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TAXING OUR WAY TO A MORE POLLUTED ENVIRONMENT

Eileen S. Mazo*

INTRODUCTION

Early in 1995, Sequence Clothing Manufacturing, Inc. ("Sequence")¹ discovered asbestos fireproofing on the ceiling of its warehouse. Co-owners, Marie and Bob Smith, were dismayed by the news and particularly concerned about the cost of asbestos removal. When Sequence purchased the warehouse in 1960, the Smiths were unaware of the asbestos fireproofing.² At that time, business was beginning to expand and their warehouse space in New York City was no longer large enough. The Smiths found their current 20,000-square-foot warehouse space across the river in New Jersey. They projected that it could accommodate Sequence's anticipated growth. Presently, Sequence is a well-respected clothing manufacturer earning an average annual net income of \$15 million.³

Although Sequence is not statutorily required⁴ to remediate⁵ the asbestos, the corporation must determine what action, if any, to take. The Smiths intend to remediate the asbestos to protect the health and safety of their employees and other members of the community, prevent lawsuits, and enhance public opinion of their operation.

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1. Sequence is a fictional corporation used to illustrate the concepts discussed throughout this Note.

2. Knowledge of the presence of asbestos at the time of purchase can affect the financial accounting treatment of the remediation expenditures. See *infra* text accompanying note 126.

3. Sequence has taxable income and currently pays income tax.

4. "For no type of structure other than a school is there a federal burden to inspect for asbestos, and no state requires removal." Shelley Bookspan, *Asbestos—A Major Real Estate Concern*, 19 REAL EST. L.J. 158, 158 (1990). The Asbestos Hazard Emergency Response Act of 1986, 15 U.S.C. §§ 2601 note, 2614, 2618, 2619, 2641-2654; 20 U.S.C. §§ 4014, 4014 note, 4021, 4022 (1988 & Supp. V 1993), requires inspection for asbestos in public and private schools. Applicable regulations, promulgated by the U.S. Environmental Protection Agency, are codified at 40 C.F.R. § 763 (1994). Certain federal statutory requirements must be followed during the process of environmental remediation. See generally Toxic Substances Control Act, 15 U.S.C. §§ 2601-2692 (1988 & Supp. V 1993); Occupational Safety and Health Act of 1970, 29 U.S.C. §§ 651-678 (1988 & Supp. V 1993); Federal Water Pollution Control Act (Clean Water Act), 33 U.S.C. §§ 1251-1387 (1988 & Supp. V 1993); Resource Conservation and Recovery Act of 1976, 42 U.S.C. §§ 6901-6986 (1988 & Supp. V 1993); Clean Air Act, 42 U.S.C. §§ 7401-7671q (1988 & Supp. V 1993); Comprehensive Environmental Response, Compensation, and Liability Act of 1980, 42 U.S.C. §§ 9601-9675 (1988 & Supp. V 1993). The applicability of these statutes is beyond the scope of this Note.

5. The term "remediate" generally refers to cleaning up products found to be hazardous to the environment. See *The Proper Income Tax Treatment of Environmental Remediation Expenditures*, 45 TAX EXECUTIVE 307, 309 (1993) [hereinafter TAX EXECUTIVE].

Sequence's situation is not unique. In 1988, the U.S. Environmental Protection Agency ("EPA") estimated that asbestos-containing materials⁶ were present in more than twenty percent of all commercial and office buildings in the United States.⁷ Friable asbestos, which is among the most harmful forms of asbestos because it can be reduced to a powder by mere pressure, contaminates approximately 730,000 of those buildings.⁸

The Smiths' choice of remediation method may depend on the tax consequences of the costs associated with the cleanup. Historically, the Internal Revenue Service ("IRS") required taxpayers to capitalize all remediation costs,⁹ systematically deducting a portion as depreciation expense¹⁰ over a number of years. These deductions reduce gross income for the useful life¹¹ of the property created by the remediation effort. Remediation costs that must be capitalized yield lower tax savings in the current year than those currently deductible.¹²

However, the IRS, in its most recent pronouncement in this area, Revenue Ruling 94-38,¹³ implied that it recognizes the importance of environmental remediation, and appears to be altering tax treatment of cleanup costs. In that ruling, the IRS permitted the taxpayer to currently deduct soil and groundwater treatment expenditures that did not create future revenue-generating benefits.¹⁴ Unlike capitalization, current-year deduction of remediation expenditures from gross income reduces a corporation's current tax liability and produces a present savings of tax dollars.

6. "The term 'asbestos-containing material' means any material which contains more than 1 percent asbestos by weight." 15 U.S.C. § 2642(4) (1988).

7. Martin S. Hall, *Asbestos: Fatal Fiber or Fiber Phobia—The Purchaser's Perspective*, 79 ILL. B.J. 228, 228 n.1 (1991) (citing U.S. ENVTL. PROTECTION AGENCY, EPA STUDY OF ASBESTOS-CONTAINING MATERIALS IN PUBLIC BUILDINGS: A REPORT TO CONGRESS 8 (1988)).

8. *Id.*; see Leslie Berkman, *Landlords Cope with the High Cost of Asbestos*, L.A. TIMES, Feb. 18, 1990, at D1.

9. See *infra* text accompanying notes 140-71.

10. The Internal Revenue Code allows an annual depreciation deduction for wear and tear of property used in a trade or business or held for the production of income. I.R.C. § 167(a) (1988).

11. See I.R.C. § 168(c)(1) (1988 & Supp. V 1993). Useful life of an asset is determined using the "applicable recovery period" table in I.R.C. § 168(c)(1). For example, five-year property (including automobiles and equipment) has a useful life of five years; nonresidential real property (i.e., office and commercial buildings) has a useful life of 39 years. *Id.*

12. A present savings of tax dollars is usually preferable to future possession of those funds due to the time value of money. In other words, a dollar today is worth more than a dollar tomorrow because present possession of the money allows present consumption or investment for additional return. Therefore, a tax deduction today is worth more than the same deduction in a future period. ROBERT G. MAY ET AL., A NEW INTRODUCTION TO FINANCIAL ACCOUNTING 39-40 (2d ed. 1980).

13. Rev. Rul. 94-38, 1994-1 C.B. 35.

14. *Id.* at 36.

This Note explores the controversy regarding tax treatment of environmental remediation costs, addressing whether cleanup costs should be deducted in the period incurred, or capitalized and deducted over the life of the "newly created" asset. While the issues apply to all environmental remediation, this Note focuses on Sequence's asbestos remediation expenditures to illustrate the controversy.

Part I of this Note presents background information on asbestos and its remediation. Part II examines Internal Revenue Code ("I.R.C.") § 162, regarding deductibility, and § 263, regarding capitalization, and discusses case law interpreting these sections. In addition, Part II analyzes the conflicting views of taxpayers¹⁵ and the IRS in the tax treatment debate, and examines the relationship between tax treatment and the taxpayer's financial accounting and reporting. Part III explores the history of tax rulings regarding environmental remediation. Part IV proposes that the IRS should extend Revenue Ruling 94-38,¹⁶ permitting remediation costs to be deducted in the period incurred because they neither increase the value or useful life of property, nor adapt property to a new use. Current deductibility of remediation expenditures would encourage effective remediation. Finally, this Note concludes that deductibility of remediation expenditures affords an accurate reflection of those costs, while prompting taxpayers to clean up the environment.

