viewed the expense as part of the cost of acquiring the transferor's property, rather than an operating expense or business loss of transferee. In declining to follow the Eighth Circuit's lead in *Rev. Rul.* 95-74, the Service said that the Eighth Circuit's approach was inconsistent with Congress' intent that Code §351 facilitate business reorganization by permitting a subsidiary to deduct costs otherwise deductible by the parent. *Rev. Rul.* 95-74 also adopts a more flexible approach to the restoration principle.

IV. LEGAL FEES AND OTHER COSTS

The question of whether legal fees and other environmental costs are deductible under Code §162 or must be capitalized under Code §263 is determined by applying the "origin of the claim doctrine".[46] Applying this doctrine, the taxpayer must examine the nature of the matter giving rise to the need for legal representation. Generally, if the underlying matter is a deductible expense, the legal fees and costs will be considered deductible. However, if the costs are related to a capital improvement, they must be capitalized.

In *Rev. Rul.* 80-245[47], the Service held that the costs of an environmental impact study are deductible under Section 162 of the Code unless chargeable to a capital account. The Service allowed costs incurred by a public utility for environmental impact studies to support an application to state regulators for expansion of the utility to be deducted under Code Section 162.[48] These costs were deemed ordinary and necessary expenses.

In TAM 9627002,[49] the Service advised that legal and consulting fees incurred for environmental clean-up are currently deductible under the theories set forth in *Rev. Rul.* 94-38. With TAM 9627002, the Service withdrew the controversial TAM 9541005[50], denying a taxpayer a current deduction for legal and consulting fees related to the assessment of contaminated property. Reversing its position, the Service concluded that the taxpayer may rely on *Rev. Rul.* 94-38 to deduct environmental assessment and related legal expenses as ordinary and necessary business expenses under Code §162.[51]

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[43] 1995-46 I.R.B. 6.

[44] Code §351 permits property transfers to corporations in exchange for stock where the transferors, after the exchange, control the corporation.

[45] 153 F.2d 323 (8th Cir. 1946).

[46] United States v. Gilmore, 372 U.S. 39 (1963).

[47] 1980-2 C.B. 72.

[48] The Service distinguished these types of expenses from research and development expenses, which are deductible under Section 174. Rev. Rul. 80-245, 1980-2 C.B. 72.

[49] *See*, Section C.5, *supra* at 37-42, for a more complete discussion of TAMs 9541005 and 9627002.

[50] *See also* TAM 9315004, (12/17/92) rejecting taxpayer's argument that legal fees, environmental assessment costs, remediation costs and government oversight costs are ordinary and necessary expenses. Instead, the Service ruled these costs should be capitalized because, by bringing the property into compliance with the current law, the taxpayer avoided penalties and increased the marketability of its property.

[51] For more detailed discussion, *See, Environmental Remediation Expenses Not Deductible Where Property Acquired in Contaminated*

Although TAM 9627002 is promising for current deductibility of these costs, the taxpayer is cautioned that the deductibility of any given legal fees and other environmental costs (such as the cost of assessment and cost to design remediation) should be determined on a case-by-case basis. Certainly, the analysis must include an examination of the nature of the matter giving rise to the need for legal representation. Also, the analysis is very similar to the analysis for determining whether a deduction is considered an ordinary and necessary business expense or a capital improvement.

V. FINES AND PENALTIES

Consistent with other sections of the Code, fines and penalties paid by a taxpayer for environmental damages are not deductible.[52] In *Allied Signal Inc. v. Commissioner*,[53] the taxpayer, a manufacturer of chemical pesticides, was fined $13 million dollars for environmental damage. A portion of the fine ($8 million) was paid to an environmental fund and the remainder was paid as a "fine". The taxpayer attempted to deduct its $8 million dollar contribution as an ordinary and necessary business expense. The corporation claimed that the contribution was made at its discretion and was not imposed by the District Court. The Court held that the contribution was involuntary because it was actually part of an overall fine. Also, the Court found that the contribution was punitive in nature because it was a way of avoiding a higher fine. The Court held that the $8 million dollar contribution to the environmental endowment fund was not deductible as an ordinary and necessary business expense under Code Section 162(a), but rather was a fine or similar penalty paid to the government for violation of law pursuant to Code Section 162(f).[54]

Similarly, in *Colt Industries v. United States*,[55] the taxpayer paid $1.6 million to the State Clean Air and Clean Water Funds in satisfaction of civil penalties imposed by a consent decree between the taxpayer and the EPA. Colt claimed an ordinary business expense deduction for the $1.6 million dollar payment under Section 162(a). The Service disallowed the deduction on the basis that the payments constituted a fine or civil penalty under Code Section 162(f). The Court pointed out that Colt has conceded that the payments at issue were civil penalties, indeed the payments were so designated in the consent decree and the inscription on the check remitted in satisfaction of the penalty noted "EPA penalty".[56] Thus, the Court found that, by the taxpayer's own admission, the amount paid by the taxpayer was part of the negotiated settlement of threatened litigation under the Clean Air and Clean Water Acts.

