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To Expense or to Capitalize? The Impact of Federal Income Tax Treatment of Environmental Cleanup Costs under CERCLA

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TO EXPENSE OR TO CAPITALIZE? THE IMPACT OF FEDERAL INCOME TAX TREATMENT OF ENVIRONMENTAL CLEANUP COSTS UNDER CERCLA

I. INTRODUCTION

The cleanup of America's hazardous waste sites has become a problem of staggering magnitude. Decades of industrial production and storage of toxic wastes have generated nearly 400,000 waste sites across the country.[1] Overall costs to clean up these waste sites are projected to reach $750 billion over the next thirty years,[2] with the average cost of a single cleanup exceeding $30 million.[3]

A critical issue for companies facing an environmental cleanup is the tax dilemma of whether cleanup costs are wholly or partially deductible as business expenses, or whether capitalization of the costs is required.[4] The issue of classification for tax purposes dramatically influences the cleanup process and may ultimately determine a company's financial survival.[5] Classification of the costs as expenses entitles a company to reduce taxes payable in the current year, offsetting present taxable income.[6] In contrast, classification of the costs as capital expenditures generally results in the addition of the cleanup costs to the basis of the property.[7] Thus, the recovery period of the cleanup costs will extend over the useful life of the asset.[8] Additionally, if the

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1. Thomas J. Salerno et al., *Environmental Law and its Impact on Bankruptcy Law - Saga of "Toxins-R-Us"*, 25 REAL PROP. PROB. & TR. J. 261, 263 (1990).

2. Daniel J. Gibby & Ronald Patella, *Deductibility of Environmental Remediation Costs*, J. ACCT., Dec. 1993, at 44.

3. Salerno, *supra* note 1, at 263.

4. *See* I.R.C. § 162(a) (1988 & Supp. IV 1992) (deductibility of trade or business expenses); *Id.* § 263 (capital expenditures); *see also* Stephen C. Jones, *Tax Treatment of Cleanup Costs at Issue*, NAT'L L.J., May 10, 1993, at 16. Throughout the text and footnotes of this Comment, the Internal Revenue Code is referred to as "I.R.C."

5. Jones, *supra* note 4, at 16.

6. Jones, *supra* note 4, at 16; *see generally* I.R.C. § 162(a) (1988 & Supp. IV 1992); *see also* 6 JACOB MERTENS, JR., MERTENS LAW OF FEDERAL INCOME TAXATION § 25.19 (1992).

7. *See* Treas. Reg. § 1.263(a)-1(b) (as amended in 1992); *see also* 1 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 20.4.1 (2d ed. 1990); 6 MERTENS, *supra* note 6, § 25.39 n.84. In tax accounting, basis is a term describing the acquisition cost of an asset. BLACK'S LAW DICTIONARY 151-52 (6th ed. 1990); *see also* I.R.C. § 1012 (1988).

8. Treas. Reg. § 1.263(a)-1(b) (as amended in 1992); *see generally* MERTENS, *supra* note 6, § 25.39. Capital expenditures are not fully deductible in the year incurred. *See* 6 MERTENS, *supra* note 6, § 25.39. If the capital expenditure is incurred relative to an asset which qualifies for depreciation, depletion, or amortization, a taxpayer may recover the expense over the useful life of the asset. *Id.*

cleanup expenditures are attributable solely to unimproved land,[9] such expenditures are recoverable only upon the sale of the property.[10] Lastly, if cleanup costs are capitalized, then the complex issue arises of how to allocate the cleanup expenditures of those "potentially responsible parties"[11] who are not present owners of the contaminated property.[12]

The Internal Revenue Service (IRS) acknowledged the confusion resulting from the absence of a well-defined policy on the tax treatment of environmental cleanup costs incurred under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980[13] (CERCLA).[14] On March 9, 1993, in an attempt to alleviate the confusion, the IRS requested that practitioners comment on five factors the IRS considers relevant in determining the tax treatment of environmental cleanup costs.[15] The IRS solicited comments from practitioners to decide whether the five factors should be issued in the form of guidance, or whether the IRS should decide the capitalization/expense is-

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9. Unimproved land has an indeterminable useful life. *See generally* Treas. Reg. § 1.167(a)-1(b) (as amended in 1972); 6 MERTENS, *supra* note 6, § 25.60. Land has an indeterminable useful life because it does not deteriorate, and therefore no fixed period of time exists over which its usefulness is depreciable. *See* Treas. Reg. § 1.167(a)-2 (1960).

10. Jones, *supra* note 4, at 16. Capitalized expenses are recoverable to the extent that the land's basis is increased by the capitalized amount, resulting in less taxable income upon the sale of the property. *See* Treas. Reg. § 1.263(a)-1(b) (as amended in 1992); 6 MERTENS, *supra* note 6, § 25.39.

11. "Potentially responsible parties" (PRPs) refers to those parties who may be liable for the cleanup costs under CERCLA. *See* 42 U.S.C. § 9601(20) (1988); *see also infra* note 44 and accompanying text.

12. Only the present owner of the land could potentially add the cleanup costs to the land's basis for the purpose of decreasing the taxable profit upon sale. *See* 2 BITTKER & LOKKEN, *supra* note 7, ¶ 42.1; *see generally* I.R.C. §§ 1011, 1012, 1016 (1988 & Supp. IV 1992). As such, non-owner PRPs cannot recoup their costs in this manner if forced to capitalize those costs. For further discussion of the specific tax issues concerning non-owner PRPs see *infra* notes 248, 262-73 and accompanying text.

13. 42 U.S.C. §§ 9601-9675 (1988 & Supp. III 1991).

14. John S. Ross, III, *Environmental Cleanup Costs: IRS to Develop Criteria Concerning Capitalization Versus Expense Problem*, 9 TAX MGMT. REAL EST. J. 82 (1993).

15. Juliann Avakian-Martin, *IRS Struggles for Bright-Line Rules on Cleanup Costs*, 58 TAX NOTES 1408 (1993). The five factors proposed by the IRS as one method of determining if capitalization is appropriate are:

> (1) whether the cost relates to creation of a new piece of property or simply to the cleaning up of existing property; (2) whether the property to which the expense relates is owned by the taxpayer; (3) whether the property to which the expenditure relates will generate future income [for the taxpayer] . . . ; (4) whether the [environmental] problem arose in the course of the taxpayer's business operations while the taxpayer was earning income or whether the property was acquired with the problem already there; and (5) whether the [cleanup] expenditure is voluntary or is involuntarily imposed by a judicial or governmental decision.

Id.

sue on a case-by-case basis.[16] Additionally, the IRS and the Treasury Department have assembled a "working group" to address this controversial issue with a decision expected in 1994.[17] Furthermore, two bills were introduced in the United States House of Representatives on November 22, 1993 to amend CERCLA and the Internal Revenue Code (I.R.C.) to allow present deductibility of environmental cleanup costs.[18]

This Comment addresses the issue of the two alternative federal income tax treatments of environmental cleanup costs and their potential ramifications. Section II of this Comment provides a background on the development of CERCLA in response to the extensive and pervasive problem of hazardous waste.[19] Section II also examines the nature of current tax deductions versus capitalization and provides a foundation of relevant tax principles for the subsequent discussion of the tax treatment of environmental remediation costs.[20] Section III then begins this discussion by detailing the varying positions on the deductibility of environmental cleanup costs.[21] Section III also examines how the burdensome impact of an adverse tax treatment for environmental cleanup costs compounds the inadequacies already present in the areas of settlement funds and insurance coverage for cleanup costs, as well as bankruptcy prioritization for government-funded cleanups.[22] Lastly, Section III addresses the similarities of CERCLA cleanup costs to expenditures that are incurred in two analogous areas of environmental repair and are permitted current deductibility as business expenses: surface mining reclamation costs and the costs involved in cleaning up soil and groundwater contaminated with petroleum.[23]

This Comment concludes that Congress must delineate specific guidelines for the tax treatment of environmental cleanup costs in the 1994 re-enactment of CERCLA. Section IV also advocates that Congress encourage environmental cleanups by allowing major, specific portions of environmental cleanup costs to be expensed as opposed to capitalized. Finally, this Comment suggests that the IRS heed the commentary solicited from practitioners and other tax experts until legislative guidelines are included in the 1994 re-enactment of CERCLA.

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16. *Brown Lists Factors That Could Be Used To See If Cleanup Costs Must Be Capitalized*, NAT'L ENVTL. DAILY (BNA) (March 11, 1993). The IRS received a "tremendous amount" of informal commentary on this issue. Marianne Lavelle, *Deductions Mulled for Environmental Cleanup Expenses*, NAT'L L.J., Dec. 20, 1993, at 15, 18.

17. Lavelle, *supra* note 16, at 18.

18. H.R. 3620, 103d Cong., 1st Sess. (1993); H.R. 3621, 103d Cong., 1st Sess. (1993).

19. *See infra* notes 29-45 and accompanying text.

20. *See infra* notes 46-93 and accompanying text.

21. *See infra* notes 94-257 and accompanying text.

22. *See infra* notes 258-304 and accompanying text.

23. *See infra* notes 305-13 and accompanying text.

II. BACKGROUND

By enacting CERCLA in 1980, Congress acknowledged the presence of substantial numbers of hazardous waste sites nation-wide.[24] As discovery of new waste sites accelerates, the vast majority of industrial or commercial taxpayers will be faced with cleanup liability for past and present environmental contamination.[25] Thus, the federal income tax treatment of environmental cleanup costs may potentially impact many taxpayers.[26] Despite good legislative intentions, one reason that CERCLA has not fulfilled cleanup expectations is that Congress failed to establish parameters on how to effectuate CERCLA's goals. The legislative history of CERCLA is minimal because Congress hastily enacted CERCLA during the last few weeks of the Carter administration.[27] Furthermore, courts have provided little insight on this issue, as evidenced by the distinct lack of case law on the proper tax treatment of CERCLA cleanup costs.[28] Thus, not only the taxpayers, but also the IRS and the courts are confused regarding the intended implementation of CERCLA.

A complete analysis of the magnitude of the hazardous waste problem and the number of parties potentially affected by a particular tax treatment of the cleanup costs requires discussion of both the environmental and the tax aspects of the issue. First, this section discusses the promulgation of CERCLA to address the need for an environmental remediation statute. Additionally, this section furnishes the foundation for the subsequent analysis of the ramifications of alternative tax treatments of CERCLA cleanup costs by providing an overview of the basic tax principles relevant to the treatment of cleanup costs.

