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Steven G. Black

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The Continuing Saga of Environmental Cleanup Costs: Current Deduction Allowed Under the Restoration Principle of *Plainfield-Union*

*We realize that we only have the land on loan, and that we must look after it properly.*¹

I. INTRODUCTION

"It has been estimated that by the end of the century, the costs associated with the cleanup of the environment will approach \$160 billion per year."² Such substantial expenditures will have serious economic effects on corporate America, the U.S. government, and ultimately on every individual residing in this country.

The deductibility of expenditures associated with the cleanup of hazardous waste has not been specifically addressed by the federal courts³ or Congress. Absent judicial or legislative guidance, the Internal Revenue Service has struggled to determine whether costs associated with environmental cleanup activities are deductible as business expenses in the year incurred,⁴ or alternatively, if these costs are to be capitalized under § 263 of the Internal Revenue Code.⁵ Two conflicting policies are involved: (1) promoting voluntary environmental cleanup activities; and (2) formulating a tax revenue plan that will alleviate, if not eliminate, the five

1. Harlan S. Byrne, *Heidemij: A Global Mr. Clean*, BARRON'S, Sept. 5, 1994, at 18 (quoting Heidemij's 1993 annual report).

2. Paul L. Langer, *Significant Current Developments in Environmental Insurance Coverage*, in ENVIRONMENTAL INSURANCE COVERAGE CLAIMS AND LITIGATION 1994, at 129, 129 (PLI Comm. L. & Practice Course Handbook Series No. 690, 1994).

3. The two most relevant cases are *Plainfield-Union Water Co. v. Comm'r*, 39 T.C. 333 (1962) (addressing the deductibility of costs associated with cleaning and lining a water pipe with cement), and *INDOPCO, Inc., v. Comm'r*, 503 U.S. 79, 87-89 (1992) (holding that expenditures that benefit future periods must be capitalized).

4. See I.R.C. § 162 (1994). A deduction allowed in the year the expense was incurred is referred to as a "current deduction" throughout this comment.

5. I.R.C. § 263 (1994).

trillion dollar national debt.⁶ Grappling with these policy issues, the Internal Revenue Service ("the Service") has recently issued three pronouncements that convey mixed results.⁷ The two most recent pronouncements⁸ adopt the "restoration principle" that was advanced by the Tax Court over thirty years ago,⁹ but which had largely been ignored by the Service in previous pronouncements.¹⁰

The purpose of this comment is to explore the current position of the Internal Revenue Service regarding the deductibility of environmental cleanup costs and to propose a strategy which balances the complex policy issues involved in capitalizing or deducting environmental cleanup costs. Part II discusses statutory and regulatory authority that govern the availability of a current business deduction. An illustration in Part II depicts the tax benefit obtained by receiving a current deduction of an expenditure under § 162 rather than capitalizing the expenditure under § 263. Part III examines judicial and administrative interpretations of the statutes and regulations and portrays the difficulties the Service has encountered in developing a consistent environmental cleanup

6. As will be discussed in Part IV, allowing a tax incentive to encourage voluntary environmental cleanup will reduce tax revenue. However, if no incentive is given and no cleanup occurs, the government may be called upon to clean up the property. Such government involvement has proven to be extremely costly to taxpayers. See *infra* note 120 and accompanying text.

7. Rev. Rul. 94-38, 1994-1 C.B. 35 (allowing deduction for soil remediation and groundwater treatment costs); Tech. Adv. Mem. 95-41-005 (Oct. 13, 1995) (disallowing deduction for environmental impact studies and related legal fees); Priv. Ltr. Rul. 94-11-002 (Mar. 18, 1994) (disallowing deduction for asbestos removal).

8. Rev. Rul. 94-38, 1994-1 C.B. 35; Tech. Adv. Mem. 95-41-005 (Oct. 13, 1995).

9. *Plainfield-Union*, 39 T.C. at 338 (addressing the deductibility of costs associated with cleaning and lining a water pipe with cement). The term "restoration principle" of *Plainfield-Union* was first used by the Service in Tech. Adv. Mem. 95-41-005 (Oct. 13, 1995). The valuation test of *Plainfield-Union* has also been referred to as the "before-and-after test."

The restoration principle analyzes whether expenditures increase the value of property. The process involves "compar[ing] the status of the asset after the expenditure with the status of that asset before the condition arose that necessitated the expenditure." Rev. Rul. 94-38, 1994-1 C.B. 35 (citing *Plainfield-Union*, 39 T.C. at 338). For a detailed analysis of the restoration principle, see *infra* part III.A.

10. Previous letter rulings of the Service have discussed the restoration principle of *Plainfield-Union* in connection with cleanup of environmentally hazardous materials, but the Service had declined to give the principle much weight. See Priv. Ltr. Rul. 94-11-002 (Mar. 18, 1994); Priv. Ltr. Rul. 93-15-004 (Apr. 16, 1993); Priv. Ltr. Rul. 92-40-004 (Oct. 2, 1992).

policy. Part III also summarizes the current law by analyzing the most recent I.R.S. pronouncements and their application of *Plainfield-Union's* restoration principle.¹¹ Part IV addresses the competing social policies of decreasing the national debt and promoting voluntary cleanup of hazardous materials. Part V concludes by proposing a two-step method for allowing a current deduction of environmental cleanup costs that is in harmony with the competing social policies.

II. STATUTORY AND REGULATORY AUTHORITY

In determining whether environmental cleanup costs are deductible, a taxpayer must examine several sections of the Internal Revenue Code that authorize or deny a business deduction. The underlying issue is whether corporations will be allowed a business deduction under I.R.C. § 162,¹² or, alternatively, whether such costs must be capitalized under I.R.C. § 263 and depreciated over a substantial number of years.¹³

A. *Section 162: Deduction for Ordinary and Necessary Expenses*

In order for environmental cleanup expenditures to be deducted in the current tax year, they must be ordinary business expenses that qualify for a deduction under § 162 of the Internal Revenue Code.¹⁴ Section 162 allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."¹⁵

11. *Plainfield-Union*, 39 T.C. at 338.

12. I.R.C. § 162 (1994).

13. See I.R.C. §§ 167-68, 263 (1994). Section 168(c)(1) states that the applicable recovery period for nonresidential real property is 39 years. See *infra* part II.C for an illustration of the financial benefit derived from receiving a current deduction of an expenditure under § 162 rather than capitalizing an expenditure under § 263 and depreciating that amount over 39 years. Since land is not depreciable under §§ 167-68, any costs that are capitalized to land may not be recovered until the property is subsequently sold.

14. I.R.C. §§ 161-162 (1994).

15. I.R.C. § 162(a) (1994); see also *Commissioner v. Tellier*, 383 U.S. 687, 689 (1966) (holding that the term "necessary" imposes "only the minimal requirement that the expense be 'appropriate and helpful' for 'the development of the [taxpayer's] business,'" (quoting *Welch v. Helvering*, 290 U.S. 111, 113 (1933))); *Deputy v. Du Pont*, 308 U.S. 488, 495 (1940) (To qualify as "ordinary" the expense must relate to a transaction "of common or frequent occurrence in the type of business involved.").