I. BACKGROUND ON ASBESTOS AND REMEDIATION OPTIONS

A. *What Is Asbestos?*

The term "asbestos" refers to a group of "naturally occurring mineral fibers."¹⁷ The fibers, once mined and processed, have many commercially beneficial properties.¹⁸ For centuries, asbestos has been valued because of its flexibility and strength.¹⁹ Moreover, asbestos does not easily burn, conduct heat or electricity, and is not easily affected by most chemicals.²⁰ Today, asbestos is principally used in ce-

15. The use of the term "taxpayer" in this Note refers to an entity currently paying income tax.

16. Rev. Rul. 94-38, *supra* note 13.

17. Hall, *supra* note 7, at 228. Amphibole and chrysotile are among the most commonly used asbestos fibers. Amphiboles are up to 50% more deadly than chrysotiles. *Id.* at 229. "Between 90 and 95 percent of the world's asbestos production consists of chrysotile[s] . . ." *Id.* (citations omitted). See generally 1 ASBESTOS 45-64 (Leslie Michaels & Seymour S. Chissick eds., 1979).

18. 1 ASBESTOS, *supra* note 17, at 45.

19. *Id.*; Brooke T. Mossman et al., *Asbestos: Scientific Developments and Implications for Public Policy*, 247 SCIENCE 294, 295 (1990).

20. 1 ASBESTOS, *supra* note 17, at 45; Mossman et al., *supra* note 19, at 295.

ment construction materials, such as pipes, siding, and roofing.²¹ It is also used in insulation, fireproofing materials, and automotive parts.²²

At the turn of the century, scientists began associating asbestos with disease.²³ Scientists found that workers with prolonged exposure to asbestos were at risk of developing asbestosis, a blockage of the lungs by thickened tissue.²⁴ In the 1950s and 1960s, researchers linked prolonged asbestos exposure to cancer of the lungs and bronchial tubes and mesothelioma, cancer of the chest and abdominal lining.²⁵

During the 1970s, several researchers discovered that certain types of asbestos are more dangerous than others.²⁶ This finding provoked debate among scientists about whether asbestos, in general, is as dangerous as previously thought.²⁷ Some scientists assert that short-term or low-level asbestos exposure is hazardous,²⁸ while others claim that asbestos poses a lesser health hazard than originally believed.²⁹

Amidst this debate, numerous lawsuits were filed as a result of medical conditions associated with asbestos exposure. "By 1990, 30,401 asbestos cases were pending in the federal courts alone, with about double that amount in the state courts, for a total of approximately 90,000 cases. . . . Another report estimates that between 1990 and 2049 another 668,363 asbestos-related claims will be filed."³⁰

B. *Asbestos Remediation*

There are three accepted approaches to asbestos remediation: removal, encapsulation, and enclosure.³¹ The type of asbestos and the

21. 1 ASBESTOS, *supra* note 17, at 73; Mossman et al., *supra* note 19, at 295.

22. 1 ASBESTOS, *supra* note 17, at 75; Mossman et al., *supra* note 19, at 295. Due to health hazards, spray-on asbestos formerly used for fireproofing and insulation, is no longer used. *Id.*

23. Mossman et al., *supra* note 19, at 294.

24. *Id.* at 294-95; see also Louis DiGiovanni, Note, *New York City's School Asbestos Debacle: An Administrative Approach to the Problem of Faulty School Inspections and a Possible New Round of Asbestos Litigation*, 6 *FORDHAM ENVTL. L.J.* 79, 85 (1994) ("[T]he problem of asbestos was viewed as a concern only to those individuals who worked with the material.").

25. Mossman, *supra* note 19, at 294; Richard Stone, *No Meeting of the Minds on Asbestos*, 254 *SCIENCE* 928, 928 (Nov. 15, 1991). For more information on asbestos-related disease, see Brooke T. Mossman & J. Bernard L. Gee, *Asbestos-Related Diseases*, 320 *NEW ENG. J. MED.* 1721 (1989).

26. See Stone, *supra* note 25, at 928.

27. *Id.* at 928-29 (Many scientists dispute this "revisionist" theory.).

28. DiGiovanni, *supra* note 24, at 84 ("[S]hort-term asbestos exposure was cited as hazardous.").

29. Stone, *supra* note 25, at 930; see, e.g., Mossman et al., *supra* note 19, at 299. Recent studies suggest that the risk of developing a disease from asbestos, especially chrysotile fibers, found in buildings is minimal. *Id.* at 298-99; Hall, *supra* note 7, at 229.

30. *Dunn v. Hovic*, 1 F.3d 1371, 1394 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 650 (1993) (citations omitted).

31. 40 C.F.R. § 763.83 (1994).

danger involved must be determined before deciding which method to use.³²

1. Removal of Asbestos-Containing Building Material

Removal is "the taking out or the stripping of substantially all [asbestos-containing building material ("ACBM")] from a damaged area."³³ "Asbestos insulation should be removed: (a) when it is breaking away from the base; or (b) when the insulation is likely to be abraded or otherwise damaged; or (c) when the surface is very friable;³⁴ or (d) when the resultant concentration of airborne³⁵ asbestos dust is above the exposure limit."³⁶ When asbestos-containing materials³⁷ do not fall into one of the above categories or are not likely to be "disturbed," a program of encapsulation or enclosure may be economically preferable.³⁸

"The cost of removing and disposing of [asbestos-containing materials] is prohibitive. Asbestos removal workers are (or should be) trained to use specialized equipment and complicated procedures for sealing-off work areas."³⁹ In many states, contractors and workers are required to be licensed or certified.⁴⁰ When engaging in asbestos removal operations, contractors must take proper precautions to ensure worker safety.⁴¹ Outer clothing,⁴² gloves,⁴³ and ventilated masks⁴⁴ are

32. INTERNATIONAL LABOUR OFFICE, *SAFETY IN THE USE OF ASBESTOS* 71 (1984).

33. 40 C.F.R. § 763.83.

34. Friable asbestos can become a powder through mere pressure or disturbance from maintenance or renovations, and circulate throughout the air. 15 U.S.C. § 2642(6) (1988); Hall, *supra* note 7, at 228.

35. Once asbestos has become airborne it is defined as a hazardous air pollutant that may result in liability under the Clean Air Act. 42 U.S.C. § 7412(b)(1) (1988 & Supp. V 1993).

36. INTERNATIONAL LABOUR OFFICE, *supra* note 32, at 71. Exposure limits are specified by state law. *See, e.g.*, N.Y. COMP. CODES R. & REGS. tit. 12, § 56-17.8(a) (1994).

37. *See supra* note 6.

38. Hall, *supra* note 7, at 230; *see infra* text accompanying notes 50-56 (discussion of encapsulation and enclosure).

39. Hall, *supra* note 7, at 228; *see generally* 29 C.F.R. § 1926.58 (1994) (Occupational Safety and Health Administration safety and health regulations for construction—asbestos).

40. Hall, *supra* note 7, at 229. *See, e.g.*, N.Y. LAB. LAW § 902(1) (McKinney Supp. 1995) ("It shall be unlawful for any contractor to engage in an asbestos project unless such contractor has a valid asbestos handling license issued by the commissioner."); An asbestos handler's certificate is also required for workers. *Id.* § 902(5) (McKinney Supp. 1995); ARK. CODE ANN. § 20-27-1001 (Michie Supp. 1993); CAL. BUS. & PROF. CODE § 7058.5 (West Supp. 1995); MICH. COMP. LAWS ANN. § 408.1058 (West 1994).

41. 1 ASBESTOS, *supra* note 17, at 285-89.