A. Hazardous Waste and CERCLA

Congress designed CERCLA to address the critical need for remediation of hazardous waste sites. CERCLA created a comprehen-

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24. Bradford C. Mank, *The Two-Headed Dragon of Siting and Cleaning Up Hazardous Waste Dumps: Can Economic Incentives or Mediation Slay the Monster?*, 19 B.C. ENVTL. AFF. L. REV. 239, 243 (1991). Hazardous waste is not defined in CERCLA; however, Congress has defined a hazardous substance as "[a]ny substance which . . . is toxic, . . . corrosive, . . . [or] an irritant . . . [which] may cause substantial personal injury or substantial illness during or as a proximate result of any customary or reasonably foreseeable handling or use." 15 U.S.C. § 1261(f) (1988). Additionally, "[t]he term 'toxic' shall apply to any substance which has the capacity to produce personal injury or illness to man through ingestion, inhalation, or absorption through any body surface." *Id.* § 1261(g).

25. Timothy A. Moan, *Basic Federal Income Tax Issues Attributable to Environmental Cleanup Costs, in* ENVIRONMENTAL TAX HANDBOOK 1-2 (George R. Farrah ed., 1993).

26. *Id.*

27. Mank, *supra* note 24, at 243.

28. *See* Lavelle, *supra* note 16, at 18. No court decisions exist that specifically deal with the deductibility of environmental cleanup costs. *Id.*

sive plan directly regulating hazardous substance release.[29] CERCLA authorizes the President of the United States to prioritize and remediate hazardous waste sites.[30] In the original promulgation of CERCLA in 1980, President Reagan delegated this power to the Environmental Protection Agency (EPA).[31] In response, the EPA has developed a "National Contingency Plan"[32] (NCP). Pursuant to the NCP, the EPA has an ongoing responsibility to identify and prioritize hazardous waste sites.[33] To meet this responsibility, the EPA has developed a "National Priorities List" (NPL) of the most serious hazardous waste sites in the United States.[34]

CERCLA provides that EPA cleanup actions are appropriate upon a release or threatened release of a hazardous substance, pollutant, or contaminant "which may present an imminent and substantial danger to the public health or welfare."[35] Such cleanup actions may include short-term removal[36] and permanent remedial[37] measures.

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29. *See* 42 U.S.C. §§ 9601-9675 (1988 & Supp. III 1991); *see also* Sally A. Drach, *CERCLA Update*, at 2 (Practicing Law Inst. Corp. Law & Practice Course Handbook Series No. B4-7027, 1993). It is noteworthy that under CERCLA, the term "hazardous substance" does not apply to petroleum or natural gas. *See* 42 U.S.C. § 9601(14)(F) (1988). For a discussion of the current deductibility of petroleum cleanup expenses and an examination of how the same tax treatment readily lends itself to CERCLA cleanup costs, see *infra* notes 305-08 and accompanying text.

In 1986, Congress enacted the Superfund Amendments and Reauthorization Act (SARA), which clarified and expanded CERCLA. Drach, *supra* note 29, at 2. SARA renewed the original CERCLA taxes and extended the expiration date of the provisions governing the Hazardous Substance Superfund Trust Fund (Superfund) and related taxes to September 30, 1990. *See* Ada S. Rousso, *Environmental Excise Taxes, in* ENVIRONMENTAL TAX HANDBOOK 278 (George R. Farrah ed., 1993). For further discussion of the Superfund and related taxes, see *infra* notes 38-44 and accompanying text.

In 1990, Congress opted to reauthorize CERCLA without revision. Presently, CERCLA is scheduled for revision and reauthorization in 1994. *See* Mank, *supra* note 24, at 245.

30. 42 U.S.C. §§ 9604(a)(1), 9605(a) (1988); *see* Daniel Klerman, *Earth First? CERCLA Reimbursement Claims and Bankruptcy*, 58 U. CHI. L. REV. 795, 797 (1991).

31. Exec. Order 12,580, 52 Fed. Reg. 2,923 (1987), *amended by* Exec. Order 12,777, 56 Fed. Reg. 54,757 (1991); *see also* 42 U.S.C. § 9615 (1988) (allowing delegation of authority).

32. 42 U.S.C § 9605 (1988).

33. *Id.*; *see also* Jill Thompson Losch, Comment, *Bankruptcy v. Environmental Obligation: Clash of the Titans*, 52 LA. L. REV. 137 (1991).

34. 42 U.S.C. § 9604 (1988); *see also*, Mank, *supra* note 24, at 243. The NPL contains at least one site from every state. 42 U.S.C. § 9605(a)(8)(B) (1988); *see also* James M. Harrison, Note, *Environmental Law: United States v. Akzo Coatings of America - CERCLA, Section 106, and the "Arbitrary and Capricious" Standard*, 18 U. DAYTON L. REV. 475, 478 (1993).

35. 42 U.S.C. § 9604(a)(4)(A)-(D) (1988).

36. 42 U.S.C. § 9601(23) defines removal as:

> the cleanup or removal of released hazardous substances from the environment, such actions as may be necessary taken in the event of the threat of release of hazardous substances into the environment, such actions as may be necessary to monitor, assess, and evaluate the release or threat of release of hazardous substances, the disposal of removed material, or the taking of such other actions as may be necessary to prevent, minimize, or mitigate damage to the public health or welfare or to the environment.

To fund CERCLA's cleanup efforts, Congress established the Superfund, financed initially through general appropriations.[38] The Superfund is also financed by excise taxes on chemical feedstocks,[39] petroleum,[40] and imported substances,[41] and by a general corporate environmental income tax.[42] Though the Superfund remains a source of funding for hazardous waste cleanups, the EPA has attempted to finance the cleanups with payments by the parties who allegedly caused the contamination,[43] namely, the "potentially responsible parties" (PRPs).[44] Additionally, the EPA may require a PRP to suspend or

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Id. § 9601(23).

37. 42 U.S.C. § 9601(24) defines remedial actions as "those actions consistent with permanent remedy taken instead of or in addition to removal actions . . . includ[ing] . . . storage, [and] confinement." *Id.* § 9601(24). "The essential difference between removal and remedial actions is that removal is directed at immediate and necessary cleanup operations, while remedial actions are concerned with more extensive and permanent efforts to rehabilitate the environment and repair the damage caused by the release of hazardous substances." SIDNEY M. WOLF, POLLUTION HANDBOOK 229 (1988).

38. CERCLA provided that not more than $8.5 billion for the five-year period beginning on October 17, 1986 be appropriated from the Superfund monies. 42 U.S.C. § 9611(a) (1988 & Supp. II 1990).

39. The chemical feedstocks excise tax imposes taxes, ranging from $.22 to $4.87 per ton, upon manufacturers, producers, or importers of chemicals that are innately hazardous or create hazardous by-products when used. Rousso, *supra* note 29, at 280.

40. The petroleum excise tax imposes a tax of 9.7 cents per barrel on crude oil, natural gas, and other petroleum products entering or processed in the United States. Rousso, *supra* note 29, at 279. The petroleum excise tax finances more than 87% of the Superfund. Elizabeth Anders Sloane, *The Federal Tax System and the Environment: Should Payments Made Pursuant to CERCLA Be Deductible?*, 10 VA. TAX REV. 707, 710 n.18 (1991).

41. The imported substances excise tax targets the importer of chemical substances. Rousso, *supra* note 29, at 283. The tax is only imposed, however, on imported substances which are at least 50% hazardous chemical by weight. *Id.* Also, if a substance is already taxed under the petroleum or chemical feedstocks tax, no additional tax is imposed. *Id.*

42. The environmental income tax imposed upon qualifying corporations is "equal to 0.12 percent of the amount of the modified alternative minimum taxable income of a corporation in excess of $2 million." Rousso, *supra* note 29, at 283.

43. CERCLA provides that the "potentially responsible parties" (PRPs) are liable for the following types of response costs:

> (A) all costs of removal or remedial action incurred by the United States Government or a State . . . not inconsistent with the national contingency plan; (B) any other necessary costs of response incurred by any other person consistent with the national contingency plan; (C) damages for injury to, destruction of, or loss of natural resources, including the reasonable costs of assessing such injury, destruction, or loss resulting from such a release; and (D) the costs of any health assessment or health effects study carried out [pursuant to CERCLA].

42 U.S.C. § 9607(a)(4) (1988). For a definition of who are the PRPs, see *infra* note 44.

44. Mank, *supra* note 24, at 244. Four classes of PRPs are liable for hazardous waste cleanup under CERCLA:

> (1) the owner and operator of a vessel or a facility,
>
> (2) any person who at the time of disposal of any hazardous substance owned or operated any facility at which such hazardous substances were disposed of,
>
> (3) any person who by contract, agreement, or otherwise arranged for disposal or treatment, . . . of hazardous substances owned or possessed by such person, by any other party

abate operations where an "imminent and substantial endangerment to the public health and welfare or the environment [exists]."[45]

B. *Tax Treatment of Business Disbursements*

The IRS considers a number of factors when determining whether a business disbursement is deductible as a business expense or must be capitalized.[46] First, under I.R.C. § 162, a disbursement must be both

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or entity, at any facility or incineration vessel owned or operated by another party or entity and containing such hazardous substances, and

(4) any person who accepts or accepted any hazardous substances for transport to disposal or treatment facilities, incineration vessels or sites selected by such person, from which there is a release, or a threatened release which causes the incurrence of response costs, of a hazardous substance.

42 U.S.C. §§ 9601(20) (1988). CERCLA imposes the following types of liability on all PRPs: strict, joint and several, and retroactive liability. *See generally* 42 U.S.C. § 9607 (1988); Moan, *supra* note 25, at 14. The limited defenses to CERCLA liability include: acts of God or war, and an "innocent landowner" defense. *See* 42 U.S.C. §§ 9607(b), 9601(35) (1988); *see also* Mank, *supra* note 24, at 246.

45. Losch, *supra* note 33, at 140. The EPA is concerned with limiting the amount of Superfund money expended by the EPA on cleanups, and thus prefers to fund cleanups with PRP contributions. *Id.*

46. "Expenditures made during the year shall be properly classified as between capital and expense." Treas. Reg. § 1.446-1(a)(4)(ii) (as amended in 1992). An expenditure properly classified as a business expense is deductible (subtracted from income and not taxed) in the current taxable year. *See* I.R.C. § 162(a) (1988 & Supp. IV 1992). An expenditure properly classified as a capital expenditure is not deductible in the current taxable year. I.R.C. § 263(a) (1988). Instead, a capital expenditure is "subsequently recovered through depreciation, amortization, costs of goods sold, as an adjustment to basis or otherwise, at such time as the property to which the amount relates is used, sold, or otherwise disposed of by the taxpayer." Treas. Reg. § 1.263(a)-1(a)(2)(B) (as amended in 1992).