Treasury Regulation section 1.162-1(a)¹⁶ provides the following examples of expenses that are considered "ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business":¹⁷ cost of goods sold, management expenses, commissions, labor, supplies, incidental repairs, operating expenses of automobiles used in a trade or business, business traveling expenses while away from home, advertising, selling expenses, insurance premiums, and rent.¹⁸ If the expenses are not necessary and ordinary, they must be capitalized and either depreciated under §§ 167 and 168 of the Code, or added to the value of the real estate.¹⁹

Environmental cleanup of hazardous materials generally involves the restoration of contaminated land and structures to an uncontaminated state. This procedure is similar to the repair of other business assets that have been damaged. Treasury Regulation section 1.162-4 permits the cost of certain repairs to be deducted in the current tax year under § 162 if certain conditions have been met.²⁰ In order to qualify, a repair must satisfy all parts of the following four-pronged test: (1) the repair must be "incidental," (2) the cost of the repair must not "materially add to the value of the property," (3) the cost of the repair must not "appreciably prolong [the useful] life" of the property, and (4) the purpose of the repair must be to keep the property in an "ordinarily efficient operating condition."²¹

Environmental cleanup costs generally must satisfy the four-pronged "incidental repair" test of Treasury Regulation section 1.162-4 in order to qualify for a current deduction under § 162. However, if the environmental cleanup costs are part of an ongoing plan of rehabilitation, Revenue Ruling 88-57 disallows a current deduction and requires the expenditures to be capitalized.²² A plan of rehabilitation is evidenced by periodic repairs that, standing alone, could qualify for a current deduction, but when viewed together constitute an integrated plan to increase the useful life or value of an asset.²³ Considering the

16. Treas. Reg. § 1.162-1(a) (as amended in 1993).

17. *Id.*

18. *Id.*

19. See I.R.C. §§ 167-168, 263 (1994).

20. Treas. Reg. § 1.162-4 (1960).

21. *Id.*

22. Rev. Rul. 88-57, 1988-2 C.B. 36; see also *Wehrli v. United States*, 400 F.2d 686 (10th Cir. 1968).

23. See Rev. Rul. 88-57, 1988-2 C.B. 36; *Wehrli*, 400 F.2d at 690. For exam-

enormous time and expense often involved in environmental cleanup activities, related costs are difficult to label as "incidental repairs" not incurred as part of a general plan of rehabilitation.²⁴

Traditionally, the burden of proof is on the taxpayer to establish that an expenditure qualifies for a current deduction under § 162.²⁵ The Service recently explained:

Section 161 of the Code clarifies the relationship between deductions allowable under section 162 and capital expenditures under section 263. Section 161 provides that the deductions allowed in Part VI [of the Code], including section 162, are subject to the exceptions set forth in Part IX [of the Code], including section 263. Thus, the capitalization rules of section 263 take precedence over the rules for deductions under section 162.²⁶

Consequently, if a taxpayer fails to carry her burden of proof under § 162, the capitalization rules of § 263 will apply.²⁷

B. Section 263: Capital Expenditures

Section 263 of the Internal Revenue Code provides that no deduction is allowed for any costs associated with "permanent

ple, suppose a large university replaces a burned-out fluorescent light with a new light that is guaranteed to have a longer life than the previous light. Viewed alone, the replacing of a light is an incidental repair expense and receives a current deduction under § 162. However, if the university decides to replace all of its old fluorescent lights with more efficient lights over an extended period of time, the process is considered to be a single event for purposes of Revenue Ruling 88-57, and the collective costs must be capitalized under § 263. See generally Rev. Rul. 88-57, 1988-2 C.B. 36.

24. See Priv. Ltr. Rul. 93-15-004 (Apr. 16, 1993) (stating that the cleanup of PCB contamination "constitutes a general plan of rehabilitation and restoration of taxpayer's properties"). Despite Regulation § 1.162-4 and Revenue Ruling 88-57, Revenue Ruling 94-38 allowed a current deduction for soil remediation and ongoing groundwater treatment costs. Rev. Rul. 94-38, 1994-1 C.B. 35. Revenue Ruling 94-38 did not indicate whether soil remediation and groundwater treatment costs are incidental repairs or part of a general plan of rehabilitation. The Service concluded that the "soil remediation and ongoing groundwater treatment expenditures do not result in improvements that increase the value of [taxpayer's] property because [taxpayer] has merely restored its soil and groundwater to their approximate condition before they were contaminated by [taxpayer's] manufacturing operations." *Id.*

25. "[I]ncome tax deductions are 'a matter of legislative grace' and . . . the taxpayer bears the burden of clearly showing the right to the claimed deduction. . . ." Tech. Adv. Mem. 95-41-005 (Oct. 13, 1995) (quoting *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79, 83 (1992)).

26. *Id.* (citing *INDOPCO*, 503 U.S. at 83.)

27. See I.R.C. § 161 (1994).

improvements or betterments made to increase the value of any property or estate.²⁸ Treasury Regulation section 1.263(a)-1(b) states that capital expenditures (1) "add to the value" of the property,²⁹ (2) "substantially prolong the [property's] useful life,"³⁰ or (3) "adapt property to a new or different use."³¹

Although § 263 is well defined and strictly applied, certain statutory exceptions are granted for activities such as the "development of mines," "research and development expenditures," "soil and water conservation," "expenditures by farmers for fertilizer," "expenditures for removal of architectural and transportation barriers to the handicapped and elderly," and up to \$17,500 for purchase of personal tangible property used in a trade or business.³² However, Congress has not yet granted an exception for environmental cleanup costs.

C. *Impact of Applying § 162 Rather than § 263*

The effect of applying § 162 rather than § 263 can be shown by the following illustration. Assume X Corporation has voluntarily commenced cleanup of environmentally hazardous materials located in a corporate warehouse for a total estimated cost of \$1 million. X Corporation's marginal tax rate is 40%. If all expenditures satisfy the four-prong test of Treasury Regulation section 1.162-4, the "incidental repairs" are fully deductible under § 162. Consequently, the immediate tax deduction reduces the overall cost from \$1 million in before-tax dollars to \$600,000 in after-tax dollars.³³ In contrast, if all cleanup costs are treated as capital expenditures and the amount is depreciated over thirty-nine years,³⁴ X Corporation's net cost is \$915,562.³⁵ Hence, X Corporation saves \$315,562 (\$915,562 -

28. *Id.* § 263.

29. Treas. Reg. § 1.263(a)-1(b) (as amended in 1994).

30. *Id.* Treasury Regulation § 1.263(a)-2(a) explains that capital expenditures create "property having a useful life substantially beyond the taxable year." Treas. Reg. § 1.263(a)-2(a) (as amended in 1987).

31. Treas. Reg. § 1.263(a)-1(b) (as amended in 1994).

32. I.R.C. § 263(a)(1)(A)-(E), (G) (1994).

33. The tax savings are computed as follows: $\$1,000,000 \times 40\% \text{ tax rate} = \$400,000$. The net cost would be $\$1,000,000 - \$400,000 = \$600,000$. These calculations assume a combined federal and state income tax rate of 40 percent.

The effect of the above calculation is that for each dollar spent on cleanup costs, X Corporation's net cost is 60 cents—the other 40 cents is contributed by the federal and state government in the form of an income tax deduction.