42. *Id.* at 286. Closely-fitting overalls are worn to keep asbestos dust off cleanup workers. The outfit includes a hood that is designed to hold a respirator mask in place. Ideally, calf-length gumboots are also worn with the overalls. All outerwear must be decontaminated after the worker leaves the worksite. *Id.*

necessary to protect workers from asbestos.⁴⁵ These garments must be specially treated after removal from the asbestos-contaminated area to prevent the spread of asbestos to non-contaminated areas.⁴⁶

These necessary precautions cause removal operations for commercial or industrial buildings to cost, on average, as much as \$70 per square foot.⁴⁷ In addition, "[asbestos] disposal can cost up to seven times the rate for [disposal of] ordinary construction debris."⁴⁸ Furthermore, factoring in lost income, moving tenants, and reconstruction of the building, overall costs may total as much as \$200 per square foot.⁴⁹

2. Encapsulation and Enclosure

Encapsulation is "the treatment of ACBM with a material that surrounds or embeds asbestos fibers in an adhesive matrix to prevent the release of fibers, as the encapsulant creates a membrane over the surface . . . or penetrates the material and binds its components together."⁵⁰ Enclosure involves placing "an airtight, impermeable, permanent barrier around ACBM to prevent the release of asbestos fibers into the air."⁵¹ Once encapsulated or enclosed, asbestos-containing materials must be monitored to insure that asbestos cannot escape.⁵² Both encapsulation and enclosure are temporary measures

43. *Id.* Gloves are used because contaminants are often trapped under fingernails. *Id.*

44. *Id.* at 285. Ventilated masks or respirators protect workers from inhaling asbestos. *Id.*

45. *Id.* at 285-86.

46. *Id.* at 286.

47. Telephone Interview with Supervisor of the Office of Environmental Policy and Management of the Port Authority of New York and New Jersey, New York, N.Y. (Feb. 3, 1995) [hereinafter Port Authority Interview]. The cost of asbestos removal varies depending on the type of removal and the geographical region. The following are average prices for asbestos removal in the New York/New Jersey area:

Pipe insulation	\$40 per linear foot
Boiler insulation	\$50 per square foot
Ducts & breaching	\$70 per square foot
Sprayed-on fireproofing	\$30 per square foot

For additional cost estimates, see Hall, *supra* note 7, at 229; Berkman, *supra* note 8.

48. Hall, *supra* note 7, at 229. The high cost of asbestos disposal results from the specifications for hazardous waste disposal in 40 C.F.R. § 763 subpt. E, app. D (1994). Asbestos must be "properly contained in leak-tight containers with appropriate labels," placed in a trench specifically prepared for the asbestos, and completely covered "within 24 hours with a minimum of 6 inches of nonasbestos material." 40 C.F.R. § 763 subpt. E, app. D. Disposal may cost an average of \$150 to \$200 per cubic foot. Port Authority Interview, *supra* note 47.

49. Berkman, *supra* note 8. This figure does not necessarily represent total remediation costs for tax purposes.

50. 40 C.F.R. § 763.83.

51. *Id.*

52. The monitoring, which involves sampling the air of the encapsulated or enclosed area, occurs before, during, and after the procedure. If the air sample taken after the completion of the procedure is asbestos-free no further work is required.

that may have to be reworked or periodically repaired if the property is damaged.⁵³

Encapsulation or enclosure of asbestos is less expensive than its removal.⁵⁴ However, because ordinary repairs or remodelling may render the encapsulated or enclosed asbestos airborne and hazardous,⁵⁵ and ultimately force removal, the cost over the long run may be much higher than if the asbestos had initially been removed.⁵⁶

In Sequence's case, cost may be a determining factor in choosing whether to remove, encapsulate, or enclose the asbestos. At an average of \$30 per square foot for removal, Sequence's cost would be at least \$600,000, compared to \$240,000 for encapsulation.⁵⁷ However, if the asbestos is later disturbed or rendered airborne, removal will be necessary, and thus is the only viable option.

II. SHOULD REMEDIATION EXPENDITURES BE DEDUCTED OR CAPITALIZED?

Sequence and other taxpaying entities expending large sums of money on remediation generally prefer to deduct rather than capitalize such costs.⁵⁸ Assume Sequence spent \$600,000 for asbestos remediation in 1995. If the expenditure is deductible, the entire \$600,000 reduces its 1995 gross income. However, if the remediation costs must be capitalized, the \$600,000 expenditure is deducted through depreciation over thirty-nine years, at a rate of \$3210 for the first fractional year, \$15,384 for each of the following thirty-eight years, and \$12,198 for the last fractional year.⁵⁹ Thus, "deductibility

Telephone Interviews with several New York, N.Y. asbestos removal contractors (Feb. 3-10, 1995) [hereinafter Interviews]. This determination depends on state law. See *supra* note 36.

53. Interviews, *supra* note 52.

54. Encapsulation and enclosure are not usually the remediation methods of choice. *Id.* It is often easier and cheaper, in the long run, to remove asbestos because the controls needed for these methods are the same as those required for removal, and subsequent removal may still be necessary. The average costs for encapsulation in the New York/New Jersey area are \$10 per linear foot for pipe insulation and \$12 per square foot for sprayed-on fireproofing. These costs, however, vary with the area to be encapsulated. Enclosure costs depend on the type of asbestos and the area to be enclosed. *Id.*; see *supra* note 47 (comparative costs of asbestos removal).

55. Bookspan, *supra* note 4, at 159.

56. Interviews, *supra* note 52.

57. These costs are calculated based on Sequence's 20,000-square-foot warehouse, \$30 per square foot for removal of sprayed-on fireproofing materials, and \$12 per square foot for encapsulation. See *supra* text accompanying note 3, and notes 47, 54.

58. See, e.g., TAX EXECUTIVE, *supra* note 5, at 307.

59. See I.R.C. §§ 167(a), 168(a), (b)(3)(A), (c)(1), (d)(2)(A), (e)(2)(B) (1988 & Supp. V 1993). The amount of annual depreciation expense for nonresidential real property is computed using the straight-line method over 39 years. I.R.C. § 168(b)(3)(A), (c)(1). Assuming that Sequence is a calendar-year taxpayer and that the remediation is completed in October, for the first year the \$600,000 expenditure is multiplied by a depreciation rate of 0.535%, resulting in \$3210 depreciation expense. I.R.S., U.S. DEP'T OF TREASURY, PUB. NO. 534, DEPRECIATION 49 tbl. A-7a (1995).

produces significant, immediate tax savings while capitalization (and depreciation) produces spread out, and therefore less, tax savings."⁶⁰

A. *Internal Revenue Code §§ 162 & 263 and Related Case Law*

To determine whether to capitalize or deduct expenditures, a taxpayer must refer to I.R.C. §§ 162 and 263. I.R.C. § 162(a) provides, "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."⁶¹ In *Commissioner v. Lincoln Savings & Loan Ass'n*,⁶² the Court determined that to qualify for a deduction under I.R.C. § 162(a), an expenditure "must (1) be 'paid or incurred during the taxable year,' (2) be for 'carrying on any trade or business,' (3) be an 'expense,' (4) be a 'necessary' expense, and (5) be an 'ordinary' expense."⁶³ The term "ordinary" in § 162(a) does not require that expenditures be "habitual or normal in the sense that the same taxpayer will have to make them often."⁶⁴ Rather, the expenditure must relate to a transaction "of common or frequent occurrence in the type of business involved."⁶⁵ "Necessary" refers to a "minimal requirement that the expense be 'appropriate and helpful' for 'the development of the [taxpayer's] business.'"⁶⁶

Treasury Regulation § 1.162 further defines ordinary and necessary expenses.⁶⁷ Section 1.162-4 states, "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."⁶⁸ Thus, repairs or maintenance charges are considered "ordinary and necessary" expenses within the meaning of section 162.⁶⁹

For the subsequent 38 years, the \$600,000 expenditure is multiplied by a 2.564% depreciation rate resulting in \$15,384 of annual depreciation, and for the final fraction of a year the \$600,000 expenditure is multiplied by 2.033% for depreciation of \$12,198.
Id.

60. Larry Witner & Michael Lynch, *Tax Consequences of Environmental Clean-Up Costs: An Updated History*, 23 REAL EST. L.J. 268, 268 (1995).

61. I.R.C. § 162(a) (1988 & Supp. V 1993).

62. 403 U.S. 345, 354 (1971) (premiums required by federal statute created an asset, and thus, must be capitalized).

63. *Id.* at 352.

