Environmental Cleanup Costs Now Deductible

by Robert W. Wood • San Francisco

The topic of environmental cleanup payments and their tax treatment has become a virtually interdisciplinary topic that taxpayers and their advisors cannot stop discussing. Given the dollars often at stake, and the pervasiveness of these types of payments, this perhaps comes as no surprise. And, the issue is directly related (or at least it has been so treated) to the *INDOPCO, Inc.*, decision, 112 S.Ct. 1039 (1992), a case that is no stranger to readers of *The M&A Tax Report*.

Revenue Ruling 94-38 casts a decidedly favorable light on environmental cleanup costs, treating them as deductible business expenses. This shift of position comes as welcome news to many taxpayers who have felt the double whammy of substantial cleanup costs that have been treated as capital expenditures.

Cleanup Facts

In the ruling, an accrual-basis corporation owned and operated a manufacturing plant that it had built on land it purchased in 1970. Although the land was not contaminated in 1970, the taxpayer discharged hazardous wastes in its manufacturing operations and buried the wastes on the land.

In 1993, in order to comply with currently applicable and reasonably anticipated federal state and local environmental regulations, the company began remediation of the soil and groundwater that had been contaminated. The decision was also made to set up a monitoring system for the groundwater to ensure that all hazardous waste had been removed.

The remediation operations involved excavating the soil, transporting it to waste disposal facilities, and backfilling the excavated areas with uncontaminated soil. Although such activities began in 1993, according to the facts of the ruling, they will not be completed until 1995. Construction of the groundwater treatment facilities also began in 1993.

Continual monitoring of the groundwater was anticipated to ensure that the soil cleanup and groundwater treatment eliminate the hazardous waste and bring the company into compliance with the environmental regulations. These groundwater facilities are expected to remain in operation until 2005.

Back to Basics

The effect of this cleanup and treatment, the ruling notes, will be to restore the company's land to essentially the same physical condition that existed before the contamination. The company will operate its plant (both during the cleanup operation and after) in the same manner it always has, except for the new methods for disposal of the hazardous wastes.

The ruling concludes that the costs incurred to clean up the land and to treat the groundwater are

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deductible under Section 162. The construction costs for the groundwater treatment facilities must be capitalized under Section 263. Significantly, the ruling notes that these two conclusions would be the same whether the company were to continue manufacturing or were to instead discontinue its hazardous-waste-causing activities and simply hold the land idle.

INDOPCO Again

The ruling confronts the authority presented by *INDOPCO*, in which the Supreme Court focused attention on whether there might be significant future benefits from a particular expenditure in determining whether that expenditure could be deducted. Soil cleanup expenses and groundwater treatment expenditures, suggests the ruling, do not produce permanent improvements to the taxpayer's land.

Using a before-and-after valuation approach, *Rev. Rul.* 94-38 concludes that the value of the land was not enhanced by the admittedly expensive cleanup and groundwater treatment expenditures.

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This conclusion is premised on the notion that the taxpayer had really only restored the land to the condition (and hence, the value) as had existed before the manufacturing activity contaminated it.

The groundwater treatment facilities were to have a useful life substantially beyond the year of construction. Consequently, the construction costs were classified as capital expenditures. Likewise, said the ruling, because the construction of the water treatment facilities constitutes production for purposes of Section 263A(g)(1), the direct costs (and an appropriate share of allocable indirect costs) of constructing the facilities will have to be capitalized. ■