34. I.R.C. § 168(c)(1) (1994) (requiring nonresidential real property to be depreciated over 39 years).

35. The overall tax benefit will be \$84,438 realized over 39 years and com-

\$600,000) or 32 percent if the cleanup costs are deemed to be deductible in the current tax year rather than depreciated over 39 years. As will be discussed in Part IV.B., a 32 percent reduction in cleanup costs will encourage many corporations to voluntarily commence cleanup activities; disallowing current deductions will, of course, have the opposite effect.

III. JUDICIAL AND ADMINISTRATIVE PRECEDENT

The Internal Revenue Service has struggled to interpret the interplay of §§ 162 and 263 regarding environmental cleanup costs. This Part summarizes the most significant cases and I.R.S. pronouncements that directly impact the deductibility of environmental cleanup costs. The most critical factor that has evolved in obtaining a current deduction for cleanup costs under § 162 is the application of the "restoration principle" developed by the Tax Court over thirty years ago in *Plainfield-Union, Inc. v. Commissioner*.³⁶

A. Plainfield-Union Water v. Commissioner

In 1962, the Tax Court in *Plainfield-Union* applied a before-and-after test³⁷ to determine whether the cost of cleaning and lining a water pipe with cement should be deducted or capitalized. The Service argued that "the *value* of the pipe to [the taxpayer] was materially increased by the expenditure and that it is, therefore, a capital expenditure."³⁸ The Tax Court did not agree with this argument and pointed out that "any properly performed repair adds value as compared with the situation existing immediately prior to that repair."³⁹ In determining whether a cost must be capitalized, "[t]he proper test would be whether the expenditure materially enhances the

puted as follows. Depreciation will be allowed at the rate of \$25,641 per year (\$1,000,000 divided by 39 years). Assuming a combined federal and state income tax rate of 40%, the tax benefit will be \$10,256 per year (\$25,641 x 40%). The present value of a \$10,256 benefit over 39 years with an assumed interest rate of 12% is \$84,438.

The effect of the above calculation is that for each dollar spent on cleanup costs, X Corporation's net cost is 92 cents—the other 8 cents is contributed by the federal and state government in the form of an income tax deduction.

36. 39 T.C. 333, 338 (1962).

37. The Service has subsequently referred to this test as the "restoration principle." See Tech. Adv. Mem. 95-41-005 (Oct. 13, 1995).

38. *Plainfield-Union*, 39 T.C. at 338 (emphasis added).

39. *Id.*

value, use, life expectancy, strength, or capacity as compared with the status of the asset prior to the condition necessitating the expenditure.⁴⁰ In applying the *Plainfield-Union* restoration principle to environmental cleanup situations, the issue is whether the value of the property before the contamination is equal to the value of the property after the contamination has been removed. If the values are roughly equivalent, the cleanup costs are deductible as a repair expense under § 162.⁴¹

The restoration principle has not been uniformly applied by the Service in determining the deductibility of environmental cleanup costs.⁴² Additionally, the decision by the U.S. Supreme Court in *INDOPCO, Inc. v. Commissioner*⁴³ has been interpreted to require capitalization in many instances and raises concerns over whether the restoration principle of *Plainfield-Union* still applies.

B. INDOPCO v. Commissioner

*INDOPCO v. Commissioner*⁴⁴ is considered "the most authoritative, current pronouncement on the issue of capitalization."⁴⁵ The Supreme Court held that when two corporations reorganize, one becoming a subsidiary of the other, the professional fees of the reorganization must be capitalized since they provide significant future benefits to the corporations.⁴⁶ Since environmental cleanup costs will undoubtedly provide future

40. *Id.*

41. For example, assume a taxpayer purchases land for \$100,000. The taxpayer commences manufacturing operations on the property and subsequently contaminates the soil. In year five, the land in its contaminated state is valued at \$50,000 while other similar properties without contamination remain valued at \$100,000. After \$60,000 is spent on soil remediation, the value of the land is once again \$100,000. The soil remediation causes the value of the land to double. Since the value of the "repair" materially adds to the value of the property, a strict application of Treasury Regulation § 1.162-4 causes the soil remediation costs to be capitalized. Treas. Reg. § 1.162-4 (as amended in 1960). However, under the *Plainfield-Union* test, the value of the land before the contamination is equal to the value of the land after the cleanup expenditures. Consequently, \$60,000 is deductible in the current year as an ordinary and necessary business expense. See *Plainfield-Union*, 39 T.C. at 338; Rev. Rul. 94-38, 1994-1 C.B. 35.

42. Compare Rev. Rul. 94-38, 1994-1 C.B. 35 with Priv. Ltr. Rul. 94-11-002 (Mar. 18, 1994); Priv. Ltr. Rul. 93-15-004 (Apr. 16, 1993); Priv. Ltr. Rul. 92-40-004 (Oct. 2, 1992).

43. 503 U.S. 79 (1992).

44. 503 U.S. 79 (1992).

45. Larry Witner & Michael Lynch, *Tax Consequences of Environmental Clean-Up Costs: An Updated History*, 23 REAL EST. L.J. 268, 270 (1995).

46. *INDOPCO*, 503 U.S. at 87-89.

benefits, a strict application of *INDOPCO* would apparently require all cleanup costs to be capitalized. However, like most broad tests, some exceptions apply.

1. Matching revenues with expenses for environmental cleanup costs as a compelling reason for an exception to a strict application of INDOPCO

Requiring environmental cleanup costs to be capitalized under § 263 offends the underlying policy of the Internal Revenue Code of matching expenses with the revenues those expenses produce.⁴⁷ The Service has stated that “the Internal Revenue Code generally endeavors to match expenses with the revenues of the taxable period to which the expenses are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes.”⁴⁸ For example, if X Corporation spends \$50,000 in 1996 to purchase a delivery truck that is to be used for seven years in its business of selling widgets, the entire purchase price should not be deducted in 1996. Instead, the cost of the truck should be capitalized and depreciated over the useful life of the truck. Under this approach, the revenue produced by the delivery truck in one particular year is partially offset by the amount of the truck’s purchase price allocated to that year. Thus, matching income with expenses more accurately portrays taxable income for a particular year.⁴⁹

Unlike the purchase of a truck, the costs associated with remedial cleanup activities generally are attributable to *past* income rather than future income. For example, if, in the production of widgets, X Corporation creates a hazardous by-product that is stockpiled on its property rather than properly disposed of, the net income for X Corporation is overstated. The reason for the overstatement of income is that disposing of the hazardous waste is an expense associated with the production of the widgets already manufactured, but this expense has not yet been recognized. Rather than capitalize subsequent expenditures for environmental cleanup and reduce future income, a more accurate matching of revenues with expenses would require the costs to be deducted to offset current income.⁵⁰ Yet,

47. *See id.* at 84; *Comm’r v. Idaho Power Co.*, 418 U.S. 1, 16 (1974).

48. Rev. Rul. 94-77, 1994-2 C.B. 19 (citing *INDOPCO*, 503 U.S. at 84; *Idaho Power*, 418 U.S. at 16).

49. *See id.*

50. The most accurate method of matching revenues with expenses would be

since the cleanup will benefit future periods of income, *INDOPCO*'s future benefits test would apparently require capitalization of the expenditures.