64. *Welch v. Helvering*, 290 U.S. 111, 114 (1933) (agent's payments of bankrupt corporation's debts were not ordinary and necessary expenses of the agent, and thus, not deductible).

65. *Deputy v. DuPont*, 308 U.S. 488, 495 (1940) (disallowing a deduction for carrying charges on short sales of stock by a taxpayer not in the business of trading securities).

66. *Commissioner v. Tellier*, 383 U.S. 687, 689 (1966) (quoting *Welch*, 290 U.S. at 113) (alteration in original).

67. Treas. Reg. § 1.162 (as amended in 1993).

68. Treas. Reg. § 1.162-4 (1960); see, e.g., *Illinois Merchants Trust Co. v. Commissioner*, 4 B.T.A. 103, 106 (1926).

69. See Treas. Reg. § 1.162-4; *United States v. Wehrli*, 400 F.2d 686, 689 (10th Cir. 1968).

I.R.C. § 263 and Treasury Regulation § 1.263(a) limit section 162 deductions.⁷⁰ I.R.C. § 263(a)(1) provides, "No deduction shall be allowed for [a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property."⁷¹ Expenditures that are not deductible by the taxpayer pursuant to section 263 must be capitalized, with the expenditure deducted as depreciation over the life of the asset.⁷²

The Treasury Department, the judiciary, and commentators have interpreted the Internal Revenue Code, identifying factors to consider in determining whether an expenditure is of a capital nature or is deductible from current income. For instance, Treasury Regulation § 1.263(a)-1(b) states that an expenditure must be capitalized if the amount paid (1) "add[s] to the value,"⁷³ or (2) "substantially prolong[s] the useful life,"⁷⁴ of property, or (3) "adapt[s] property"⁷⁵ to a new or different use.⁷⁶

Courts weigh the following in making the capitalization determination:

- the recurring nature of the expenditure;⁷⁷
- the voluntary or involuntary nature of the expenditure;⁷⁸

70. See I.R.C. § 263 (1988 & Supp. V 1993); Treas. Reg. § 1.263(a) (as amended in 1993).

71. I.R.C. § 263(a)(1) (1988).

72. See I.R.C. §§ 263, 167, 168.

73. See, e.g., *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333, 338 (1962) (lining pipes with cement did not increase the value of the pipes); see *infra* text accompanying notes 98-103 (the *Plainfield-Union* test). This test is used to determine whether an expenditure adds value to property and must therefore be capitalized. *Id.*

74. See, e.g., *Mountain Fuel Supply Co. v. United States*, 449 F.2d 816, 821 (10th Cir. 1971) (reconditioning pipeline to begin a new expected life, not to continue operations during the original estimated life of the pipes, must be capitalized), *cert. denied*, 405 U.S. 989 (1972); *Electric Energy, Inc. v. United States*, 13 Cl. Ct. 644, 667 (1987) (replacing boiler elements prolonged the useful life of the boiler, and therefore, must be capitalized).

75. See, e.g., *Coors Porcelain Co. v. Commissioner*, 52 T.C. 682, 697 (1969) (repairs altered equipment, changing its function, and therefore were capitalized), *aff'd*, 429 F.2d 1 (10th Cir. 1970).

76. Treas. Reg. § 1.263(a)-1(b) (as amended in 1993); see, e.g., *Plainfield-Union*, 39 T.C. at 338; Carol Conjura, *IRS Reverses Course and Allows Current Deductions for Cost of Environmental Cleanup in Rev. Rul. 94-38*, 10 Tax Mgmt. Real Est. J. (BNA) 135, 136 (Sept. 7, 1994).

77. See, e.g., *United States v. Times-Mirror Co.*, 231 F.2d 876, 880 (9th Cir. 1956) ("The . . . nonrecurring nature of the expense might well be urged upon the trier of fact, . . . [yet i]t is not conclusive."); *Connecticut Light & Power Co. v. United States*, 299 F.2d 259, 264 (Ct. Cl. 1962) ("The nonrecurring nature of the disbursement does not preclude deductibility . . .").

78. See, e.g., *Teitelbaum v. Commissioner*, 294 F.2d 541, 544 (7th Cir. 1961) (involuntary conversion of electricity in building did not render the expenses ordinary, and thus deductible, in the current period), *cert. denied*, 368 U.S. 987 (1962); *Woolrich Woolen Mills v. United States*, 289 F.2d 444, 448 (3d Cir. 1961) ("The involuntary nature of the expenditure . . . does not render deductible as expense an item which would otherwise be non-deductible as capital.").

- whether the useful life of the new asset is in excess of one year,⁷⁹ and
- whether the expenditure is substantial in comparison with other operating expenses.⁸⁰

Though not individually dispositive, each factor is a guide in the determination of the tax treatment of expenditures.

One useful factor to consider in the capitalization determination is the purpose for which the expenditure was made.⁸¹ "[T]he purpose of a repair is to keep property in an ordinarily efficient operating condition; and the purpose of capital expenditures is to prolong the property's life, increase its value, or make it adaptable to a new use."⁸²

Several IRS personnel have interpreted I.R.C. §§ 162 and 263 regarding environmental remediation costs. Shortly before issuance of Technical Advice Memorandum ("TAM") 93-15-004,⁸³ IRS Associate Chief Counsel (Domestic) Stuart L. Brown identified five factors to consider when evaluating environmental remediation costs.⁸⁴ These are:

- (1) whether the cost relates to the creation of new property or simply cleaning up existing property; (2) whether the property is owned by the taxpayer; (3) whether the property to which the expenditure relates will generate future income; (4) whether the problem was a pre-existing condition or whether it arose during the course of the taxpayer's business operations; and (5) whether cleanup expendi-

79. *United States v. Mississippi Chem. Corp.*, 405 U.S. 298, 310 (1972) (an expenditure was "of value in more than one taxable year," and thus nondeductible); *United States v. Wehrli*, 400 F.2d 686, 689 (10th Cir. 1968) ("the 'one-year' rule of thumb . . . was intended to serve as a mere guidepost . . . , not as an absolute rule requiring the automatic capitalization of every expenditure providing the taxpayer with a benefit enduring for a period in excess of one year"); *Times-Mirror*, 231 F.2d at 880 ("The mere fact that [an expenditure] would last longer than the taxable year is not controlling."); *Treas. Reg. § 1.446-1(a)(4)(ii)* (as amended in 1993).

80. *See, e.g., Connecticut Light & Power*, 299 F.2d at 264 ("The . . . nature of the disbursement does not preclude deductibility; nor does its mere dollar amount."); *Times-Mirror*, 231 F.2d at 880 ("The size . . . of the expense . . . is not conclusive."); *Electric Energy, Inc. v. United States*, 13 Cl. Ct. 644, 665 (1987) ("The sheer amount of the expenditure is not a reliable focal point for this case."); George R. Farrah, *Deductibility of Environmental Cleanup Costs—Recent Developments*, 12 Tax Mgmt. Wkly. Rep. (BNA) 751, 752 (May 31, 1993).

81. *Midland Empire Packing Co. v. Commissioner*, 14 T.C. 635, 640 (1950) (quoting *Illinois Merchants Trust Co. v. Commissioner*, 4 B.T.A. 103, 106 (1926) ("[I]t is necessary to bear in mind the purpose for which the expenditure was made.")).

82. Michael M. Megaard & Susan L. Megaard, *IRS Explains Deductions for Environmental Cleanup Costs*, 23 TAX'N FOR LAW. 152, 152 (1994).

83. *Tech. Adv. Mem. 93-15-004* (Dec. 17, 1992); *see infra* text accompanying notes 154-58.