An important distinction must be made regarding the types of environmental costs addressed in this Comment. CERCLA creates two distinctly separate categories of payment for which PRPs are liable: natural resources damages and cleanup costs. *See* Sloane, *supra* note 40, at 772. I.R.C. § 162 allows a deduction for all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." I.R.C. § 162(a) (1988 & Supp. IV 1992). However, § 162(f) disallows any deduction for fines and penalties "paid to a government." *See id.* § 162(f). The § 162(f) disallowance applies to criminal fines and any "similar retributive civil penalty intended to deter conduct the state specifically seeks to prohibit." Sloane, *supra* note 40, at 713. Treasury Regulation § 1.162-21(b)(2), however, provides that "[c]ompensatory damages . . . paid to a government do not constitute a fine or penalty." Treas. Reg. § 1.162-21(b)(2) (as amended in 1975).

Neither CERCLA nor the I.R.C. consider payments for natural resources damages to be fines or penalties. *See* Sloane, *supra* note 40, at 719. The court in *Colt Indus., Inc. v. United States*, however, classified Clean Water Act and Clean Air Act fines as nondeductible penalties. 880 F.2d 1311, 1312 (Fed. Cir. 1989). Furthermore, in *True v. United States*, civil penalties imposed for a violation of the Federal Water Pollution Control Act were nondeductible. 894 F.2d 1197 (10th Cir. 1990). For an extensive discussion of the deductibility of environmental fines and penalties, see Thomas H. Yancey & Nina B. Finston, *Deductibility of Environmental Fines and Penalties, in* ENVIRONMENTAL TAX HANDBOOK 113-29 (George R. Farrah ed., 1993).

Congress should, therefore, separately address the deductibility of natural resources damages paid under CERCLA. All further deductibility analysis in this Comment will exclude natural resources damages and refer only to cleanup costs.

ordinary and necessary to qualify as an expense.[47] Treasury Regulation section 1.162-4 elaborates on I.R.C. § 162 as allowing current deductions for "incidental repairs" that meet the ordinary and necessary requirement.[48] Second, I.R.C. § 263[49] and the "plan of rehabilitation" doctrine[50] limit the present deductibility of business expenditures. Third, an accrual basis taxpayer, as opposed to a cash basis taxpayer, faces additional hurdles because an accrual basis taxpayer must pass the "all events" test and the "economic performance" test prior to taking current-year deductions for qualified environmental cleanup costs.[51] Finally, the doctrine of income matching influences the tax treatment determination.[52]

1. "Ordinary and Necessary" Expenses

According to I.R.C. § 162, an expenditure must pass the threshold requirement of "ordinary and necessary" to be considered potentially deductible in the current year.[53] An ordinary expense is one that is "normal, usual, or customary."[54] Moreover, to be considered "ordinary" under § 162, an expense does not have to be habitual or recurring.[55] A "necessary" expense must only meet the basic requirement that it be "appropriate and helpful" relative to the taxpayer's busi-

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47. I.R.C. § 162 (1988 & Supp. IV 1992); *see generally* MERTENS, *supra* note 6, § 25.14.

48. Treas. Reg. § 1.162-4 (1960); *see generally* 6 MERTENS, *supra* note 6, § 25.64.

49. I.R.C. § 263 (1988 & Supp. IV 1992).

50. *See* 6 MERTENS, *supra* note 6, § 25.65.

51. *See generally* BORIS I. BITTKER & MARTIN J. MCMAHON, JR., FEDERAL INCOME TAXATION FOR INDIVIDUALS § 36.4 (1988). For further discussion of the "all events" test and economic performance requirements, see *infra* notes 81-91 and accompanying text.

52. Income matching is a concept requiring a taxpayer to make a conscientious effort to correlate disbursements to the income generated by those disbursements. *Company Analyzes Deductibility of Cleanup Costs*, 93 TAX NOTES TODAY 158-31, July 29, 1993, *available in* LEXIS, Fedtax Library, TNT File [hereinafter *Cleanup Deductibility*]; *see also* Commissioner v. Tellier, 383 U.S. 687, 691 (1966) (supporting the income matching concept by addressing income after expenses are deducted - "we start with the proposition that the federal income tax is a tax on *net* income" (emphasis added)). For a discussion of the matching concept as it relates to environmental cleanup costs, see *infra* notes 225-57 and accompanying text.

53. I.R.C. § 162 (1988 & Supp. IV 1992). According to § 162 of the Internal Revenue Code, "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" qualify for deductions. *Id.*

54. Deputy v. du Pont, 308 U.S. 488, 495 (1940); *accord* Brizell v. Commissioner, 93 T.C. 151, 157 (1989); *see generally* 6 MERTENS, *supra* note 6, § 25.13.

55. Welch v. Helvering, 290 U.S. 111, 114 (1933). In *Welch*, the Supreme Court defined "ordinary":

> Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often . . . . [T]he expense is an ordinary one because we know from experience that payments for such a purpose, *whether the amount is large or small*, are the common and accepted means of defense against attack.

Id. (emphasis added); *see generally* 6 MERTENS, *supra* note 6, § 25.15.

ness.[56] Treasury Regulation section 1.162-4 elaborates upon the application of the "ordinary and necessary" standard with respect to expenditures for repairs.[57] Section 1.162-4 allows present deductibility for "[t]he 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."[58]

2. Limitations on "Ordinary and Necessary" Under I.R.C. § 263

Ordinary and necessary expenses, however, are not always currently deductible. I.R.C. § 263 limits the application of a § 162 deduction. Section 263 requires capitalization of expenditures incurred for permanent improvements that increase the value of the property.[59] Capital expenditures are generally classified as any amounts paid or incurred: (a) to add value to the property; or (b) to adapt property to a new or different use; or (c) to substantially prolong the useful life of the property.[60]

The United States Supreme Court, however, suggested an expansion of the categories of expenses which should be capitalized.[61] In *Indopco, Inc. v. Commissioner,* the Court emphasized the significance of taxpayer benefits extending beyond the year of disbursement in determining capitalization treatment.[62] Subsequently, the IRS referred to *Indopco* in a Technical Advice Memorandum (TAM)[63] dealing with the deductibility of hazardous PCB[64] cleanup costs.[65] This reference

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56. *Welch*, 290 U.S. at 113; *accord Tellier*, 383 U.S. at 689. For an analysis of case law with analogous fact patterns demonstrating that environmental costs are ordinary and necessary expenses of conducting a business under these standards, see *infra* notes 104-18 and accompanying text.

57. Treas. Reg. § 1.162-4 (1960).

58. *Id.* Examination of the meaning of the words "incidental" and "repair" in the context of environmental remediation costs further substantiates the proper classification of these costs as presently deductible expenses. *See infra* notes 183-224 and accompanying text.

59. I.R.C. § 263 (1988 & Supp. IV 1992); *see also* 6 MERTENS, *supra* note 6, § 25.37.

60. *See generally* Treas. Reg. § 1.263(a)-1(b) (as amended in 1992). For a closer look at each factor used to identify capital expenditures, showing that environmental remediation costs fail to qualify as capital expenditures, see *infra* notes 119-82 and accompanying text.

61. *See* Indopco, Inc. v. Commissioner, 112 S. Ct. 1039, 1044-45 (interim ed. 1992) (applying capitalization treatment to certain takeover expenses).

62. *Id.*

63. Tech. Adv. Mem. 92-40-004 (June 29, 1992). A TAM presents the position and rationale of the IRS with respect to a specific taxpayer's real life tax conflict. *See* 26 C.F.R. § 601.105(b)(5) (1992) (defining a TAM); *see also* James D. Ruffner, II, Comment, *Corporate Reorganization Expenses: An Overview of the Denial of Current Federal Tax Deductibility and Resulting Capitalization*, 19 U. DAYTON L. REV. 197, 216-17 (1993). Although a TAM is made available for public inspection, *see* I.R.C. § 6110(a) (1988), a TAM "may not be used or cited as precedent." *Id.* § 6110(j).

64. PCBs are poly-chlorinated biphenyls, considered to be hazardous substances for CERCLA purposes. 42 U.S.C. § 9601(14) (1988). Hazardous substances are further defined in 42

created quite a stir within the tax community.[66] As a result of this unexpectedly broad interpretation of *Indopco,* tax analysts feared potentially devastating ramifications in other areas of tax law that involved capitalization versus deduction debates.[67] The IRS, however, has withdrawn any reliance on *Indopco* with respect to the issue addressed in the TAM and will reissue the TAM without reference to *Indopco.*[68] Therefore, the unrest about *Indopco's* significance, at least in the area of environmental cleanups, has been minimized.

3. "Repair" Doctrine Versus "Plan of Rehabilitation" Doctrine

Taxpayers and the IRS frequently clash over the distinction between a currently deductible expense and a capital expenditure because the "ordinary and necessary" standard is subject to limitless interpretations.[69] To reduce controversy and clarify the differences between the alternative tax treatments, courts and the IRS have developed two closely related doctrines: the "repair" doctrine and the "plan of rehabilitation" doctrine.[70]

The repair doctrine permits a current deduction for costs that qualify as repairs.[71] A repair does not increase the value or the life expectancy of property, but merely maintains property in an "ordinarily efficient operating condition."[72] The United States Tax Court, in *Plainfield-Union Water Co. v. Commissioner,*[73] concluded that an expenditure is considered a deductible repair if it "returns the property to the state it was in before the situation prompting the expenditure arose,

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U.S.C. § 6924(d)(2)(D) (1988). For a definition of a hazardous substance, see *supra* note 24. *See also IRS Says Environmental Remediation Costs Must Be Capitalized to Related Asset,* Daily Tax Report (BNA) No. 32, at G-6 (Feb. 19, 1993) [hereinafter *Environmental Remediation*].

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

66. *See Peat Marwick Requests Guidance on Proper Treatment of Environmental Cleanup Costs,* 93 TAX NOTES TODAY 148-25, July 15, 1993, *available in* LEXIS, Fedtax Library, TNT file [hereinafter *Peat*].

67. *Id.*

68. *See* F.R. Nagle, *IRS's Carrington Defends Asbestos Abatement Ruling,* 58 TAX NOTES 834 (1993).

69. *See* Jones, *supra* note 4, at 16; *see also, e.g.,* Tech. Adv. Mem. 92-40-004 (June 29, 1992); Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992).

70. *See* United States v. Wehrli, 400 F.2d 686, 689 (10th Cir. 1968) (case remanded for fact-sensitive determination of whether repairs should be capitalized under plan of rehabilitation doctrine); Cowell v. Commissioner, 18 B.T.A. 997, 1002 (1930) (applying plan of rehabilitation doctrine to force capitalization of hotel repair costs); *see also* Jones, *supra* note 4, at 16. The "plan of rehabilitation" doctrine is also referred to as the "plan of improvement" doctrine. Jones, *supra* note 4, at 16.

71. *See, e.g.,* Moss v. Commissioner, 831 F.2d 833, 842-43 (9th Cir. 1987) (finding hotel remodeling expenditures to be ordinary and necessary repairs despite existence of a general remodeling plan); Jones, *supra* note 4, at 16, 18.