In developing an exception to *INDOPCO* for environmental cleanup costs, two exceptions previously recognized by the Service are relevant, namely, severance payments and advertising expenses.

2. *An analogy between environmental cleanup costs and severance payments: an exception to a strict application of INDOPCO*

Severance payments are generally used in connection with a business down-sizing in which employees are compensated for early dismissal. After down-sizing, a business may be in a more favorable position to minimize losses and/or maximize gains. Consequently, severance benefits generally will provide future benefits—thus making the expenditures subject to capitalization under the *INDOPCO* decision. Revenue Ruling 94-77 dealt with whether *INDOPCO* affects the deductibility of severance payments made by a taxpayer to its employees.⁵¹ The Service indicated:

[A]lthough severance payments made by a taxpayer to its employees in connection with a business down-sizing may produce some future benefits, such as reducing operating costs and increasing operating efficiencies, these payments principally relate to previously rendered services of those employees. Therefore, such severance payments are generally deductible as business expenses under § 162 and § 1.162-10.⁵²

A similarity can be drawn between expenditures related to environmental cleanup costs and severance benefits. Although both types of expenditures may contribute to "reducing operat-

to allow the costs to be carried back to prior years to offset prior income. This might occur if expenses exceed revenues in the current tax year and a net operating loss (NOL) results. I.R.C. § 172 allows an NOL to offset income in "each of the [three] taxable years preceding the taxable year of such loss." I.R.C. § 172(b)(1)(A)(i) (1994).

51. Rev. Rul. 94-77, 1994-2 C.B. 19.

52. *Id.* Revenue Ruling 94-77 goes on to state that certain limitations still apply. For example, "if severance payments that would otherwise be deductible under section 162 are made to employees under a plan, method, or arrangement deferring the receipt of compensation, these payments are deductible under section 404(a) subject to the limitations thereof." *Id.*

ing costs and increasing operating efficiencies," both are also attributable to previously incurred income and expenses. Thus in order to "match expenses with the revenues of the taxable period to which the expenses are properly attributable,"⁵³ environmental cleanup expenditures, like severance benefits, should be allowed a current deduction under § 162 of the Internal Revenue Code.

3. *An analogy between environmental cleanup costs and advertising expenses; an exception to a strict application of INDOPCO*

Revenue Ruling 92-80⁵⁴ indicates that "[t]he *INDOPCO* decision does not affect the treatment of advertising costs under section 162(a) of the Code. These costs are generally deductible under that section even though advertising may have some future effect on business activities, as in the case of institutional or goodwill advertising."⁵⁵ According to Revenue Ruling 92-80, even though advertising expenditures will benefit future periods, they are deductible under the theory that they maintain corporate goodwill.⁵⁶ Advertising, therefore, is considered an "incidental repair," deductible under Treasury Regulation section 1.162-4.⁵⁷

53. *Id.*

54. Rev. Rul. 92-80, 1992-2 C.B. 57.

55. *Id.*; see also Treas. Reg. §§ 1.162-1(a) (as amended in 1993), 1.162-20(a)(2) (as amended in 1969).

56. Rev. Rul. 92-80, 1992-2 C.B. 57.

57. Treas. Reg. § 1.162-4 (1960). To explore the concept that even expenditures for the most expensive advertising campaigns can be considered a current deduction, one only needs to look to the extraordinary event known as the Superbowl. For roughly four hours, viewers are intermittently blitzed with advertising campaigns that are tremendously costly. Kevin Goldman, *Superbowl Ad Teams Drop Ball, Calling Dull, Old Plays*, WALL ST. J. EUR., Feb. 1, 1995, at 4 ("Sponsors paid on average \$1 million for a 30-second spot" in Superbowl XIX.). For example, Coopers & Lybrand, a "Big Six" accounting firm, bucked the previous tradition of no national advertising in the accounting industry and spent millions of dollars on a 30 second advertising spot in Superbowl XVII. Richard Greene & Katherine Barrett, *Auditing the Accounting Firms*, FINANCIAL WORLD, Sept. 27, 1994, at 30. In Superbowl XIX, Nike spokesperson Stanley Craver (Dennis Hopper) rambled for 90 seconds about his love for the game of football—a \$3 million dollar speech! *Stanley Ads Strengthening Nike's Super Bowl Connection*, ORLANDO SENTINEL, Jan. 29, 1995, at H4. Can a current deduction for such extremely expensive advertisements be justified along the reasoning that the expense is merely an "incidental repair to corporate goodwill"? Although the Superbowl commercials undoubtedly influence corporate goodwill and thus should be expected to benefit future periods, Revenue Ruling 92-80 creates an exception to the *INDOPCO* decision and

One important reason why a corporation would want to voluntarily commence cleanup activities is to maintain corporate goodwill. Like advertising expenses, environmental cleanup can be viewed as an "incidental repair" used to maintain a corporate image, and therefore should be deductible under Treasury Regulation section 1.162-4.

In summary, an exception to the future benefits test of *INDOPCO* for environmental cleanup costs can be supported by three theories: (1) matching revenues with expenses, (2) the similarity between environmental cleanup costs and deductible severance payments, and (3) the similarity between environmental cleanup costs and advertising.

C. Pronouncements of the Internal Revenue Service

The Internal Revenue Service has released a number of pronouncements that have attempted to balance §§ 162 and 263 of the Code with *Plainfield-Union* and *INDOPCO*. Unfortunately, the Service has not been consistent in its application of the law concerning environmental cleanup costs. These inconsistencies are revealed by an analysis of the Service's rulings concerning two significant environmental issues, asbestos abatement, and soil remediation.

1. Asbestos abatement

PLR 9240004⁵⁸ is the first of two letter rulings from the Service concerning asbestos abatement.⁵⁹ This ruling addressed the deduction claimed by a taxpayer for the removal of asbestos insulation. The taxpayer argued that the costs (1) were "minor in relation to the total repair costs" and value of the equipment, (2) did not add value to, prolong the life of, or increase the efficiency of the equipment, and (3) merely restored the equipment to the value it had prior to the time the taxpayer discovered the asbestos problem.⁶⁰ The IRS determined that the value of the taxpayer's property had increased,

allows these expenditures to be currently deducted under § 162.

58. Priv. Ltr. Rul. 92-40-004 (Oct. 2, 1992).

59. There are three accepted methods of asbestos abatement: (1) encapsulation, (2) removal, and (3) enclosure. 40 C.F.R. § 763.83 (1994). Encapsulation involves the coating and sealing of walls, ceilings, pipes, or other structures. *Id.* Removal involves the elimination of asbestos from the property. *Id.* Enclosure involves the construction of a barrier between the asbestos and the environment. *Id.*

60. Priv. Ltr. Rul. 92-40-004 (Oct. 2, 1992).

thus creating a permanent improvement to the property. Consequently, the expenditures would provide significant future benefits and thus all cleanup costs should be capitalized.⁶¹

Two years later, the Service, in PLR 9411002, ventured into dangerous territory by holding that expenditures for temporary asbestos abatement may be deductible, but expenditures for permanent abatement must be capitalized.⁶² In this ruling, the taxpayer was required by its lender to remove all asbestos-containing materials from its boiler house. Additionally, the taxpayer was required to encapsulate damaged asbestos-containing pipe insulation in its warehouse.⁶³