84. John S. Ross, III, *Environmental Cleanup Costs: IRS to Develop Criteria Concerning Capitalization Versus Expense Problem*, 9 Tax Mgmt. Real Est. J. (BNA) 82, 83-84 (Apr. 7, 1993); Megaard & Megaard, *supra* note 82, at 158, 159 n.19. Brown's announcement was made at the Federal Bar Association Section of Taxation annual conference in Washington, D.C. on March 9, 1993. *Id.* at 159 n.19.

tures are voluntary or are imposed by a court or governmental authority.⁸⁵

Ironically, these items were not relied on in either of the TAMs that followed Brown's statement.⁸⁶ Although the courts may apply some of the criteria cited by Brown,⁸⁷ it is not clear how, or if, these items will affect IRS rulings in the future.⁸⁸

Another IRS official proposed the following test:⁸⁹

(1) [I]f the taxpayer replaces an asset, the expenditure must be capitalized. [(2) I]f no asset is replaced but the expenditure creates an economic benefit, capitalization is required. [(3)] If neither an asset is replaced nor an economic benefit is created, the expenditure may still be capital in nature if it is very large in amount because action has been delayed for a number of years and the expenditure is no longer "incidental."⁹⁰

The first point of the test encompasses both the repair and replacement argument found in both the I.R.C. and the Regulations, as well as the issue of the recurring nature of the expenditure considered in case law. The second point is analogous to Treasury Regulation § 1.263(a)-1(b), which addresses the capitalization of future revenue-generating benefits. Finally, the third point suggests capitalization of expenditures that, although initially constituting incidental repairs, become substantial due to delay in action.⁹¹

Despite these statements by two of its officials, the IRS has not definitively declared its position regarding capitalization of environmental remediation costs and continues to study the matter.⁹² Thus, the debate between taxpayers and the IRS continues.

85. Ross, *supra* note 84, at 84; *Brown Lists Factors That Could Be Used to See if Cleanup Costs Must Be Capitalized*, Daily Tax Rep. (BNA), at D-19 (Mar. 10, 1993).

86. Megaard & Megaard, *supra* note 82, at 158; *see infra* text accompanying notes 136-39 (discussion of TAMs).

87. *See supra* text accompanying notes 77-80.

88. *See infra* text accompanying note 92.

89. This statement was made by IRS Assistant Chief Counsel (Income Tax & Accounting) Glenn Carrington at the Federal Bar Association Section of Taxation annual conference in Washington, D.C. on March 9, 1993. *Official Gives Update on Series of Guidance on Tax Accounting Issues*, Daily Tax Rep. (BNA) No. 46, at D-6 (Mar. 11, 1993). Carrington is no longer with the Department of the Treasury. Telephone Interview with Merrill Feldstein, Attorney Advisor, Office of the Assistant Chief Counsel (Income Tax & Accounting), Department of the Treasury, Washington, D.C. (Feb. 9, 1995) [hereinafter Feldstein Interview].

90. Ross, *supra* note 84, at 84.

91. *See, e.g.,* *Wolfsen Land & Cattle Co. v. Commissioner*, 72 T.C. 1, 17-18 (1979) (requiring capitalization for expenditures normally deductible as annual maintenance when expenditures were not made, forcing the entire system to be restored).

92. Feldstein Interview, *supra* note 89; *Environmental Cleanup Costs*, CCH Tax Day: Federal (Nov. 1, 1994); *Private Sector Groups Meet with IRS, Treasury on Remediation*, Nat'l Env't Daily (BNA), at D-11 (Feb. 6, 1995); *Treasury Releases 28 Letters Under Freedom of Information Act*, Daily Rep. for Execs. (BNA) No. 224, at D-48 (Nov. 23, 1994).

B. *Controversy Between Taxpayers and the IRS About Capitalization of Environmental Remediation Costs*

Treasury Regulation § 1.263(a)-1(b) provides that expenditures that "add to the value, or substantially prolong the useful life, of property . . . or . . . adapt property to a new or different use" must be capitalized rather than deducted pursuant to I.R.C. § 162.⁹³ Therefore, with respect to environmental remediation expenditures, the goal of the capitalization decision is to determine whether such expenditures increase the property's useful life and value, and thus are capital, or are necessary to continue business, and thus are deductible.⁹⁴ Traditionally, the IRS has claimed that remediation expenditures create a future benefit that must be capitalized,⁹⁵ while taxpayers have sought to deduct cleanup costs as repairs.⁹⁶

1. Increase in Value

"Generally, if the correction's cost increases the property's value, the expenditure could be considered a capital expense. However, since virtually all repairs increase the repaired property's value (and marketability),"⁹⁷ the question of when to capitalize an expenditure that increases property value remains. The Tax Court, in *Plainfield-Union Water Co. v. Commissioner*, determined that "[t]he proper test is whether the expenditure materially enhances the value, use, [and] life expectancy [of an asset] . . . as compared with the status of the asset prior to the condition necessitating the expenditure."⁹⁸ Under this standard, if the expenditure returns the property to the state it was in before the need for the expenditure arose, without rendering the property more valuable, it is considered deductible in the current period.⁹⁹

Taxpayers assert that the *Plainfield-Union* test should be utilized to ascertain whether expenditures increase property value and should be

93. Treas. Reg. § 1.263(a)-1(b).

94. See I.R.C. §§ 162, 263; Treas. Reg. § 1.263(a)-1(b).

95. See TAX EXECUTIVE, *supra* note 5, at 308.

96. See *id.* at 307.

97. Nicholas Fiore, *Deductibility of Repairs*, J. ACCT., Dec. 1992, at 32, 32.

98. *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333, 338 (1962). In *Plainfield-Union*, the petitioner cleaned out pipe and lined it with cement to eliminate tuberculation and the necessity for periodic cleaning. *Id.* These expenditures were held to be deductible because the lining was not permanent and would eventually wash away. *Id.* The cleaning and cement lining restored the pipes, allowing their continued use in petitioner's operation. *Id.* at 337. They did not "materially increase the useful life, value, or structural strength of the pipes involved, nor . . . render those pipes suitable for any new or additional use." *Id.*

99. *Id.* at 338. For a more recent case, see *Niagara Mohawk Power Corp. v. United States*, 558 F.2d 1379, 1387 (Ct. Cl. 1977) (holding that repair of leaks did not increase the value of pipes as compared to their value before the repairs were needed).

capitalized.¹⁰⁰ The IRS, however, in TAM 92-40-004, found the *Plainfield-Union* test indeterminate of property value increases in asbestos removal cases.¹⁰¹ It reasoned that it is difficult to accurately value property when the taxpayer is unaware of an existing condition.¹⁰² This is especially true when the condition is discovered only as a result of the tightening of statutory guidelines such as environmental standards.¹⁰³

The IRS claims that asbestos removal diminishes the risk of developing asbestos-related disease.¹⁰⁴ This decreased health risk lessens the potential liability to employees and inhabitants of the area and increases property value.¹⁰⁵ Therefore, property is more attractive to both purchasers and lenders.¹⁰⁶

In addition, the IRS alleges that expenditures made pursuant to statutes requiring remediation increase property value.¹⁰⁷ The required cleanup increases the marketability of the property because potential purchasers will not have to include the cost to get the property "up to code" when computing purchase price.¹⁰⁸ The Seventh Circuit, in *Teitelbaum v. Commissioner*,¹⁰⁹ concurred with the IRS's view. In that case, the court held that "[e]ven though [involuntary modifications] may not improve the property by increasing its attractive appearance or efficiency, or prolonging its life, such modifications do render the property more valuable for the taxpayer's use by bringing the property into compliance with applicable regulation."¹¹⁰

100. See *infra* text accompanying notes 146-76; see also *Conjura*, *supra* note 76, at 137.

101. Tech. Adv. Mem. 92-40-004 (June 29, 1992). "The IRS expressed several reasons for limiting the application of the *Plainfield-Union* test, the most persuasive of which was that, because asbestos was an integral part of the equipment when manufactured, the equipment could not be valued prior to the existence of the asbestos—the condition necessitating the expenditure." Ross, *supra* note 84, at 83. Revenue Ruling 88-57 implied that the *Plainfield-Union* test should apply only to cases of "sudden and unanticipated damage to an asset." Rev. Rul. 88-57, 1988-2 C.B. 36, 37. However, this was modified in Revenue Ruling 94-38. Rev. Rul. 94-38, *supra* note 13, at 36.