72. Treas. Reg. § 1.162-4 (1960).

73. 39 T.C. 333 (1962), *nonacq.* 1964-2 C.B. 8.

and which does not make the relevant property more valuable, more useful, or longer-lived."[74]

Conversely, the plan of rehabilitation doctrine dictates that expenditures which would be independently deductible as repairs must be capitalized if incurred as part of a plan of capital improvements.[75] Courts generally evaluate four factors to determine whether the plan of rehabilitation doctrine limits the present deductibility of an expenditure.[76] First, courts examine the value of the work and question whether the expenditures add material value to the taxpayer's property.[77] Second, courts consider the purpose of the work, such as whether the taxpayer's goal is to increase the trade or business productivity of the property.[78] Third, courts look at the nature of the work to determine if the expenditures create lasting trade or business value for the taxpayer.[79] Lastly, courts examine the extent of the work to compare the cost of the expenditure relative to the value of the underlying asset.[80]

4. Cash Basis Versus Accrual Basis Taxpayer — the "All Events" and "Economic Performance" Tests

Even if one establishes that particular costs are currently deductible as business expenses, restrictions exist regarding the proper year of

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74. *Id.* at 337. For a discussion of environmental cleanup costs as repairs and thus presently deductible, see *infra* notes 183-224 and accompanying text.

75. Jones v. Commissioner, 24 T.C. 563, 568 (1955), *aff'd*, 242 F.2d 616 (5th Cir. 1957); *see also* United States v. Wehrli, 400 F.2d 686, 689 (10th Cir. 1968). The court in *Estate of Walling v. Commissioner* saw the essential factor determining application of the plan of improvement doctrine as whether the taxpayer incurred an expense to maintain an asset in operating condition (a repair) or to place an asset in operating condition (a capital improvement). 373 F.2d 190, 193 (3d Cir. 1967).

76. *See* Moan, *supra* note 25, at 10.

77. *See, e.g.*, American Bemberg Corp. v. Commissioner, 10 T.C. 361, 377-78 (1948), *aff'd*, 177 F.2d 200 (6th Cir. 1949) (extensive drilling expenditures to support factory floors did not increase value of factory and thus were currently deductible repairs); *see also* Jones, *supra* note 4, at 18.

78. *See, e.g.*, Seahill Co. v. Commissioner, 23 T.C.M. (CCH) 408, 411 (1964) (expenditures for improvements made in conjunction with roof repairs were intended to increase value of rental property and must be capitalized); *see also* Moan, *supra* note 25, at 10; Jones, *supra* note 4, at 18.

79. *See, e.g.*, Cowell v. Commissioner, 18 B.T.A. 997, 1002 (1930) (hotel repair costs capitalized due to existence of a "greater plan of rehabilitation, enlargement and improvement of the entire property"); *see also* Moan, *supra* note 25, at 11; Jones, *supra* note 4, at 18.

80. *See, e.g.*, Stoeltzing v. Commissioner, 266 F.2d 374, 376 (3d Cir. 1959) (repair costs exceeding 200% of building's value were capital expenditures); *see also* Jones, *supra* note 4, at 18. This fourth factor implicates a belief that proportionally large expenditures on an asset relative to its value may be considered more than "incidental" and thus must be capitalized. Moan, *supra* note 25, at 11.

deduction. An accrual basis[81] taxpayer's year of deduction is determined by the "all events" test[82] set out in I.R.C. § 461.[83] An accrual basis taxpayer's expenditures meet the "all events" test only when "all events have occurred that establish the fact of liability, the amount of liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability."[84] The all events test requires that the taxpayer's liability be "fixed and determinable"[85] prior to accruing an expenditure.[86]

In 1984, Congress added fulfillment of "economic performance"[87] as a third requirement that accrual basis taxpayers must satisfy prior to accruing a deduction under I.R.C. § 461(h).[88] Section 461(h) provides that economic performance must occur with respect to the liabil-

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81. The accrual method of accounting is one of two principal accounting methods customarily used to figure reported income; the other method is the cash method of accounting. *See generally* I.R.C. § 446 (1988); Treas. Reg. § 1.446-1 (as amended in 1992). Under the accrual method of accounting, the status of accounts receivable and payable is determined when the obligation to receive or pay becomes fixed, regardless of when payment actually occurs. MARVIN CHIRELSTEIN, FEDERAL INCOME TAXATION 233 (6th ed. 1991). Accrual is a "technique for recognizing revenue items prior to their receipt in cash and for recognizing expense items prior to their actual payment." *Id.* The cash method of accounting is a method of accounting that recognizes only the income actually received or expenditures actually paid in any given taxable year. *See generally* 6 MERTENS, *supra* note 6, § 12A.01. Of the two methods, most sizeable businesses employ the accrual method of accounting when acknowledging and reporting revenues and expenses. *See* CHIRELSTEIN, *supra*, at 233.

82. The "all events" test was first enunciated in United States v. Anderson, 269 U.S. 422, 441 (1926).

83. I.R.C. §§ 461(a), (h)(4) (1988); *see also* Treas. Reg. § 1.461-1(a)(2) (as amended in 1992). To include income or deductions in a given taxable year, the accrual method requires that the all events test is satisfied, and that economic performance has occurred. *See* 6 MERTENS, *supra* note 6, § 12.01.

84. Treas. Reg. § 1.461-1(a)(2) (as amended in 1992).

85. A liability is "fixed" when it "is not subject to conditions precedent, contingencies, or other circumstances preventing the taxpayer from recognizing the liability." Moan, *supra* note 25, at 12; *see also* I.R.C. § 461(h) (1988). An unspecified payee or conditions subsequent that might limit liability do not, however, prevent accrual. *See* Washington Post Co. v. United States, 405 F.2d 1279, 1284 (Ct. Cl. 1969); *see generally* Moan, *supra* note 25, at 12.

The second requirement under the all events test is that the amount of the liability be "determinable" with reasonable accuracy. *See generally* Treas. Reg. § 1.461-1(a)(2) (as amended in 1992). The taxpayer may deduct a portion of the liability if that portion can be determined with reasonable accuracy, even if the entire amount of the liability is not ascertainable with reasonable accuracy. *See* Treas. Reg. § 1.461-1(a)(2)(ii) (as amended in 1992).

86. Treas. Reg. § 1.461-1(a)(2) (as amended in 1992); *see also Anderson*, 269 U.S. at 441.

87. *See generally* Deficit Reduction Act of 1984, Pub. L. 98-369, 1984 U.S.C.C.A.N. (98 Stat.) 494. Congress introduced the economic performance rules into the I.R.C. under the Deficit Reduction Act of 1984 so that accrual basis taxpayers would not take deductions prior to actual payment of the liabilities. *See* Moan, *supra* note 25, at 13 n.74. These rules, however, are potentially more restrictive in application than anticipated by Congress and may impede accrual despite actual payment of the liability. *Id.*

88. I.R.C. § 461(h) requires economic performance before accrual of either § 162 current deductions or § 263 capital expenditures. I.R.C. § 461(h) (1988).

ity in question before the all events test will be satisfied.[89] Additionally, economic performance of a service liability[90] differs from economic performance of a payment liability.[91]

5. Matching of Income with Corresponding Expenses

A basic premise of accrual accounting is that the taxpayer should make a conscientious effort to match expenses to the corresponding income that was generated by those expenses.[92] Matching income with expenses thus creates a record that reflects the true net income of a business.[93] To assess which treatment of expenditures "clearly reflects income," expenditures must be matched with the income generated from those expenditures to determine the true net taxable income.

III. ANALYSIS

The majority of taxpayers engaged in manufacturing or resource-related industries are affected by the federal income tax treatment of environmental remediation expenditures.[94] For years, businesses have

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89. *Id.*; *see also* Treas. Reg. § 1.461-4(a) (1992).

90. A service liability exists when a taxpayer has an obligation to provide services (or property) to another party (e.g., EPA). Moan, *supra* note 25, at 13. Economic performance of a service liability occurs when the taxpayer "incurs the cost to perform the services or causes another party to perform the services." *Id.* Economic performance occurs only when the services are performed, whether the taxpayer performs them or pays a third party to perform the services, regardless of when payment is made to the third party. *Id.* at 13 n.75; *see also* Treas. Regs. § 1.461-4(d)(4), (6)(i), (7) (1992). There are several exceptions to this general rule, such as payment for immaterial, recurring items. Moan, *supra* note 25, at 13; *see generally* Treas. Regs. §§ 1.461-4(d)(6)(ii), -5(b) (1992).

Assuming the EPA will label cleanup costs as service liabilities, economic performance under section 461(h) will not occur in a CERCLA project until actual cleanup occurs. *See* Moan, *supra* note 25, at 14. I.R.C. § 468B(g) treats CERCLA liabilities as service liabilities in reference to qualified settlement funds. *Id.* at 14 n.84; *see also* Treas. Reg. § 1.468B(g) (1993). Consequently, a third party must actually perform the cleanup activities to satisfy the economic performance rules. *See* Treas. Reg. § 1.461-4(d)(2), (5) (1992). Furthermore, payments into a remediation fund would only satisfy the economic performance rules for service liabilities if the fund qualifies as a bona fide settlement fund, *see generally* De Minimis Settlements Under Superfund, 1 C.F.R. § 305.92-9 (1992), and the payments extinguish the taxpayer's remediation liabilities. *See* Moan, *supra* note 25, at 15. A remediation fund is a fund established by a remediation entity (e.g., the EPA) to hold the contributions of the PRPs for use in performing actual cleanup services. *Id.* For further discussion of settlement funds, *see infra* notes 262-74 and accompanying text.

91. Economic performance of a payment liability generally occurs upon payment to the person to whom the liability is owed. *See* Moan, *supra* note 25, at 14.

92. *Cleanup Deductibility*, *supra* note 52; *see also* Commissioner v. Tellier, 383 U.S. 687, 691 (1966).

93. I.R.C. § 446 requires the taxpayer to use an accounting method which "clearly reflects income." I.R.C. § 446(b) (1988); *(see also* I.R.C. § 162(a) (1988 & Supp. IV 1992); *Cleanup Deductibility*, *supra* note 52. For a discussion of environmental remediation costs in the context of income matching, see *infra* notes 225-57 and accompanying text.