The Service held that the removal of asbestos resulted in capital expenditures since "the asbestos removal costs increased the value, use, and capacity of the taxpayer's facility."⁶⁴ To support its position, the Service pointed out that the asbestos-free building was much more valuable than the asbestos-contaminated building since the removal of asbestos (1) "created better operating conditions," (2) made the property "significantly more attractive to potential buyers," and (3) enabled the taxpayer to provide additional office space and a garage free of the asbestos hazard.⁶⁵ The Service distinguished *Plainfield-Union* by asserting that costs to remove asbestos "permanently eliminated the defect," therefore the expenditures were "not similar to incidental repair costs, but must be capitalized as permanent improvements under section 263 of the Code."⁶⁶

For the temporary solution of asbestos encapsulation,⁶⁷ the Service concluded that "encapsulation of asbestos-containing materials . . . constitute incidental repair costs that neither materially add to the value of [the] property nor appreciably prolong its life."⁶⁸ The consequence of this ruling is to treat a temporary remedy as deductible under § 162, but a permanent remedy as adding value to the property, hence requiring capitalization of the expenditures under § 263.⁶⁹ Allowing deduc-

61. *Id.*

62. Priv. Ltr. Rul. 94-11-002 (Mar. 18, 1994).

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.* (asserting that the remedy in *Plainfield-Union* was only temporary in nature).

67. See *supra* note 59 for a definition of encapsulation.

68. Priv. Ltr. Rul. 94-11-002 (Mar. 18, 1994).

69. *Id.* PLR 9411002 does not indicate whether enclosure of asbestos is con-

tions for temporary solutions while requiring capitalization of permanent remedies is not sound tax policy. The tax savings could entice some companies to opt for a deductible "quick fix" rather than a permanent remedy for the situation. Both PLR 9240004 and PLR 9411002 focus on the immediate increase of value asbestos abatement will have on property and fail to give significance to the restoration principle of *Plainfield-Union*.⁷⁰

If the *Plainfield-Union* restoration principle were applied to both PLR 9411002 and PLR 9240004, the outcomes probably would have been different.⁷¹ The deductibility of the removal of asbestos would focus on the value of the asset after the removal compared with the value of the asset before the asbestos was determined to be a health hazard.⁷² If the value of the asset had increased, then the expenditures would be capitalized under § 263. If the value of the asset had not increased, the costs would be deductible under § 162, regardless of whether the remedy was permanent or temporary.

2. Soil remediation

Both Revenue Ruling 94-38 and PLR 9315004 involve soil remediation issues. In PLR 9315004,⁷³ the EPA required the taxpayer to clean up contamination of soil and underground water caused by the taxpayer dumping lubricants containing PCB into surrounding earthen pits.⁷⁴ To support a current deduction under § 162, the taxpayer asserted that the cleanup simply restored the property to its value prior to contamination, thus the "incidental repair" was deductible under Treasury Regulation section 1.162-4 by applying the restoration principle of *Plainfield-Union*.⁷⁵ The taxpayer also argued that the future benefits test of *INDOPCO* did not apply since the cleanup costs related to past activities.⁷⁶ The IRS disagreed

sidered a temporary or permanent remedy.

70. Three months after PLR 9411002, the Service released Revenue Ruling 94-38, which adopted the *Plainfield-Union* restoration principle without discussion of whether a remedy must be permanent or temporary.

71. Glenn R. Carrington, *Tax Treatment of Environmental Clean-Up Costs*, in CREATIVE TAX PLANNING FOR REAL ESTATE TRANSACTIONS, at 863, 870 (A.L.I.-A.B.A. Course of Study C967, 1994).

72. *Id.*

73. Priv. Ltr. Rul. 93-15-004 (Apr. 16, 1993).

74. *Id.*

75. *Id.*

76. *Id.*

with the taxpayer's position and ruled that the costs were not incidental under Treasury Regulation section 1.162-4 since "the cleanup operations . . . constitute a general plan of rehabilitation and restoration of taxpayer's properties."⁷⁷ In addition, the IRS minimized the importance of the *Plainfield-Union* test and held that the "taxpayer's property will be more valuable in its business after it is cleaned of PCB residues [than property that is] in need of remediation."⁷⁸ This proposition is clearly reversed in Revenue Ruling 94-38.

Unlike previous pronouncements, Revenue Ruling 94-38 fully embraces the restoration principle of *Plainfield-Union*.⁷⁹ Revenue Ruling 94-38 involved a taxpayer who commenced a three-year process of replacing contaminated soil with uncontaminated soil.⁸⁰ In addition, the taxpayer began construction of groundwater treatment facilities including wells, pipes, pumps, and other equipment.⁸¹ In a "burst of sanity,"⁸² the Service reversed its position in PLR 9315004 and concluded that soil remediation and groundwater treatment costs do not (1) increase the value of the land, (2) prolong the useful life of the land, or (3) adapt the land to a new or different use.⁸³ In adopting the restoration principle of *Plainfield-Union*, the Service stated:

Under the facts of this ruling, the appropriate test for determining whether the expenditures increase the value of property is to compare the status of the asset after the expenditure with the status of that asset before the condition arose that necessitated the expenditure (i.e., before the land was contaminated by X's hazardous waste).⁸⁴

77. *Id.*

78. *Id.*

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

80. *Id.*

81. *Id.*

82. Martin D. Ginsburg & Jack S. Levin, *Corporate Mergers, Acquisitions and Buyouts—Summary of the Basic Tax and Legal Considerations*, in TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES AND OTHER STRATEGIC ALLIANCES, FINANCINGS, REORGANIZATIONS, AND RESTRUCTURINGS 1994, at 7 (PLI Tax Law and Estate Planning Course Handbook Series No. 359, 1994).

83. Rev. Rul. 94-38, 1994-1 C.B. 35; see Treas. Reg. § 1.263(a)-1(b) (as amended in 1994).

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

Finding that the value of the land had not increased under the restoration principle, the Service concluded that "soil remediation expenditures and ongoing groundwater treatment expenditures . . . do not produce permanent improvements to X's land within the scope of § 263(a)(1) or otherwise provide significant future benefits."⁸⁵ Noticeably absent from Revenue Ruling 94-38 was a discussion of whether the three-year rehabilitation of the soil and groundwater constituted a general plan of rehabilitation, or whether the expenditures were considered "incidental repairs."⁸⁶

Applying the elements of Treasury Regulation § 1.263(a)-1(b),⁸⁷ the Service allowed a current deduction for soil remediation costs and properly required capitalization of costs associated with constructing assets to monitor possible future contamination.⁸⁸ Although Revenue Ruling 94-38 allows a current deduction under § 162 for soil remediation and groundwater treatment costs, the ruling did not make it clear whether its rationale applies to other cleanup activities.

3. *Recent application of the restoration principle*

The taxpayer in TAM 9541005⁸⁹ attempted to apply the rationale of Revenue Ruling 94-38 to expenses associated with contamination studies, legal fees, and consulting fees after its land was designated as a Superfund site under CERCLA.⁹⁰ The taxpayer had for nearly two decades used an island as a site "for the disposal of industrial waste such as agricultural chemical wastes and coke oven by-products."⁹¹ The taxpayer had attempted to donate the property to the county to be used as a recreational park,⁹² but when the county discovered the

85. *Id.*

86. *Cf.* Priv. Ltr. Rul. 93-15-004 (Apr. 16, 1993). In PLR 9315004, the expenditures to remove PCB contamination from the soil were required by the Service to be capitalized since they were "not repairs within the meaning of section 1.162-4 of the Income Tax Regulations" and they "constitute[d] a general plan of rehabilitation." *Id.*

87. *See supra* notes 29-31 and accompanying text.