102. See TAX EXECUTIVE, *supra* note 5, at 314.

103. *Id.*

104. See, e.g., John S. Ross, III, *Environmental Cleanup Costs: Legislative Solution Unlikely; Taxpayers Await Administrative Action by IRS*, 9 Tax Mgmt. Real Est. J. (BNA) 216, 218 (Nov. 3, 1993).

105. *Id.*

106. *Id.*

107. See, e.g., *RKO Theatres, Inc. v. United States*, 163 F. Supp. 598, 602 (Ct. Cl. 1958) (requiring capitalization of expenditure for statutorily-required alterations to theatre that increased its value); *Hotel Sulgrave, Inc. v. Commissioner*, 21 T.C. 619, 621 (1954) (complying with a sprinkler system requirement did not increase the value of the hotel or prolong its useful life, but did increase the business value of the building, and therefore expenditures must be capitalized).

108. See Ross, *supra* note 104, at 217. Compliance with statutory regulations may also result in avoidance of government penalties for noncompliance. *Id.*

109. 294 F.2d 541 (7th Cir. 1961), *cert. denied*, 368 U.S. 987 (1962).

110. *Id.* at 544.

Therefore, due to the increase in value, remediation costs had to be capitalized.

Applying the *Plainfield-Union* test to Sequence's asbestos removal operation, the value of the warehouse after removal will not materially increase from its value prior to the removal. The asbestos removal merely returns the warehouse to its original state. Although, as the IRS asserts, the removal operation will most likely diminish health risks and thus decrease potential liability, this does not increase the value of the warehouse.

2. Increase in Useful Life

Expenditures must be capitalized when they substantially prolong the useful life of property over its expected life before the expenditures were needed.¹¹¹ However, expenditures made for repairs "necessary" to keep a building in operating condition have consistently been found to be deductible for income tax purposes.¹¹² These repairs do not extend the original useful life of the property. Instead, they allow the continued use of the property throughout its expected life.

Taxpayers argue that environmental remediation rarely extends the expected life of an asset.¹¹³ Rather, remediation permits the continued use of the property over its expected useful life.¹¹⁴ Nonetheless, the IRS finds that remediation extends the useful life of the property.

Accordingly, the IRS would contend that removing the asbestos from the ceiling of Sequence's warehouse extends the useful life of the property. Sequence, on the other hand, would assert that the asbestos remediation is "necessary" to keep the warehouse functioning, and therefore, the remediation simply permits continued use of the property for its original useful life, and thus, should not be capitalized.¹¹⁵

3. Change in Utility

Expenditures enabling property "to be put to a new, different use . . . [or] adapt[ing] an asset so it can function in a different manner"

111. See TAX EXECUTIVE, *supra* note 5, at 316; Treas. Reg. § 1.263(a)-1(b); see also *Electric Energy, Inc. v. United States*, 13 Cl. Ct. 664, 667 (1987) (altering boiler prolonged its useful life, and must be capitalized); *Midland Empire Packing Co. v. Commissioner*, 14 T.C. 635, 641 (1950) ("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.").

112. See, e.g., *Illinois Merchants Trust Co. v. Commissioner*, 4 B.T.A. 103, 107 (1926) (replacing rotting piles under a building was an allowable expense); *Midland Empire*, 14 T.C. at 642-43 (required lining of a cellar wall with additional concrete was an ordinary expense); *American Bemberg Corp. v. Commissioner*, 10 T.C. 361, 377 (1948) (reconstructing an expensive foundation was an ordinary and necessary expense), *aff'd*, 177 F.2d 200 (6th Cir. 1949); *City Nat'l Bank v. Commissioner*, 11 T.C.M. 411 (1952) (repointing a wall to preserve a building was a deductible expense).

113. See TAX EXECUTIVE, *supra* note 5, at 316.

114. *Id.*

115. *Id.* at 308.

must be capitalized.¹¹⁶ Thus, consideration must be given to the original intended use of the property and the use of the property after the expenditure.¹¹⁷ Taxpayers claim that asbestos remediation merely restores property to its "original, useful and non-hazardous condition," thus not adapting the property to any new use, and rendering the cleanup costs deductible.¹¹⁸ The IRS, however, asserts that asbestos remediation brings about significant change, resulting in a permanent improvement/benefit to property.¹¹⁹

Sequence would argue that removing asbestos fireproofing does not adapt the warehouse's use or cause it to function in a different manner. Instead, the removal merely allows the warehouse to continue operating for its intended purpose, albeit in a non-hazardous condition. The warehouse served as storage space for thirty-five years and will continue as the storage area for Sequence's inventory. The IRS would probably disagree, claiming that the asbestos removal significantly changes the warehouse and its ceiling.

C. Relationship Between Tax Treatment and Financial Accounting and Reporting of Environmental Remediation Expenditures¹²⁰

Generally, a corporation's tax treatment of an item follows its treatment for financial accounting purposes¹²¹ unless a superseding rule is present in the I.R.C.¹²² Therefore, a taxpayer's decision about the tax treatment of environmental remediation expenditures may be influenced by concerns for reporting net income to shareholders and/or creditors.

The Emerging Issues Task Force ("EITF"), formed by the Financial Accounting Standards Board ("FASB")¹²³ to identify and resolve financial reporting problems,¹²⁴ has established guidelines for the treat-

116. Fiore, *supra* note 97, at 32; *see, e.g.*, Treas. Reg. § 1.263(a)-1(b).

117. *See* TAX EXECUTIVE, *supra* note 5, at 316.

118. *Tax Treatment of Environmental Remediation Expenses*, 13 Tax Mgmt. Wkly. Rep. (BNA) 777, 777 (June 6, 1994).

119. Patrick G. Doohar, *Asbestos Removal: Expense or Capital Improvement*, 34 Tax Mgmt. Mem. (BNA) 19, 21 (Jan. 25, 1993).

120. A complete analysis of this subject is beyond the scope of this Note.

121. Financial reporting is based on standards, known as Generally Accepted Accounting Principles, as pronounced by the Financial Accounting Standards Board ("FASB"). PATRICK R. DELANEY ET AL., *GAAP INTERPRETATION & APPLICATION 6* (1994). The FASB, an independent body, is the "designated authoritative organization" on financial accounting matters. *Id.*

122. I.R.C. § 446 states that "[t]axable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." I.R.C. § 446(a) (1988).

123. *See supra* note 121.

124. DELANEY ET AL., *supra* note 121, at 7. Once the EITF reaches a consensus on an issue, no further action by the FASB is necessary. *Id.* The application of an EITF consensus is mandatory. EITF ABSTRACTS: A SUMMARY OF PROCEEDINGS OF THE FASB EMERGING ISSUES TASK FORCE ii (Fin. Accounting Standards Bd. 1994) [hereinafter EITF ABSTRACTS].

ment of environmental remediation costs. The financial reporting requirements are that remediation costs are to be expensed unless the remediation: (1) extends the life, capacity, safety, or efficiency of the asset; (2) will prevent or mitigate future environmental contamination; or (3) is incurred to prepare the property for sale.¹²⁵ However, if the purchaser was aware of the hazard at the time of purchase, remediation costs incurred within a reasonable time of the purchase must be capitalized.¹²⁶ In addition, remediation costs that are not reported on the financial statements because they are not both probable and estimable may still have to be disclosed in a corporation's financial statements.¹²⁷

For financial reporting purposes, income and the expenditures made to generate that income are reported in the period incurred.¹²⁸ "[T]he [Internal Revenue] Code [also] endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes."¹²⁹ However, because the I.R.C. requires capitalization of remediation costs unless they constitute incidental repairs,¹³⁰ while the FASB focuses on expensing cleanup costs,¹³¹ tax and book treatment will not necessarily be consistent.