94. *See TEI Contends Clean-up Costs Should Be Currently Deductible*, 93 TAX NOTES TODAY 133-76, June 23, 1993, *available in* LEXIS, Fedtax Library, TNT File [hereinafter *TEI*

taken repair and maintenance deductions for most environmental cleanup costs, and the deductions have gone largely unchallenged.[95] Recently, uncertainty has arisen regarding the proper federal income tax treatment of remediation expenditures. The uncertainty is traceable to two TAMs[96] issued by the IRS, which appear to establish new capitalization guidelines for hazardous waste cleanup costs.[97]

A significant number of tax law practitioners and other tax experts strongly objected to the IRS position and rationale in the TAMs, and eagerly responded to the IRS's request for commentary on the issue.[98] The consensus of tax law practitioners and other tax experts, after "extensive analysis of the relevant financial and tax accounting principles,"[99] is overwhelming opposition to the IRS position in the two TAMs.[100] The practitioners conclude that in the two TAMs, the IRS has "misinterpreted established legal precedent" and has "misapplied fundamental tax concepts."[101] The practitioners' comments label the IRS position as "contrary to sound tax policy and environmental goals,"[102] and urge the IRS to issue guidance confirming that environmental remediation expenses are generally deductible as business expenses.[103] A comparison of the IRS position versus the practitioners' position illustrates the divergent results obtainable under analogous fact patterns when alternative tax treatments are applied.

Contends]. Tax Executives Institute, Inc. (TEI) is the principal association of corporate tax executives in North America, comprised of nearly 4,900 individual members representing approximately 2,300 of the leading corporations in North America. *Id.*

95. *Id.*

96. Tech. Adv. Mem. 92-40-004 (June 29, 1992) (requiring capitalization of asbestos abatement costs); Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992) (requiring capitalization of PCB cleanup costs).

97. *See TEI Contends*, *supra* note 94.

98. *See generally TEI Contends*, *supra* note 94; *see also Raby Examines IRS Position on Deductibility of Environmental Cleanup Costs*, 93 TAX NOTES TODAY 108-13, May 20, 1993, *available in* LEXIS, Fedtax Library, TNT File [hereinafter *Raby*]; *Akin Gump Says IRS's Position on Environmental Cleanup Costs Distorts Case Law*, 93 TAX NOTES TODAY 158-18, July 29, 1993, *available in* LEXIS, Fedtax Library, TNT File [hereinafter *Akin*]; *Attorneys Offer Views on Deductibility of Environmental Cleanup Costs*, 93 TAX NOTES TODAY 207-50, Oct. 7, 1993, *available in* LEXIS, Fedtax Library, TNT File [hereinafter *Ivins*].

99. *TEI Contends*, *supra* note 94.

100. *See generally TEI Contends*, *supra* note 94; *see also PMAA Says Cleanup Costs Should Be Deductible*, 92 TAX NOTES TODAY 251-13, Dec. 2, 1992, *available in* LEXIS, Fedtax Library, TNT File; *Akin*, *supra* note 98.

101. *Cleanup Deductibility*, *supra* note 52.

102. *Cleanup Deductibility*, *supra* note 52.

103. *See TEI Contends*, *supra* note 94.

A. Applications and Implications of Alternative Tax Treatments of Hazardous Waste Remediation Costs

1. Ordinary, Necessary, and Incidental Expenses

Treasury Regulation section 1.162-4 permits a current deduction for "[t]he 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."[104] In one TAM,[105] the IRS stated that the nature of the work in relation to the taxpayer's operations was important in determining whether an expenditure was an incidental repair.[106] The IRS also noted that the level of costs was not dispositive of the repair versus improvement issue.[107] The IRS ultimately concluded that the taxpayer's PCB remediation activities were permanent improvements, not incidental repairs.[108]

The IRS analogized the taxpayer's activities of remediating PCB contamination to those of the taxpayer in *Wolfsen Land & Cattle Co. v. Commissioner*.[109] The IRS relied heavily on *Wolfsen* because of the similarity of the facts in *Wolfsen* to the PCB taxpayer's situation.[110] The IRS's lengthy discussion of *Wolfsen*, however, fails to mention that the *Wolfsen* taxpayer's expenses were incurred replenishing an asset which had been totally depleted.[111] The *Wolfsen* court noted that the expenditures created an independent, intangible asset with an amortizable life.[112] The court also found that the expenditures enhanced the operating efficiency and productivity of the property.[113] The expenditures in *Wolfsen* were "in the nature of capital 'replacement' expenditures which must be capitalized and amortized over their appropriate

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104. Treas. Reg. § 1.162-4 (1960).

105. In TAM 93-15-004, the IRS decided the issue of whether the taxpayer's costs to clean up PCB-contaminated soil were currently deductible as expenses, or whether those costs should be capitalized. Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992).

106. *Id.*; *see Environmental Remediation, supra* note 64, at G-6 to G-7.

107. Tech. Adv. Mem. 93-15-004; *see Environmental Remediation, supra* note 64, at G-7.

108. Tech. Adv. Mem. 93-15-004.

109. *Id.*; *see* Wolfsen Land & Cattle Co. v. Commissioner, 72 T.C. 1 (1979). In *Wolfsen*, the taxpayer failed to maintain irrigation ditches that had gradually deteriorated over a ten-year period. *Id.* at 18. The *Wolfsen* court concluded that the costs to restore the dysfunctional irrigation system were in the nature of capital "replacement" expenditures. *Id.* at 18.

110. In TAM 93-15-004, the IRS noted that the PCB taxpayer's activities paralleled those of the *Wolfsen* taxpayer in three areas: (1) the expenditures involved a systematic remediation plan as opposed to annual maintenance or a "one-time deferred large expenditure;" (2) the extensive nature of the restoration activities involved; and (3) the increased value for the taxpayer's property after expenditure, relative to immediately prior to expenditure. *See* Tech. Adv. Mem. 93-15-004; *Environmental Remediation, supra* note 64, at G-6 to G-7.

111. *Akin, supra* note 98.

112. *Wolfsen*, 72 T.C. at 18.

113. *Id.*

useful lives" as opposed to being classified as incidental repairs.[114] *Wolfsen* is therefore distinguishable from TAM 93-15-004. The taxpayer in *Wolfsen* created a new asset. In contrast, PCB and other hazardous waste remediation is merely in the nature of incidental repairs.[115]

Furthermore, the IRS failed to acknowledge that the taxpayer in *Wolfsen* knew of the defective condition of the ditches when acquiring the property and presumably agreed to the property's purchase price in light of that factor.[116] In contrast, the PRPs in a typical remediation case acquired property when the hazardous condition was unknown. Under such circumstances, a PRP cannot seek a reduction in the purchase price with awareness of the prospective capital expenditures involved. Some practitioners who point out these discrepancies suggest that the IRS employed a "distorted view" of case law in TAM 93-15-004 and showed misguided reliance on *Wolfsen*.[117] These practitioners assert that *Wolfsen* stands merely for the proposition that "expenditures amounting to replacement" of a piece of property must be capitalized.[118]

2. Limitation of Current Deductibility under I.R.C. § 263

Although environmental cleanup costs may be considered "ordinary, necessary and incidental" expenses under I.R.C. § 162, the IRS interpretation of I.R.C. § 263 limits deductibility of such costs. If the expenditure results in the creation of a new asset or in permanent improvements, § 263 generally mandates capitalization treatment.[119] The Treasury Regulations accompanying § 263 provide the following three factors as capitalization criteria: whether amounts paid or incurred (1) add to the value of the property; or (2) adapt the property to a new or different use; or (3) substantially prolong the useful life of the property.[120] The existence of any one of these factors will necessitate capitalization of the expenditures.[121]

Using these three factors, the courts have developed the following capitalization standard for remedial expenditures: "[a]n expenditure that returns the property to the state it was in before the situation prompting the expenditure arose, and which does not make the relevant

114. *Id.*; *see also Akin*, *supra* note 98.
115. *See Akin*, *supra* note 98.
116. *Wolfsen*, 72 T.C. at 18.
117. *Akin*, *supra* note 98.
118. *Akin*, *supra* note 98; *see also Ivins*, *supra* note 98.
119. I.R.C. § 263 (1988 & Supp. IV 1992).
120. Treas. Reg. § 1.263(a)-1(b) (as amended in 1992).
121. *Id.*; *see also Cleanup Deductibility*, *supra* note 52.

property more valuable, more useful, or longer lived, is usually deemed a deductible repair."[122] The courts focus on the three factors to determine whether capitalization is required.[123] The courts permit a current deduction if an expenditure does not implicate one of the three factors.[124] An evaluation of the following cases and the criteria utilized in determining capitalization under I.R.C. § 263 demonstrates that the costs incurred in environmental remediation are clearly currently deductible expenses.[125]

a. Added Value

I.R.C. § 263 requires capitalization of expenditures that increase or add value to property.[126] Although most expenditures add some measure of value to property, § 263 concerns itself only with a limited spectrum of added value.[127] Section 263 governs only those expenditures that provide a substantial benefit to the taxpayer.[128] A substantial benefit is one which benefits the taxpayer beyond the current taxable year into future years.[129]

In *Schneider v. Commissioner*,[130] the Tax Court concluded that the taxpayer-employer's contributions to three different employee plans qualified as currently deductible business expenses.[131] Although the employer received benefits of increased loyalty, goodwill, and productivity because of the contributions, these benefits were incidental, not substantial benefits requiring capitalization under § 263.[132] Similarly, soil remediation costs produce incidental benefits that do not add value

122. Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333, 337 (1962), *nonacq.* 1964-2 C.B. 8. In *Plainfield-Union*, acidic river water forced the taxpayer to clean and cement-line water transport pipes after connection to the city water supply. *Id.* at 335. The court found that the repair did not materially increase the useful life or add value to the pipes, nor did it create any new or additional use for the pipes. *Id.* at 341.

123. *See, e.g.*, Jones v. Commissioner, 242 F.2d 616 (5th Cir. 1957) (requiring capitalization of costs to restore a historic building).

124. *See, e.g.*, Collingwood v. Commissioner, 20 T.C. 937 (1953) (allowing present deductibility of erosion-prevention expenditures since the expenditures did not adapt the property for a new or different use); *see also Cleanup Deductibility*, *supra* note 52.

125. *See Cleanup Deductibility*, *supra* note 52.

126. I.R.C. § 263 (1988 & Supp. IV 1992); *see also* Treas. Reg. § 1.263(a)-1(b) (as amended in 1992).

127. Evans v. Commissioner, 557 F.2d 1095, 1101 (5th Cir. 1977). In *Evans*, a deduction was allowed for the costs of preventing seepage of water through a dam since the taxpayer's sole purpose was to keep the dam in an ordinarily efficient operating condition over its useful life. *Id.* From a common sense perspective, nearly every repair increases the value of property in comparison to the value before the repair was performed. *See Raby, supra* note 98.

128. *See* 6 MERTENS, *supra* note 6, § 25.66.

129. Schneider v. Commissioner, 63 T.C.M. (CCH) 1787, 1794 (1992).

130. *Id.*

131. *Id.* at 1797.