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

89. Tech. Adv. Mem. 95-41-005 (Oct. 13, 1995).

90. *Id.*; Comprehensive Environmental Response, Compensation and Liability Act, 42 U.S.C. §§ 9601-9675 (1994); *see also infra* note 117 and accompanying text (discussing the effectiveness of CERCLA).

91. Tech. Adv. Mem. 95-41-005.

92. The taxpayer "claimed a deduction under section 170 of the Code for its contribution of the [l]and to the County based on the fair market value of the

contamination, it conveyed the land back to the taxpayer for one dollar.

Although no cleanup of hazardous waste had yet occurred, the taxpayer argued that the restoration principle allowed a current deduction for contamination study costs, legal fees, and consulting fees since the expenditures did "not result in improvements that increased the value of the property."⁹³ The Service held that the restoration principle did not apply to this case since the taxpayer had purchased the land from the county in a "contaminated condition."⁹⁴ The restoration principle "applies only if a taxpayer's environmental remediation expenditures restore the contaminated property to what was its uncontaminated condition at the time it was acquired by the taxpayer."⁹⁵ Although a current deduction was not allowed in this ruling, TAM 9541005 does indicate the Service's continuing reliance on *Plainfield-Union's* restoration principle. The Service outlined three requirements in order for the restoration principle of *Plainfield-Union* to apply.⁹⁶ The taxpayer must (1) "acquire the property in a clean condition," (2) "contaminate the property in the course of its everyday business operations," and (3) "incur costs to restore the property to its condition at the time the taxpayer originally acquired the property."⁹⁷ The first requirement precludes application of the restoration principle when contamination of property is attributable to a previous owner. Absent reliance on the restoration principle, a taxpayer is left to shoulder the burden of satisfying the four-prong test of Treasury Regulation section 1.162-4.⁹⁸

[]land," even though taxpayer was aware of the contamination of the land. Upon a subsequent review of taxpayer's tax returns, an agreed adjustment was made that "reduced the total allowable charitable contribution to the amount of the original basis in the land." *Id.*

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.*

97. *Id.*

98. See Treas. Reg. § 1.162-4 (1960). The Service may only allow a current deduction for prior contamination if the remedy is temporary. See Priv. Ltr. Rul. 94-11-002 (Mar. 18, 1994) (holding that costs associated with temporary asbestos abatement are deductible, but costs associated with permanent removal of asbestos must be capitalized). See *infra* note 132 and accompanying text for "innocent landowner" defense.

4. *Summary of the Service's position on the deductibility of environmental cleanup costs*

After reviewing the most recent pronouncements of the Internal Revenue Service, a number of presumptions can be drawn about the deductibility of environmental cleanup costs. First, the future benefits test of *INDOPCO* will not be strictly applied.⁹⁹ Second, the restoration principle of *Plainfield-Union*¹⁰⁰ will be applied, provided that the taxpayer (i) acquire the property in a clean condition, (ii) contaminate the property in the course of its everyday business operations, and (iii) incur costs to restore the property to its condition at the time the taxpayer originally acquired the property.¹⁰¹ Third, soil remediation and groundwater treatment costs are deductible if expenditures do not (i) increase the value of the property (using the restoration principle), (ii) substantially prolong the useful life of the property, or (iii) adapt the property to a new or different use.¹⁰² Fourth, a three-year soil remediation plan is not considered a general plan of rehabilitation.¹⁰³

What remains uncertain is whether deductibility of cleanup costs will extend to other cleanup activities such as underground storage tank removal,¹⁰⁴ asbestos removal, or legal fees incurred in cleanup activities. TAM 9541005 disallows a current deduction for legal fees,¹⁰⁵ but its broad interpretation of Revenue Ruling 94-38 suggests all environmental cleanup costs are eligible for a deduction under § 162 if the requirements of the restoration principle have been met.¹⁰⁶ Such a conclusion can be drawn by looking at the broad language used in TAM 9541005. The phrase "environmental remediation expenditures"¹⁰⁷ is used in the memorandum rather than "soil remediation expenditures." The inference is that the type of

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

100. 39 T.C. 333, 338 (1962).

101. Tech. Adv. Mem. 95-41-005 (Oct. 13, 1995).

102. See Treas. Reg. § 1.263(a)-1(b) (as amended in 1994).

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

104. Leaking underground storage tanks represent a significant hazard to the environment. It is estimated that between 350,000 and 400,000 underground storage tanks in the United States are leaking environmentally hazardous materials, with a total cleanup cost of \$32 billion. Amy A. Ripepi, *Environmental Remediation Liabilities: An Accountant's Perspective*, 5 VILL. ENVTL. L.J. 395, 397 (1994).

105. Tech. Adv. Mem. 95-41-005 (Oct. 13, 1995).

106. See *id.*

107. *Id.*

hazardous materials being cleaned up is not the determinative factor in whether the costs may be deducted under § 162. The true test is whether the expenditures meet the restoration principle set forth in *Plainfield-Union*.¹⁰⁸

IV. POLICY CONSIDERATIONS OF ENVIRONMENTAL CLEANUP

The cleanup of environmentally hazardous materials involves numerous conflicting social and tax policies. The national debt poses a tremendous restriction on viable options available to the government to clean up existing hazardous sites itself, or to offer tax incentives to polluters to induce voluntary cleanup.¹⁰⁹ Before proposing a method by which the I.R.S. should determine whether cleanup costs are currently deductible, it is important to understand the competing policies underlying this issue.

A. National Debt

As the national debt continues its ascent to astronomical new heights, reducing the deficit and the national debt is becoming an increasingly pressing issue. The Republican Contract With America attempted to address this issue by requiring a balanced budget by the year 2002.¹¹⁰ As evidenced in November of 1995, The Republican Congress is even willing to risk default on government obligations and permit the government to shut down in order to achieve this goal.¹¹¹ In order to attain a balanced budget, a combination of two events must occur: (1) revenues must increase, and (2) spending must decrease. Contrary to this simple formula, environmental cleanup expenditures may result in a decrease of tax revenues (if costs are currently deducted) and an increase in government spending (if government intervention is expanded).

108. 39 T.C. at 338.

109. See *infra* part IV.B.

110. Although the balanced budget amendment was defeated in the Senate in March of 1995, the Republicans are still optimistic that a balanced budget will be achieved by the year 2002. Robert J. Samuelson, *Deliver Now, Pay Later*, THE WASH. POST, April 12, 1995, at A25.

111. David Wessel & Jackie Calmes, *Clinton, GOP Leaders Play the Waiting Game To See Who Will Blink First in Budget Battle*, WALL ST. J., Nov. 13, 1995, at A16.