Distinguished from the breadth of authority regarding fines and penalties is *S & B Restaurant v. Commissioner*.[57] In that case, the Court held that monthly payments to the State's Clean Water Fund were not fines or similar penalties within the meaning of Section 162(f), and were deductible under Section 162(a). Petitioner had operated a motel, whereby it discharged a significant amount of raw sewage directly underground. The company entered into an agreement with the State of Pennsylvania in which it agreed to connect to and discharge into the sanitary sewer system of the township, and to donate a sum per month to the Clean Water Fund of the State until a sanitary system was created by the State. The company paid into the Fund over a two-year period. After entering into the agreement, it continued to discharge raw sewage directly underground. Neither the State nor any municipality provided treatment of the discharged raw sewage, but the State would have sought to prevent petitioner from constructing its own treatment facility.

The question before the Court was whether the payments to the Clean Water Fund were fines or penalties within the meaning of Code Section 162(f). The Court, after reviewing the record, was satisfied that the payments in question were in furtherance of State laws to control pollution through consolidated rather than individual facilities. So, it found that the payments made by the company were for the license to discharge its waste, rather than a fine or penalty. The Court recognized that the agreement between the company and the State included a provision that the State would not charge the company for any violations of State law. But the Court viewed this

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Condition, 36 TAX MGMT. MEMO 340 (11/13/95), *compare Deduction of Environmental Assessment Costs Permitted as IRS Withdraws Controversial TAM 9541005*, 37 TAX MGMT MEMO 13 (3/18/96).

[52]§162(f); Reg. §1.162-21(b) which states that fines or similar penalties paid to the government for violation of the law is not deductible, but the non-deductible fine or penalty does not include the cost of defending against prosecution or a civil suit.

[53]54 F.3d 167 (3rd Cir. 1995).

[54]*See also* Tank Truck Rentals Inv. v. Commissioner, 356 U.S. 30, 35-36 (1958)(Supreme Court observing that courts have uniformly held that permitting deductions for fines would frustrate public policy by reducing the "sting" of the penalty); Waldman v. Commissioner, 850 F.2d 611 (9th Cir. 1988)(payment was considered a fine or similar penalty because the sentencing court ordered payment of restitution by defendant); Stephens v. Commissioner, 905 F.2d 667 (2nd Cir. 1990)(payment was a non-deductible fine under Code Section 162(f) because payment was made as a result of a criminal conviction and it was ordered in lieu of an additional prison term); Bailey v. Commissioner, 756 F.2d 44 (6th Cir. 1985)(civil penalty applied in settlement of class action pursuant to court order and not deductible under Section 162(f)).

[55]880 F.2d 1311 (Ct. Cl. 1989).

[56]*Id.* at 1313.

[57]73 T.C. 1226 (1980).

as merely incidental to the main purpose of the agreement, which was to insure that the petitioner would join a municipal disposal system and not build its own sanitary sewer system.

The analysis in these three cases focused on the underlying intent of the payment, not how the payment was labeled or to what entity the payment was made. The central issue in determining whether fines or penalties can be deducted is whether the payment was intended to be punitive in nature. In *Allied Signal* and *Colt* the courts found the intent of the regulatory agency was to punish the taxpayer. In contrast, in *S&B Restaurant* the Court believed that while the payments resolved the environmental dispute between the parties, they were not punitive in nature.

VI. CONCLUSION

As discussed in this article, the principles by which an expense is analyzed to determine whether it is deductible or capitalized for federal income tax purposes have become clearer. These principles include the general rule for determining whether an expense is an ordinary and necessary expense or capital in nature. If the expense merely restores property to its former condition it can be argued that it is an ordinary expense.

Even though the standards have become clearer, the determination of whether the expense fits into the deductible category or capitalized category is still difficult to make because it is fact dependent. The Service has come a long way in recognizing the difficulty in making a decision which will withstand audit, by providing an opportunity for taxpayers to step forward and request private letter rulings on deductibility. This opportunity is described in *Notice* 97-7 and *Announcement* 97-22. Hopefully, the rulings issued by the Service under these procedures will be published as private letter rulings. While these private letter rulings will not be officially useful as precedents, they will provide greater guidance for taxpayers and their representatives.

As discussed throughout this article, it appears that the Service is leaning in the direction of allowing current deductibility in a greater number of instances. If the trend does indeed continue, it should provide a small dose of incentive towards prompt clean-up of environmentally damaged properties.