132. *Id.* at 1796.

to the property under § 263.[133] Remediation merely returns land to the same condition it was in prior to contamination.[134] Furthermore, remediation expenditures do not improve a taxpayer's ability or capacity to generate income in the future, in comparison to pre-contamination ability.[135] The purpose underlying soil remediation is not to increase productivity or revenues. As such, the process does not create added value as intended by I.R.C. § 263.[136]

Additionally, the IRS requires capitalization when the expenditures add value to an asset which can be depreciated against the future income generated by the asset.[137] The taxpayer in *Jones v. Commissioner*[138] incurred restoration costs in renovating a historic building.[139] The United States Court of Appeals for the Fifth Circuit required capitalization of the expenditures because the previously uninhabitable building was restored to a usable, income-producing condition.[140] In contrast, soil remediation costs are not associated with an independent asset that can be depreciated against the future income generated by the asset, nor do they create value that can be depreciated into the future.[141]

In *Collingwood v. Commissioner*,[142] the Tax Court approved a current deduction for terracing expenditures aimed at preventing topsoil loss from water erosion.[143] The Tax Court found that the expenditures merely maintained the farms in an "ordinarily efficient operating condition" for continuing the same type of farming, and that these expenditures did not create a new or different use for the farm.[144] The Tax Court further found that the expenditures merely preserved the normal productivity of the soil, indicating that no extension of useful life resulted from the expenditures.[145] The expenditures did not add to the productivity of the land, did not convert the land to any use different from its initial use, and did not add anything to the land of a struc-

133. *Cleanup Deductibility*, *supra* note 52.

134. *Cleanup Deductibility*, *supra* note 52.

135. *Cleanup Deductibility*, *supra* note 52.

136. *Cleanup Deductibility*, *supra* note 52.

137. *Cleanup Deductibility*, *supra* note 52.

138. 242 F.2d 616 (5th Cir. 1957).

139. *Id.* at 617-18. The restoration primarily involved structural replacements, such as replacement of unsafe rafters, partial replacement of the roof, plumbing and electrical systems, and installation of an air conditioning system. *Id.* at 618.

140. *Id.* at 620.

141. *Cleanup Deductibility*, *supra* note 52.

142. 20 T.C. 937 (1953).

143. *Id.* at 938.

144. *Id.* at 942-43. "New or different use" is a third factor prompting capitalization. *See id.*

145. *Id.* at 943.

tural nature.[146] Similarly, soil remediation is primarily undertaken to maintain the land in its original "operating condition" and does not increase the land's productivity beyond initial expectations.[147]

Additionally, expenditures incurred to comply with government regulations do not result in added value based solely on the mandatory nature of the expenditures.[148] In *Commissioner v. Lincoln Savings and Loan Ass'n*,[149] the Supreme Court found that neither legal nor economic compulsion influences the expense/capitalization decision.[150] If a payment is made in order to comply with government regulations, it has no bearing in determining whether the payment is currently deductible or a capital expense.[151] Capitalization of all payments made in compliance with government rules would result if all compulsory payments must be capitalized.[152]

The IRS cited *Hotel Sulgrave, Inc. v. Commissioner*[153] for the proposition that where a taxpayer's modifications to property were made in compliance with government regulations, the likelihood that the taxpayer would be required to capitalize the modification expenditures increased.[154] In *Hotel Sulgrave*, the taxpayer installed a sprinkler system in a hotel to comply with a city Housing and Building Department order.[155] In TAM 93-15-004, however, the IRS rejected the taxpayer's argument that the expenditures in *Hotel Sulgrave* would have been capital due to added value, regardless of whether they were mandated by the government.[156] The IRS also rejected the taxpayer's argument that other cases relied upon by the IRS were distinguishable be-

146. *Id.* at 942.

147. *Cleanup Deductibility*, *supra* note 52.

148. *Cleanup Deductibility*, *supra* note 52.

149. 403 U.S. 345 (1971).

150. *Id.* at 358-59. For commentary on the effect of Indopco, Inc. v. Commissioner, 112 S. Ct. 1039 (interim ed. 1992), on other important aspects of the *Lincoln Savings* decision, see Mark A. Segal, *Recent Cases Clarify the Distinction Between Deductible and Capitalized Expenses*, OHIO CPA J. Dec. 1992, at 37-40.

151. *Lincoln*, 403 U.S. at 358-59; *see also Coopers & Lybrand Suggests Environmental Cleanup 'Bright-Line' Rules*, 93 TAX NOTES TODAY 196-80, Sept. 22, 1993, *available in* LEXIS, Fedtax Library, TNT File [hereinafter *Coopers*]; *Ivins*, *supra* note 98.

152. *Cleanup Deductibility*, *supra* note 52. For example, capitalization treatment would be required for the payment of minimum wages, which are compulsory payments. *Id.*

153. 21 T.C. 619 (1954).

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

155. 21 T.C. at 620.

156. Tech. Adv. Mem. 93-15-004. The TAM taxpayer argued that the sprinkler system was an improvement whose life extended beyond the present year, especially since there was a structural alteration in the facility, and the costs of installation would therefore have to be capitalized regardless of government mandate. *Id.*

cause the expenditures in each were capital due to structural alterations, not to mandatory government compliance.[157]

Practitioners have noted that in TAM 93-15-004 the IRS misapplied existing case law and failed to consider a relevant case that "undermines a capital treatment for government-mandated costs."[158] In *Midland Empire Packing Co. v. Commissioner*,[159] federal health inspectors mandated that the taxpayer eliminate oil seepage into a basement meat curing facility.[160] The Tax Court permitted the taxpayer to deduct the expenditures made in compliance with the government mandate.[161] *Midland Empire*, therefore, refutes the IRS's contention that an expenditure made in compliance with a government mandate must be capitalized.

b. New or Different Use

The IRS should have also considered *Midland Empire* in examining the second factor that potentially triggers capitalization under I.R.C. § 263. The second factor is whether the expenditure allows the property to be put to a new or different use.[162] If a new or different use is found, then the expenditure must be capitalized.[163] In *Midland Empire*, the court permitted the deduction of the taxpayer's costs to oil-proof the basement of a meat processing facility.[164] The *Midland Empire* court found that the expenditure merely resulted in the basement's continued use for meat processing, as opposed to rendering the basement suitable for new or additional uses.[165]

Similar to the oil-proofing in *Midland Empire*, soil remediation expenditures do not render land suitable for new or additional uses.[166] At the time the need for cleanup arises, the land has been continuously

157. *Id.* The taxpayer argued that the following cases upon which the IRS relied were distinguishable: Teitelbaum v. Commissioner, 294 F.2d 541 (7th Cir. 1961), *cert. denied*, 368 U.S. 987 (1962); Blue Creek Coal, Inc. v. Commissioner, T.C.M. (CCH) 1504 (1984); and Cerda v. United States, 84-1 U.S.T.C. (CCH) 9490 (N.D. Ill. 1984). The IRS rejected this argument. Tech. Adv. Mem. 93-15-004; *see generally, Environmental Remediation, supra* note 64.

158. *Full Text: Attorney's Ways & Means Subcommittee Testimony Stating IRS Misunderstands the Law Applicable to Environmental Cleanup Costs*, 93 TAX NOTES TODAY 128-28, Sept. 24, 1993, *available in* LEXIS, Fedtax Library, TNT File; *see also Environmental Remediation, supra* note 64.

159. 14 T.C. 635 (1950).

160. *Id.* at 641-43.

161. *Id.*

162. Treas. Reg. § 1.263(a)-1(b) (as amended in 1992).

163. *Id.*

164. 14 T.C. 635, 642-43 (1950).

165. *Id.* at 641.

166. *Cleanup Deductibility, supra* note 52.

used for its original purposes.[167] Thus, remediation does not render the land more suitable for a new or different use.[168]

c. Extended Life

An "extension of useful life" under I.R.C. § 263 occurs if an expenditure, in essence, generates a new life span for the subject property.[169] In *Mountain Fuel Supply Co. v. Commissioner*,[170] the taxpayer recoated and rewrapped portions of a pipeline system.[171] The United States Court of Appeals for the Tenth Circuit denied current deductibility of the reconditioning expenditures because the work improved the insulation of the pipes beyond their original insulation capacity.[172]

> The record thus clearly demonstrates that the reconditioning was not done to enable the pipeline to continue to operate during its initial estimated life, but was instead accomplished to enable the pipeline to begin a new period of expected life. This purpose and result of the reconditioning places the expenditures clearly within the capital improvement category.[173]

The court concluded that the expenditure initiated another life span for those portions of the pipeline which had been reconditioned.[174]

In contrast, no extension of useful life was found in *Appeal of Illinois Merchants Trust Co., Executor*,[175] where an unexpected drop in a river's water level forced the taxpayer to replace rotting wooden foundation pilings.[176] The court permitted the expenditures to be currently deductible for two reasons.[177] First, the court found that the expenditures did not increase the property's value above its value prior to the unanticipated rotting.[178] Second, the court determined that repairing the damage to the pilings did not alter the facility's original projected useful life.[179] The expenditures could not, therefore, have extended the facility's useful life.[180] Thus, it is evident that the life of the property

167. *Cleanup Deductibility*, *supra* note 52.
168. *Cleanup Deductibility*, *supra* note 52.
169. I.R.C. § 263 (1988 & Supp. IV 1990).
170. 449 F.2d 816 (10th Cir. 1971), *cert. denied*, 405 U.S. 989 (1972).
171. *Id.* at 818-19.
172. *Id.* at 821.
173. *Id.*
174. *Id.* at 820.
175. 4 B.T.A. 103 (1926).
176. *Id.* at 104.
177. *Id.* at 107.
178. *Id.*
179. *Id.*
180. *Id.*

must be extended beyond its original useful life for related expenditures to be subject to capitalization.

In the remediation context, hazardous waste cleanup simply does not prolong the useful life of land.[181] Since undeveloped land has an "infinite" useful life, its useful life would not be extended by expending money on it.[182] Thus, environmental cleanup costs should not be subject to capitalization under the third factor of § 263. In summary, with respect to I.R.C. § 263, environmental cleanup expenditures do not: (a) add value to the property; (b) adapt the property to a new or different use; or (c) extend the useful life of the property. It is, therefore, inappropriate to utilize § 263 to force capitalization of environmental cleanup costs.

3. Repair Versus Plan of Rehabilitation

In TAM 93-15-004, the IRS denied the taxpayer a current repair deduction for PCB cleanup costs.[183] In denying the deduction, the IRS focused on the plan of rehabilitation doctrine, "superimposed" by case law on Treasury Regulation section 1.162-4.[184] The plan of rehabilitation doctrine is an "overriding doctrine [providing] that expenses incurred as part of a general plan of rehabilitation or restoration must be capitalized even though the same expense, if incurred separately, would be deductible as an ordinary and necessary business expense."[185] In support of its position, the IRS cited a number of cases.[186]

A careful reading of the case law that the IRS relied upon in TAM 93-15-004 has prompted practitioners to comment that the IRS inappropriately applied the plan of rehabilitation doctrine.[187] Substantively, the doctrine simply elaborates on the Treasury Regulation section 1.162-4 requirement that "[r]epairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall either be capitalized and depreciated in accordance with [I.R.C.] section 167 or charged against the depreciation

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181. *Cleanup Deductibility*, *supra* note 52.