1. *Decrease of tax revenues*

If the before-and-after test of *Plainfield-Union* is applied to the cleanup of all environmentally hazardous material, the decrease in tax revenues could be enormous. If deductible cleanup expenses amounted to \$160 billion each year,¹¹² the lost tax revenue could be as high as \$56 billion.¹¹³ Such a large amount of lost tax revenue would significantly inhibit Congress's ability to eliminate deficit spending and the five trillion dollar national debt.

2. *Increase in government spending*

The obligation to clean up environmentally hazardous waste is not limited to corporate America. As reported in *The Washington Post* in July of 1993, "The federal government has been fouling its own nest and taxpayers will ultimately have to pay tens of billions of dollars to clean it up."¹¹⁴ The article quoted Rep. George Miller (D-Calif.), chairman of the Democratic staff of the House Natural Resources Committee as stating, "As a result of inadequate laws and decades of neglect, the American taxpayer will be saddled with billions of dollars in cleanup costs. These costs currently do not appear on any budget ledger, yet they are genuine liabilities that the taxpayer will one day incur."¹¹⁵ Thus, while Congress is grappling with the method to reduce deficit spending, tens of billions of dollars may be needed in the next decade alone to clean up government-owned property.¹¹⁶

112. Langer, *supra* note 2 at 129.

113. $\$160,000,000 \times 35\% = \$56,000,000$ (assuming a corporate tax rate of 35%).

114. Tom Kenworthy, *Land Cleanup In Billions Foreseen; 'Decades of Neglect' Confront Taxpayers*, THE WASH. POST, July 9, 1993, at A19.

115. *Id.* (quoting Rep. George Miller (D-Calif.)).

116. For example, both the Bush and Clinton administrations have attempted to reduce defense spending by closing certain military bases across the nation. See Robert S. Greenberger, *Bush Suggests a Coup May Be Best Way To End Iraq's Nuclear Arms Efforts*, WALL ST. J., July 11, 1993, at A2 (President Bush "announced that he had accepted the recommendations of a commission on military base closings."); Clinton, *With Reluctance, Approves Closing of Bases*, WALL ST. J., July 14, 1995, at A4 ("President Clinton reluctantly approved a list of recommended military base closings . . ."). However, by closing a base, the government must face cleanup of waste left from decades of military activities.

Almost 100,000 acres of land controlled by the Interior Department's Bureau of Land Management are heavily contaminated with unexploded ordnance from military firing exercises that will be tremendously difficult to remove. The problem is likely to get worse as BLM takes over bases

Government spending for environmental cleanup costs is also increasing under CERCLA and its "Superfund" sites throughout the nation.¹¹⁷

closed as part of the military's downsizing. For example, the agency may take over 8,000 acres of firing range at Fort Ord, California, that could cost hundreds of thousands of dollars per acre to make safe.

Kenworthy, *supra* note 114 (citing the report of the Democratic House Natural Resources Committee).

An example of how costly a base closure may be is shown by the closing of Jefferson Proving Ground (JPG) near Madison, Indiana. Since World War II, JPG had served as a major weapons testing facility for the Army, causing considerable contamination to more than one hundred square miles of southeastern Indiana. Richard A. Wegman & Harold G. Bailey, Jr., *The Challenge of Cleaning Up Military Wastes When U.S. Bases are Closed*, 21 *ECOLOGY* L.Q. 865, 870 (1994).

The Base Closure Commission originally estimated that closing the JPG would cost only \$30 million . . . [b]ut to remove all bombs and other unexploded ordnance from the JPG, the Army would have to strip the entire facility to a depth of thirty feet, using specially armored bulldozers to do so; the Army estimates this task could cost \$5 to \$10 billion, and other estimates suggest as high as \$13 billion.

Id. Consequently, the cost for closing the base would be over 300 times more expensive than originally anticipated. *See id.*

117. Comprehensive Environmental Response, Compensation and Liability Act, 42 U.S.C. § 9607 (1994).

[CERCLA] was a reaction to public panic over Love Canal, the residential development built near an old chemical dump in upstate New York. There were supposedly about 500 other Love Canals. The EPA would identify these "ticking time bombs," and force "responsible parties" to clean them up pronto via suits and threats of civil penalties. The program was supposed to phase itself out five years and perhaps \$1.6 billion later.

Charlotte Allen, *Environmental Folly: Superfund Toxic Problems Require More Than a Quick Fix*, *BARRON'S*, Sept. 12, 1994, at 62. CERCLA has not been looked upon favorably as evidenced by the following comments:

[T]he authors of [CERCLA] attempted to harness the tort system to pay for cleaning up the environment. Instead of collecting taxes to underwrite all the cleanup, Congress chose to rely mainly on the liability system: the filing of civil suits for tort damages against landowners, chemical companies and waste transporters.

That means treating them like wrongdoers, even though the overwhelming majority broke no federal, state or local laws in effect at the time of the dumping. Many not only had proper permits but were complying with state mandates.

[CERCLA] is thus a system of retroactive liability—a concept that is unconstitutional in the criminal sector (we don't allow *ex post facto* laws) and ought to be equally unconstitutional in the civil sector (it's taking property without compensation).

Congress got away with this perversion of justice because big chemical companies make convenient villains. The same cowboys-and-Indians mentality underlies the Clinton Administration's current reluctance to abolish retroactive liability. "That would let Corporate America off the hook," a horrified EPA official declared recently.

There are now some 38,000 Superfund sites nationwide. . . . About 1,300 of them are on a "national priority list" of sites so noxious that they presumably require immediate federal intervention. Estimates of total cleanup costs range from \$300 billion to \$1 trillion, and the job is expected to take at least 30 years.¹¹⁸

Although the federal government under CERCLA is to be reimbursed by "potentially responsible parties" for any cleanup expenditures incurred, the government has been unsuccessful in large scale recoveries—\$6.8 billion of the \$7.3 billion expended through fiscal 1992 has not been reimbursed.¹¹⁹ Consequently, EPA involvement in cleanup activities undoubtedly will prove extremely costly to the federal government, thereby serving as another catalyst to increase the national debt.

B. Encouraging Polluters to Voluntarily Clean Up Hazardous Waste

Cleanup of Superfund sites has proven to be slow and inefficient. In the 14 years of the EPA's Superfund existence, the EPA has spent \$9.1 billion in moving 13 million cubic yards of environmental waste.¹²⁰ In comparison, Kennecott Copper mine located southwest of Salt Lake City, Utah has moved 13 million cubic yards of environmental waste at a cost of \$80 million.¹²¹ From this comparison, it appears that the most cost effective method of environmental cleanup occurs at the corporate, rather than the government level. One reason for the inefficiency at the government level is the enormous litigation expenses incurred both by private parties and by the government. "Recent estimates of transaction costs [from litigation and related expenses] have ranged from 30 percent to 70 percent of total cleanup costs."¹²² Thus, according to these estimates, a substantial percent of the expenses associated with cleanup under CERCLA may go to lawyers, rather than being

Id.

118. Allen, *supra* note 117, at 62.

119. *Id.*

120. Peter Samuel, *Treasure House or Pollution Pit?*, FORBES, Sept. 12, 1994, at 54, 58.

121. *Id.*

122. Peter B. Prestley, *The Future of Superfund: After the Rio Summit, Domestic Policy Won't be the Same*, 79 Aug. A.B.A. J. 62, 62 (1993).

spent on actual cleanup activities.¹²³ To alleviate enormous federal spending on Superfund sites, the federal government should seek methods to encourage corporations to engage in voluntary cleanup of environmental waste before costly EPA intervention is necessary. As previously discussed, allowing a deduction for cleanup costs could result in up to a thirty-two percent reduction in cleanup expenditures for a corporation.¹²⁴ Such a significant tax savings could serve as a pivotal factor for a corporation in determining whether to proceed with voluntary cleanup activities.