III. CURRENT TAX TREATMENT OF ENVIRONMENTAL REMEDATION COSTS

I.R.C. §§ 162 and 263 provide guidance for determining whether an expenditure is a capital one or may be deducted in the current period.¹³² For more specific treatment of environmental remediation

125. CAPITALIZATION OF COSTS TO TREAT ENVIRONMENTAL CONTAMINATION, EITF Issue No. 90-8, in EITF ABSTRACTS, *supra* note 124, at 591-92.

126. ACCOUNTING FOR THE COST OF ASBESTOS REMOVAL, EITF Issue No. 89-13, in EITF ABSTRACTS, *supra* note 124, at 557.

127. A corporation must report its contingent liabilities to properly reflect its current financial position. FASB's Statement of Financial Accounting Standards No. 5 § 8 sets the standards for disclosing a liability if it is either probable or estimable, or if there is a reasonable possibility that a liability may have occurred. However, it does not specifically address reporting of contingent environmental liabilities. ACCOUNTING FOR CONTINGENCIES, Statement of Financial Accounting Standards No. 5 (Fin. Accounting Standards Bd. 1975).

128. RALPH ESTES, DICTIONARY OF ACCOUNTING 83 (1981). This is referred to as the "matching principle." *Id.*

129. *INDOPCO, Inc. v. Commissioner*, 112 S. Ct. 1039, 1043 (1992). "The primary effect of characterizing a payment as either a business expense or a capital expenditure concerns the timing of a taxpayer's cost recovery . . ." *Id.* at 1042; *see, e.g., Commissioner v. Idaho Power Co.*, 418 U.S. 1, 15 (1974) ("[W]here a taxpayer's generally accepted method of accounting is made compulsory by the regulatory agency and that method clearly reflects income, it is almost presumptively controlling of federal income tax consequences.").

130. *See supra* text accompanying notes 68-72.

131. *See supra* text accompanying note 125.

132. For discussion of I.R.C. §§ 162 and 263, *see supra* text accompanying notes 61-72.

costs, the taxpayer must look to Treasury Department Revenue Rulings and Technical Advice Memoranda.¹³³ Revenue Rulings are published. "conclusion[s] of the [IRS] on how the law is applied to a specific set of facts."¹³⁴ Taxpayers, IRS agents, and others can use Revenue Rulings for guidance and information.¹³⁵

TAMs are responses to requests by an IRS district office in connection with a dispute regarding a taxpayer's return.¹³⁶ They "are issued to assist IRS personnel in closing cases . . . and [in] maintain[ing] consistency among [the] IRS districts."¹³⁷ TAMs cannot be relied on as authority by anyone other than the taxpayer subject to the response.¹³⁸ While Revenue Rulings and TAMs are not as authoritative as the I.R.C. or Treasury Regulations, they illustrate the current applications and policies of the IRS.¹³⁹ Therefore, taxpayers consult them when engaging in tax planning.

In the past several years, the IRS has addressed the tax treatment of environmental remediation in three TAMs and a Revenue Ruling.¹⁴⁰ In the TAMs, the IRS consistently ordered remediation costs to be capitalized.¹⁴¹ However, in its most recent guidance, Revenue Ruling 94-38, the IRS changed course and held that soil and groundwater remediation costs are deductible in the period incurred.¹⁴²

A. Prior IRS Treatment of Remediation Expenditures

1. TAM 92-40-004

TAM 92-40-004 involved the discovery of asbestos insulation in the processing facility of a manufacturing and sales corporation.¹⁴³ When faced with the decision of removing or encapsulating the asbestos, the corporation chose removal because of its long-term cost effectiveness.¹⁴⁴ The replacement insulation was ten percent less thermally efficient than the original asbestos insulation.¹⁴⁵ The taxpayer claimed

133. See JAMES J. FREELAND ET AL., *FUNDAMENTALS OF FEDERAL INCOME TAXATION* 26 (8th ed. 1994). Revenue Rulings and TAMs are issued under statutory authority granted to the Treasury Department by Congress and are issued by the National Office of the Internal Revenue Service. *Id.*

134. Rev. Proc. 95-1, 1995-1 I.R.B. 9; see Treas. Reg. § 601.601(d)(2)(i)(a) (as amended in 1987).

135. Rev. Proc. 95-1, 1995-1 I.R.B. 9.

136. Treas. Reg. § 601.105(b)(5)(i)(a) (as amended in 1987).

137. Linda Galler, *Emerging Standards for Judicial Review of IRS Rulings*, 72 B.U. L. REV. 841, 841 n.4 (1992); see Treas. Reg. § 601.105(b)(5)(i)(a).

138. I.R.C. § 6110(j)(3) (1988); see FREELAND ET AL., *supra* note 133, at 27.

139. FREELAND ET AL., *supra* note 133, at 26.

140. See Tech. Adv. Mem. 92-40-004 (June 29, 1992), 93-15-004 (Dec. 17, 1992), 94-11-002 (Nov. 19, 1993); Rev. Rul. 94-38, *supra* note 13.

141. See *infra* text accompanying notes 148-53, 158, 165-67.

142. Rev. Rul. 94-38, *supra* note 13, at 36.

143. Tech. Adv. Mem. 92-40-004 (June 29, 1992).

144. *Id.*

145. *Id.*

the removal costs as tax deductions in the current period.¹⁴⁶ Relying on *Plainfield-Union*, the taxpayer advanced three main arguments for deductibility: (1) the removal costs were so insignificant in comparison to the total equipment repair costs and the total value of the equipment that they constituted incidental repairs; (2) no value was added because the new insulation was less efficient than the asbestos insulation; and (3) the useful life of the equipment did not increase because the replacement of the insulation merely restored the property to its original state.¹⁴⁷

The IRS rejected the taxpayer's arguments, requiring the expenditures to be capitalized and deducted over the new useful life of the equipment.¹⁴⁸ The IRS determined that asbestos removal was a permanent improvement that provides a significant change in the equipment¹⁴⁹ and thus increases the useful life of the property. In addition, the IRS asserted that (1) property not contaminated by asbestos is inherently more valuable than that same property before asbestos removal;¹⁵⁰ (2) the asbestos removal brings the property into compliance with regulations, thus increasing its marketability;¹⁵¹ (3) removal reduces or eliminates health risks, therefore decreasing the potential liability to employees;¹⁵² and (4) the absence of asbestos increases efficiency by reducing the possibility of equipment interruption due to safety violations.¹⁵³ For these reasons, the IRS capitalized the remediation costs.

2. TAM 93-15-004

The taxpayer in TAM 93-15-004 used polychlorinated biphenyls ("PCBs") in its business for many years, unaware of the health risks involved.¹⁵⁴ The EPA found soil contamination that had resulted from dumping of the PCBs, and required the taxpayer to clean up the soil surrounding its facility to bring it into compliance with applicable regulations.¹⁵⁵

The taxpayer claimed that the cleanup expenditures were deductible in the current year as "ordinary and necessary" business expenses.¹⁵⁶ It further asserted that the expenditures were incurred to correct activities that had occurred in prior years. Thus, the taxpayer argued that because the costs were not attributable to future income,

146. *Id.*

147. *Id.*

148. *Id.*

149. *Id.*

150. *Id.*

151. *Id.*

152. *Id.*

153. *Id.*

154. Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992).