182. *See* Jones, *supra* note 4, at 18.

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

184. *Id.*; *see generally* United States v. Wehrli, 400 F.2d 686, 689 (10th Cir. 1968) (question of whether rental property repairs were extensive enough to be capitalized under the plan of rehabilitation doctrine is a question of fact to be decided by the jury).

185. Tech. Adv. Mem. 93-15-004; *see also Akin*, *supra* note 98.

186. The IRS cited the following cases: Mountain Fuel Supply Co. v. United States, 449 F.2d 816 (10th Cir. 1971), *cert. denied*, 405 U.S. 989 (1972); *Wehrli*, 400 F.2d 686; Stoeltzing v. Commissioner, 266 F.2d 374 (3d Cir. 1959); Jones v. Commissioner, 242 F.2d 616 (5th Cir. 1957); Cowell v. Commissioner, 18 B.T.A. 997 (1930); and Bank of Houston v. Commissioner, 19 T.C.M. (CCH) 589 (1960).

187. *Environmental Remediation*, *supra* note 64, at G-6 to G-8; *see also Ivins*, *supra* note 98.

reserve."[188] The judicially formulated plan of rehabilitation doctrine mandates capitalization treatment for "expenditures made pursuant to an overall plan, even though the expenditures when taken separately might be otherwise deductible."[189] The mere presence of a systematic plan will not trigger capitalization treatment under the plan of rehabilitation doctrine.[190] Moreover, since an extensive work plan is consistent with sound business practices, the IRS should not attempt to apply the plan of rehabilitation doctrine based solely on the existence of a written work plan.[191]

The principle underlying the plan of rehabilitation doctrine is that "at some point, a series of related repairs rises to the dignity of a capital project."[192] Upon reaching that point, any and all project expenditures must be capitalized, regardless of whether the individual repair expenditures would be currently deductible if occurring in isolation.[193] Concrete rules regarding the application of the plan of rehabilitation doctrine have not been established due to the fact-intensive nature of the doctrine.[194] The following four factors, however, are utilized in the decision-making process: (1) the value of the work; (2) the purpose of the work; (3) the nature of the work; and (4) the extent of the work.[195]

The first and most influential factor examines whether the expenditures increase the fair market value of the property.[196] The court in *United States v. Wehrli*[197] required capitalization treatment for ex-

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188. Treas. Reg. § 1.162-4 (as amended in 1960); *see generally Environmental Remediation, supra* note 64; *Ivins, supra* note 98.

189. *Cleanup Deductibility, supra* note 52; *see also Wehrli*, 400 F.2d 686 (remanding case for determination of whether rental property should be capitalized under plan of rehabilitation doctrine).

190. *See* Moss v. Commissioner, 831 F.2d 833 (9th Cir. 1987).

191. *Moan, supra* note 25, at 11-12.

192. *Moan, supra* note 25, at 10.

193. *See* Jones v. Commissioner, 24 T.C. 563, 568 (1955), *aff'd*, 242 F.2d 616 (5th Cir. 1957) (requiring capitalization of the costs to restore a historic building); *see also* Moan, *supra* note 25, at 10.

194. *See, e.g.*, United States v. Wehrli, 400 F.2d 686 (10th Cir. 1968) (remanding case for fact-sensitive determination of whether rental property should be capitalized under plan of rehabilitation doctrine); *see also* Moan, *supra* note 25, at 10.

195. *Moan, supra* note 25, at 10-11. These four factors were initially weighed in *Wehrli*, 400 F.2d at 690. Some practitioners do not rely on the four criteria examined here, but require the presence of one of the § 263 factors to elevate a series of repairs to a plan of rehabilitation status. *See, e.g., TEI Contends, supra* note 94; *Cleanup Deductibility, supra* note 52. Upon close examination, however, the four factors address concepts similar to the three § 263 factors which can potentially trigger capitalization. *See supra* notes 119-82 and accompanying text (discussing § 263 factors).

196. Moan, *supra* note 25, at 10.

197. 400 F.2d 686 (10th Cir. 1968).

penditures made in connection with a general plan to modernize and improve rental property.[198] The *Wehrli* court stated that,

> [w]hether the plan exists, and whether a particular item is part of it, are usually questions of fact to be determined by the fact finder based upon a realistic appraisal of all the surrounding facts and circumstances, including, but not limited to . . . *whether the work was done . . . to adapt the property to a different use, or, . . . whether what was done resulted in an appreciable enhancement of the property's value.*[199]

A similar result occurred in *Bank of Houston v. Commissioner*,[200] where the court required capitalization of bank renovation expenditures incurred in connection with a general rehabilitation and improvement plan.[201] Since cleanup expenditures usually only raise the fair market value of a property to a "lesser negative" value, this factor may be difficult to weigh in a plan of rehabilitation determination.[202]

The second factor that is examined to determine whether to apply the plan of rehabilitation doctrine is the purpose of the work. If the purpose of the work is to increase the productivity of property in the taxpayer's trade or business, the doctrine will be judicially applied.[203] Thus, the Tax Court in *Hotel Sulgrave v. Commissioner*[204] applied the plan of rehabilitation doctrine to deny a current repair deduction for a sprinkler system installation because the underlying purpose of the installation was not to keep the property in its ordinary operating condition, but rather to create a permanent improvement.[205]

The third factor that may potentially trigger the application of the plan of rehabilitation doctrine is the nature of the work. A court may apply the doctrine if a series of the repairs are of such a nature as to create "lasting value" in the taxpayer's trade or business.[206] Substantial structural improvements may also implicate application of the plan of rehabilitation doctrine, especially when the structure repaired was dete-

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198. *Id.* at 688, 690.

199. *Id.* at 690 (emphasis added).

200. 19 T.C.M. (CCH) 589 (1960).

201. *Id.* at 591-92.

202. Moan, *supra* note 25, at 10.

203. *See, e.g.*, Seahill Co. v. Commissioner, 23 T.C.M. (CCH) 408, 411 (1964) (expenditures for improvements made in conjunction with roof repairs were intended to increase the value of rental property and must be capitalized); *see* Moan, *supra* note 25, at 10. The doctrine is triggered with the presence of this second factor, despite an absence of a marked increase in the fair market value of the property under the first factor. Moan, *supra* note 25, at 11.

204. 21 T.C. 619 (1954).

205. *Id.* at 621.

206. *See* Moan, *supra* note 25, at 11. The third factor is qualitative in its review of the facts. *Id.* Thus, documentation of the nature and effect of the work is extremely important in an effort to avoid capitalization under this factor. *Id.*

riorating.[207] In *Cowell v. Commissioner*,[208] expenditures incurred in the repair and remodeling of a hotel were held to be capital in nature.[209] The majority of the remodeling work involved structural improvements.[210] The court determined that the work's overall effect was a general rehabilitation of the hotel.[211] The *Cowell* court concluded that the repair costs, though deductible in isolation, must be capitalized "when involved in a greater plan of rehabilitation, enlargement and improvement of the entire property."[212]

The fourth and final factor affecting application of the plan of rehabilitation doctrine is the extent of the work. The cost of the work is weighed against the property's underlying value.[213] In *Stoeltzing v. Commissioner*,[214] the Tax Court required capitalization of a building's repair costs because the costs exceeded 200 percent of the building's value.[215] This factor reflects the principle that expenditures which are substantial in relation to the value of an asset cannot be characterized as "incidental" repairs, and consequently must be capitalized.[216]

In general, the plan of rehabilitation doctrine is not applicable where the expenditures pertain more to the *maintenance* of the property in its "originally intended condition," as opposed to an *improvement or alteration* of the property's "originally intended condition."[217] The Tax Court in *Moss v. Commissioner*[218] applied the plan of rehabilitation doctrine to require capitalization of the taxpayer's hotel remodeling expenditures.[219] The United States Court of Appeals for the Ninth Circuit overruled the Tax Court's decision and held the repair-like remodeling costs to be currently deductible as ordinary and necessary expenses despite the existence of a general remodeling plan.[220] In reaching the decision, the Ninth Circuit discussed the excellent physical condition of the hotel and noted that the plan of rehabilitation doc-

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207. Treas. Reg. § 1.263(a)-1(a)(2) (as amended in 1992).

208. 18 B.T.A. 997 (1930).

209. *Id.* at 1002.

210. *Id.* at 1000. The improvements included reconstruction of the interior; installation of steel supports; replacement of the roof, plumbing, and electrical wiring; and installation of a new heating system. *Id.*

211. *Id.* at 1002.

212. *Id.*

213. *See* Moan, *supra* note 25, at 11.

214. 266 F.2d 374 (3d Cir. 1959).

215. *Id.* at 376.

216. *See* Moan, *supra* note 25, at 11.

217. *Cleanup Deductibility*, *supra* note 52.

218. 831 F.2d 833 (9th Cir. 1987).

219. *Id.* at 834, 835.

220. *Id.* at 842-43.

trine was typically applied only in cases involving substantial improvements to deteriorated facilities.[221]

Thus, application of the plan of rehabilitation doctrine is not appropriate for environmental remediation costs. Such costs are not in the nature of replacements, nor do they arrest the deterioration of or appreciably prolong the life of the land. Additionally, an examination of the purpose and nature of remediation activities demonstrates that these activities do not aim to create or improve productivity beyond the original use of the property.[222] Furthermore, environmental cleanup does not involve structural changes to property in a state of disrepair.[223] To the contrary, the nature of environmental remediation costs is maintenance of the land in its "originally intended condition."[224] Hence, application of the four enumerated factors suggests that hazardous waste cleanup does not fit the profile of a plan of rehabilitation. Therefore, the plan of rehabilitation doctrine should not be applied to force capitalization of environmental remediation costs.

4. Matching of Income and Expenses

The accounting concept of matching income with its corresponding expenditures provides additional support for the current deductibility of environmental remediation costs.[225] "A fundamental requirement in accrual accounting is that every effort be made to match expenses to the income generated by those expenses so that the accounting reflects the net income of the business."[226] A taxpayer's accounting method, and thus his taxable income, is addressed in I.R.C. § 446 and the corresponding Treasury Regulations.[227] Section 446 calls for the taxpayer to use an accounting method which "clearly reflects income."[228] To assess which treatment of expenditures "clearly reflects income," expenditures

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221. *Id.*

222. Jones, *supra* note 4, at 18. Cleaning up hazardous waste on a piece of property and perhaps surrounding property merely allows for continued use of the property. A new asset is not created by the cleanup.

223. *Cleanup Deductibility*, *supra* note 52.

224. *Cleanup Deductibility*, *supra* note 52.