Allowing a current tax deduction for environmental cleanup expenditures represents a double-edged sword for the federal government, however. If current deductions are allowed under § 162, the government will lose tax revenue.¹²⁵ In contrast, without the incentive of current deductibility, corporations may not be willing or able to clean up hazardous waste. This could eventually lead to the EPA declaring more Superfund sites, thus causing governmental expenditures, and the national debt, to increase.

If a current deduction is allowed for cleanup activities, the lost revenue to the government should be considered an "investment" in the environmental stability of the United States. The return on this "investment" may even prove to be economically profitable for the federal government considering that if a culpable company does not clean up its own environmental waste, the federal government may be obliged to do so. Consequently, allowing a current deduction now may prevent costly government involvement in the future.

V. PROPOSED METHOD OF DETERMINING THE DEDUCTIBILITY OF CLEANUP COSTS

To balance the two social policies that appear to be in direct conflict with one another—namely, decreasing the national debt and encouraging voluntary cleanup of hazardous materials¹²⁶—a two-step test is proposed in order for environmental cleanup costs to be deducted under § 162 of the Internal Revenue Code. First, the guidelines of Revenue Ruling 94-38

123. *Id.*

124. *See supra* part II.C.

125. *See supra* part II.C.

126. *See supra* part IV.

must be met, and second, the expenditures must be incurred in a voluntary cleanup activity.

A. *First Step: Satisfying the Guidelines of
Revenue Ruling 94-38*

The first step of the proposal is to expand Revenue Ruling 94-38¹²⁷ to apply to all environmental cleanup costs as long as the expenditures do not (1) increase the value of the property, (2) substantially prolong the useful life of the property, or (3) adapt the property to a new or different use. In determining whether these guidelines are met, the condition of the asset after the contamination is removed is compared with the condition of the asset before the environmental contamination was determined to be a health hazard.¹²⁸ If this "restoration principle" is met, then all costs, including environmental impact studies, attorney fees, and other professional fees, can be currently deducted under I.R.C. § 162. Although cleanup of environmentally hazardous materials will generally provide future benefits, a strict application of *INDOPCO*¹²⁹ will not be required and an exception is created, much like the exceptions for severance benefits and advertising expenses.¹³⁰

If contamination is attributable to a prior owner, a current deduction is permissible if the present owner paid an amount that would represent the fair market value of the property had the property been free and clear of all contamination (and the present owner did not know or should not have known of the contamination at the time of purchase). After hazardous materials have been removed, the fair market value of the property will approximately equal what the purchaser paid for the property. Since no value has been added to the property, a deduction is allowed for the cleanup costs, assuming the other guidelines have also been met. A similar approach has been adopted by Congress in assessing liability under CERCLA.¹³¹ According to the "innocent landowner defense," a nongovernment entity that intentionally acquires property may escape

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

128. See *Plainfield-Union Water Co. v. Comm'r*, 39 T.C. 333, 338 (1962); Tech. Adv. Mem. 95-41-005 (Oct. 13, 1995).

129. *INDOPCO, Inc., v. Comm'r*, 503 U.S. 79 (1992).

130. See *supra* part III.B.2-3.

131. Comprehensive Environmental Response, Compensation and Liability Act, 42 U.S.C. §§ 9607, 9601(A)-(C) (1994); see also *supra* note 117 and accompanying text for a discussion concerning the effectiveness of CERCLA.

CERCLA liability if: (1) the entity can establish that the hazardous substances were placed at the site before the acquisition of the property, and (2) the entity exercised due diligence to detect contamination of the property before the purchase.¹³² Consequently, CERCLA liability is avoided if the purchaser was unaware of the contamination at the time of the purchase. This "innocent landowner" should also be eligible for a current deduction for environmental cleanup expenditures.

In contrast, if the present owner knew or should have known about the existing contamination of the property at the time of purchase, any subsequent cleanup expenditures should be capitalized. In such a case, the purchase price is likely discounted to reflect the contingent liability of potential cleanup costs. Consequently, expenditures for environmental cleanup will increase the value of the land in the hands of the present owner, and thus such costs should be capitalized.

The guidelines of the first step will serve as the mechanism to preserve the traditional notions of ordinary business expenses of § 162 and capital expenditures of § 263.

B. Second Step: Voluntary Environmental Cleanup

In order to qualify for a current deduction, an entity must engage in *voluntary* cleanup activities. The difficult part of the second step is defining the meaning of "voluntary." Consequently, it may be beneficial to address the purpose of the first requirement. As noted, the EPA appears to be relatively inefficient in cleanup activities as compared to the private sector.¹³³ Thus, the objective of the second step is to encourage businesses to voluntarily commence cleanup activities to prevent intervention by the federal government. Although allowing current deductions for potentially billions of dollars in cleanup

132. 42 U.S.C. § 9601(A)-(C); see also 4 JACKSON B. BATTLE & MAXINE I. LIPELES, ENVIRONMENTAL LAW 317 (2d ed. 1993).

In light of the due diligence requirement, and the relatively advanced techniques for detecting contamination, the innocent landowner defense is not likely to protect many current purchasers from future CERCLA liability. The defense has, however, encouraged many current purchasers to conduct pre-acquisition environmental audits of the property to be acquired.

Id. The innocent landowner defense can be used "by current property owners who acquired their CERCLA sites in the past, without knowing of the contamination, and now seek to invoke the defense to avoid CERCLA liability." *Id.*

133. See *supra* notes 120-23 and accompanying text.

activities will at first appear to be a step in the wrong direction in eliminating the federal deficit, the deduction must be considered an investment in the environmental stability of the United States—an investment that will pay dividends in the future by forcing environmental cleanup costs into the more efficient corporate sector, rather than leaving them in the more costly governmental sector. Consequently, “voluntary” should be defined as “not requiring governmental intervention.” Defined as such, compliance with government regulations and directive orders would be considered “voluntary,” but expenditures for cleanup of a Superfund site would not.¹³⁴

VI. CONCLUSION

Encouraging voluntary environmental cleanup must be a primary concern of the federal government and should be regarded as a long-term investment in America. Considering the complexities surrounding the national debt, Congress is in the best position to implement an integrated plan that, first, serves to encourage voluntary cleanup of environmental waste by allowing a deduction under § 162, and second, addresses the impact that a current deduction may have on the national debt. Some people may question whether the federal government can afford to allow billions of dollars of environmental expenditures to be currently deducted, but ultimately we must ask ourselves whether the federal government can afford not to.

Steven G. Black

134. Under this approach, the taxpayer in Tech. Adv. Mem. 95-41-005 would not be allowed a current deduction, even if the property had not been transferred after the taxpayer had contaminated the land. Since the land was designated as a Superfund site, an additional penalty is that the costs cannot be deducted under § 162. See Tech. Adv. Mem. 95-41-005 (Oct. 13, 1995).