155. *Id.*

156. *Id.*

they should be currently deductible, not capitalized and deducted in future years.¹⁵⁷ The IRS, however, concluded that the expenditures increased the property's value, and therefore, must be capitalized.¹⁵⁸

3. TAM 94-11-002

The taxpayer in TAM 94-11-002 was a corporation with facilities including a warehouse and boiler house.¹⁵⁹ To secure a bank loan, the taxpayer removed asbestos from the boiler house and encapsulated asbestos-containing pipe insulation in the warehouse.¹⁶⁰ After the encapsulation, the air in the warehouse had to be monitored to certify that asbestos concentrations were at a safe level.¹⁶¹

The IRS viewed the cleanup as two steps: first, the removal; and second, the encapsulation and monitoring. It concluded that the expenditures involved with the removal added value to the property and adapted it to a new use and thus must be capitalized.¹⁶² The encapsulation and monitoring, however, did not increase the value, nor prolong the useful life of the property, and thus could be deducted.¹⁶³

The IRS utilized the *Plainfield-Union* test in determining the increase in value of the property resulting from asbestos removal.¹⁶⁴ The IRS found that the removal of asbestos increased the value, use, and capacity of the boiler house as compared to the property when it contained asbestos.¹⁶⁵ This increase was due to the elimination of health risks, the new attraction to potential buyers and investors, and the enhanced usefulness and capacity of the property as the taxpayer would be able to rent it to others once it was asbestos-free.¹⁶⁶ Thus, the cleanup costs were capitalized because the IRS found that they increased the property's value.¹⁶⁷

The encapsulation, however, was not found to increase the value of the property, adapt it to a new use, or prolong its useful life and thus did not require capitalization.¹⁶⁸ It reduced, but did not eliminate, the threat of asbestos exposure, and the quality of the air would still have to be monitored.¹⁶⁹ The IRS reasoned that the effects of the encapsulation were temporary and did not eliminate health risks.¹⁷⁰ Thus, the

157. *Id.*

158. *Id.* The IRS allowed the expenditures to be capitalized as part of the cost of the property rather than as part of the land, which is not depreciable. *Id.*

159. Tech. Adv. Mem. 94-11-002 (Nov. 19, 1993).

160. *Id.*

161. *Id.*

162. *Id.*

163. *Id.*

164. *Id.*

165. *Id.*

166. *Id.*

167. *Id.*

168. *Id.*

169. *Id.*

170. *Id.*

encapsulation expenditures were for "incidental" repairs, and were determined to be deductible under I.R.C. § 162.¹⁷¹

B. *Current IRS Tax Treatment of Remediation Expenditures—
Revenue Ruling 94-38*

The taxpayer in Revenue Ruling 94-38 owned and operated a manufacturing plant that discharged hazardous waste.¹⁷² This waste, which was buried on portions of the property, caused soil and groundwater contamination.¹⁷³ To comply with environmental regulations, the taxpayer remediated the soil and groundwater and established a system to continually monitor the groundwater for hazardous waste contamination.¹⁷⁴ The taxpayer constructed a treatment facility that would remain in operation for more than ten years.¹⁷⁵ The remediation and monitoring restored the taxpayer's land to essentially the same physical state it was in prior to the remediation, but without the hazardous condition.¹⁷⁶

Again, the IRS applied the *Plainfield-Union* test in the taxpayer's situation, stating that the test is appropriate for determining whether environmental remediation expenditures increase property value.¹⁷⁷ However, the IRS did not construe "improved health and safety, reduced exposure to lawsuits, and ability to continue business as future benefits that render . . . expenditures capital in nature."¹⁷⁸ Pursuant to the *Plainfield-Union* test, the IRS found that the remediation expenditures did not add value to the property.¹⁷⁹ Thus, the remediation expenditures were deductible as "ordinary and necessary" expenses under I.R.C. § 162.¹⁸⁰ However, the groundwater treatment facility, having a useful life beyond the current year and producing a permanent benefit, had to be capitalized.¹⁸¹

Based on Revenue Ruling 94-38, it appears that the IRS shifted its focus in determining whether to capitalize environmental remediation expenditures and did not rely on intangible factors as determinative of capitalization.¹⁸² However, the IRS has indicated that the holding will be limited to the Revenue Ruling's specific facts.¹⁸³

171. *Id.*

172. Rev. Rul. 94-38, *supra* note 13, at 35.

173. *Id.*

174. *Id.*

175. *Id.*

176. *Id.*

177. *Id.*

178. *Conjura*, *supra* note 76, at 139.

179. Rev. Rul. 94-38, *supra* note 13, at 36.

180. *Id.*

181. *Id.*

182. *See Conjura*, *supra* note 76, at 139.

183. *Court's Allowance of Ordinary Loss Deduction Prior to Demolition of Building May Impact Treatment of Environmental Cleanup Costs*, 35 Tax Mgmt. Mem. (BNA) 325, 325 (Oct. 17, 1994); *see Feldstein Interview*, *supra* note 89.

IV. REMEDIATION COSTS SHOULD BE DEDUCTIBLE IN THE PERIOD INCURRED

Environmental remediation costs, particularly those for asbestos remediation, do not increase the value or useful life of property, nor change its utility. Accordingly, the IRS should allow taxpayers to deduct remediation costs in the period incurred by extending Revenue Ruling 94-38, including the *Plainfield-Union* test, to all environmental remediation expenditures. In addition, this approach matches current expenditures with income of the same period. Moreover, deductibility of these expenditures would encourage swift remediation.

To determine whether remediation "materially enhances the value, use, [or] life expectancy"¹⁸⁴ of property, the IRS should apply the *Plainfield-Union* test. Doing so involves comparing the property after remediation with its state before the need arose, allowing for accurate measurement of the effect of the remediation on the property.

No material or tangible value is added to a taxpayer's property as a result of environmental remediation. Nor does the remediation increase the useful life of property. Rather, remediation allows for the continued use of property for its original useful life. In addition, environmental remediation does not adapt property to a new use. Instead, it merely returns the property to its original use, but in a non-hazardous condition. The removal and replacement of asbestos does not change the use of the pipe or the walls from which it was removed. Nor does the replacement of contaminated soil alter the utility of the land. Thus, remediation expenditures should not be capitalized pursuant to Treasury Regulation § 1.263(a)-1(b).¹⁸⁵

Sequence's remediation, most likely removal, will not alter the warehouse in any material way. After the cleanup, the value of the warehouse will not increase, there will not be an extension of its useful life, and it will still be used to store clothing. The remediation simply restores property to the position it was in before the cleanup occurred.

Furthermore, capitalization of remediation costs distorts income. Remediation "does not create an asset" that should be capitalized, rather it "extinguishes a liability."¹⁸⁶ These expenditures discharging the liability are not related to currently produced income, but rather are a result of prior period activity. Accordingly, these cleanup costs should be expensed, "matching" the present costs with income of the current period.¹⁸⁷

One should not forget that the focus of this controversy should be the importance of environmental remediation. The government

184. *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333, 338 (1962).

185. See *supra* text accompanying notes 73-76.

186. TAX EXECUTIVE, *supra* note 5, at 310.

187. See Ross, *supra* note 104, at 219.

should use its taxing power¹⁸⁸ to encourage protection of the environment through environmentally conscious tax policies. Generally, the primary benefits from environmental remediation efforts are to the environment and the general public, not to the corporation implementing the cleanup. Therefore, preferential tax treatment may speed the process of remediation, resulting in more effective cleanup. Allowing a current deduction rewards corporations for their environmental contributions, encouraging swift remediation. Without the benefit of a deduction, corporations are more likely to seek less costly, and possibly less effective, cleanup methods or simply delay the cleanup.

CONCLUSION

Environmental remediation expenditures should be currently deductible because remediation does not tangibly increase the value or useful life of property, or adapt its utility. Furthermore, allowing deductions for environmental remediation in the period incurred encourages prompt, effective remediation. Thus, tax policy permitting current deductibility of remediation expenditures accurately reflects the cleanup of property, while benefiting society and the environment.

188. U.S. CONST. art. I, § 8, cl. 1.