225. *Cleanup Deductibility*, *supra* note 52. A representative from the Treasury's Office of Tax Legislative Counsel stated that "[T]he 'matching concept'. . . should be the analytical basis for determining whether environmental cleanup costs should be capitalized." *'Matching Concept' Should Provide Framework for Tax Treatment of Environmental Cleanup, Says Treasury Official*, 94 TAX NOTES TODAY 8-3, Jan. 12, 1994, *available in* LEXIS, Fedtax Library, TNT File.

226. *Cleanup Deductibility*, *supra* note 52; *see generally* Treas. Reg. § 1.446-1 (as amended in 1992).

227. *See* I.R.C. § 446(a), (b) (1988); *see also* Treas. Reg. § 1.446-1(a)(2) (as amended in 1992).

228. I.R.C. § 446(b) (1988); *see also* I.R.C. § 162(a) (1988 & Supp. IV 1992). An example of this principle is that deductions for ordinary and necessary expenses should be taken in the year in which they were incurred or paid in the taxpayer's trade or business.

must be matched with the income generated from those expenditures to determine net taxable income.[229] Since "clear reflection of income" is the "guiding principle" in resolving accounting issues for tax items, a "clear reflection of income" dictates that environmental cleanup costs be currently deductible.[230]

Expenditures that relate to income to be earned in a future period should be capitalized, while expenditures that relate to the production of current or prior period income should be currently deducted.[231] Since environmental remediation costs can be precisely aligned with activities that generated prior period income, it is appropriate to match the cleanup expenditures against that past income.[232] A taxpayer's operations and disposal practices may have been in accordance with the legal standards in effect during a prior income period, since the environmental contamination may have been scientifically undiscoverable at the time of contamination.[233] Because the taxpayer was unaware of the need for precautionary measures, and thus expended no money for this purpose, prior period net income from the contaminating activity would be artificially inflated for tax purposes.[234] Carryback treatment is actually contemplated in I.R.C. § 172 for net operating loss situations.[235]

In *Arrowsmith v. Commissioner*,[236] the Supreme Court held that a series of related transactions, despite occurring in different tax years, may be considered as one unit in determining the proper classification of the most recent transaction for tax purposes.[237] In *Arrowsmith*, corporate assets were liquidated during a four year period and the corpo-

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229. *See Coopers, supra* note 151.

230. *See Coopers, supra* note 151.

231. *See Commentator Analyzes Tax Treatment Environmental Cleanup Costs*, 93 TAX NOTES TODAY 206-50, Oct. 6, 1993, *available in* LEXIS, Fedtax Library, TNT File [hereinafter *Grigsby*].

232. *Cleanup Deductibility, supra* note 52.

233. *See Cleanup Deductibility, supra* note 52.

234. *See Cleanup Deductibility, supra* note 52.

235. I.R.C. § 172(f) (Supp. IV 1992); *see also Cleanup Deductibility, supra* note 52. If a taxpayer incurred a net operating loss in a given taxable year due to remediation expenditures, I.R.C. § 172 assists in the matching or spreading of the loss to the probable income-earning periods. I.R.C. § 172 (1988 & Supp. IV 1992); *see also* 6 MERTENS, *supra* note 6, §§ 29.10, 29.31. Under I.R.C. § 172(b), the net operating loss for a given taxable year may be carried back, first to each of the three taxable years preceding the year of loss, then chronologically over to each of the fifteen taxable years following the year of loss. I.R.C. § 172(b) (Supp. IV 1992); *see also* 6 MERTENS, *supra* note 6, § 29.10. Using this method, the net operating loss for the year of loss is offset by the taxable income for those years to which the net operating loss may be carried back or carried over, until the loss is absorbed or offset. 6 MERTENS, *supra* note 6, § 29.10.

236. 344 U.S. 6 (1952).

237. *Id.* at 8-9.

ration was subsequently dissolved.[238] The taxpayer correctly reported his gains from the liquidation as capital gains.[239] The taxpayer was later required to make payments to a corporate creditor and treated the payments as ordinary losses.[240] The Tax Commissioner integrated all of the transactions and considered them together to determine the proper tax character of the payments to the corporate creditor.[241] The Supreme Court affirmed the Tax Commissioner's integration of the transactions and the proper tax characterization of the payments to the creditor as capital losses.[242]

Arrowsmith thus requires consistent tax characterization of transactions which occur after a taxpayer no longer operates a given trade or business.[243] The *Arrowsmith* doctrine readily lends itself to the proper tax classification of environmental cleanup costs.[244] The cleanup costs would properly have been deducted as ordinary and necessary expenses incurred in conjunction with the production of current income had they been incurred in the same years that the business generated income.[245] Under *Arrowsmith*, these cleanup costs must necessarily be considered together with the income generated to determine the proper tax characterization of the later transaction.[246] The reasoning in *Arrowsmith* readily supports the concept of matching the ordinary and necessary expenses of disposing of the hazardous by-products with the

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238. *Id.* at 7. Corporate liquidation consists of distribution of all corporate assets to the shareholders in proportion to their number of shares of corporate stock. HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS § 382, at 1148 (3d ed. 1983). In exchange, shareholders surrender to the corporation their stock in the corporation. *See* 3 BITTKER & LOKKEN, *supra* note 7, § 93.5.1. In *Arrowsmith*, the taxpayer was a shareholder in a corporation which liquidated its assets and then went out of existence. 344 U.S. at 7.

239. 344 U.S. at 7. The predecessor of I.R.C. § 331 in effect at the time *Arrowsmith* was decided required capital gain treatment of gains realized by shareholders from stock liquidation. Interview with E. Dale Searcy, Professor of Law, University of Dayton School of Law, in Dayton, Ohio (Jan. 27, 1994).

240. 344 U.S. at 7. The taxpayer's rationale for treating the payments as ordinary losses was that no sale or other disposition of a capital asset (corporate property) had occurred within the taxable year. *Id.* Thus, the taxpayer determined that the loss must be ordinary and not capital, since I.R.C. § 1231(a)(3) requires the sale or other disposition of a capital asset to qualify the transaction as a capital loss. *Id.*

241. *Id.* at 8.

242. *Id.* at 9.

243. Additional support for the concept of looking to previous transactions to determine the tax character of later income (and similarly, expenses) is found in I.R.C. § 691(a)(3). I.R.C. § 691(a)(3) states that the character of the income received by a decedent's estate is determined by the character the income would have been accorded "in the transaction in which the right to receive the income was originally derived." I.R.C. § 691(a)(3) (1988).

244. *See Grigsby, supra* note 231.

245. *See generally* Treas. Reg. § 1.162-1(a) (as amended in 1988); *see also Cleanup Deductibility, supra* note 52.

246. *See Grigsby, supra* note 231.

corresponding income produced while the taxpayer was involved in that trade or business.[247] The *Arrowsmith* doctrine, along with the accepted practice of matching expenses with corresponding income, thus provides a strong argument for allowing the present deductibility of hazardous waste cleanup costs as ordinary business expenses.

If the situation does not lend itself to the matching of income and expenses, however, the next best alternative is to permit current deduction of cleanup costs at the time payment is made.[248] While the period of expenditures and the period of earnings may differ, current deduction is consistent with the I.R.C. § 446 requirement that taxable income be based upon the taxpayer's records to clearly reflect income.[249] Furthermore, the cleanup expenses would generally have been expensed had the taxpayer realized the need for such cleanup during the income-producing years of the trade or business.[250] From the perspective of economic performance, current deduction of a fixed and determinable liability is appropriate in the year of payment.[251]

Capitalization to future periods grossly distorts prior period net income, current period net income, and future period net income for tax purposes.[252] Capitalization artificially increases prior period gross income and artificially decreases future period net income.[253] With capitalization, there is a relationship to neither the income-earning activity

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247. *See* Moan, *supra* note 25, at 12.

248. *Cleanup Deductibility*, *supra* note 52. The party most concerned with the tax character of the cleanup costs (currently deductible expense versus capital expenditure) is the PRP who no longer owns the contaminated property. Under I.R.C. § 1231, if the overall § 1231 losses exceed the overall § 1231 gains for a taxpayer in the year cleanup costs are incurred, then all of the taxpayer's losses (including the cleanup costs) will be classified as currently deductible ordinary loss. *See* I.R.C. § 1231 (1988 & Supp. IV 1992). A § 1231 loss includes "any recognized loss from a sale or exchange, or conversion" of property used in a trade or business. *Id.* § 1231(a)(3). Since cleanup costs are likely to exceed a taxpayer's gains in the year of cleanup, both the PRP who owns the property and those PRPs who do not own the property will be able to deduct the cleanup costs as expenses in the year of cleanup.

Even if an owner PRP is forced to claim all gains as capital gains, an owner PRP has the option of adding the capitalized cleanup costs to the basis of the property, and recouping the costs through depreciation and upon the sale of the property. PRPs who do not own the property potentially face the least favorable tax consequences if cleanup costs receive capital expenditure treatment under § 1231. If, during the year cleanup costs are incurred, a non-owner PRP is forced under the terms of § 1231 to characterize the cleanup costs as capital losses, then the non-owner PRP will face the potential problems addressed in this Comment. Under forced capitalization treatment, the non-owner PRP suffers the most because that taxpayer owns no property, and thus no basis exists, to which that PRP could add the costs to recoup upon sale of the property.

249. *See Cleanup Deductibility*, *supra* note 52.

250. *See Cleanup Deductibility*, *supra* note 52.

251. *See* I.R.C. § 461(h) (1988).

252. *Cleanup Deductibility*, *supra* note 52.

253. *Cleanup Deductibility*, *supra* note 52.

that gave rise to the liability nor the actual expenditure.[254] Capitalization requires a link to the production of future income.[255] Because there is no direct link to the production of future income, capitalization of environmental cleanup costs is inappropriate.[256] Environmental remediation costs should be matched against prior period income because of the direct relationship between the income earned from the polluting activities and the eventual cleanup costs. Capitalization of environmental cleanup costs distorts the prior year's income since such capitalization does not accurately reflect the fact that cleanup costs were accruing in the prior year. Therefore, the accounting concept of matching income with expenses strongly supports the current deductibility of environmental remediation costs.[257]

B. Impact of IRS Interpretation on Settlement Funds, Insurance Coverage, and Bankruptcy

In addition to considering the short-term implications of current deductibility versus capitalization treatment of environmental cleanup expenses, taxpayers, Congress, and the IRS must carefully scrutinize the over-all long-term ramifications of electing one tax method over another. The primary objective of CERCLA is to clean up hazardous waste sites.[258] Additionally, since CERCLA is a remedial statute, it should be construed liberally to effectuate its goals.[259] A "revenue-maximizing course of action" on the part of the IRS contradicts tax law principles regarding cleanup expenditures[260] and is "counter-productive for environmental policy."[261] The long-term consequences of IRS policies regarding environmental cleanup costs must be examined in light of the public policy CERCLA was meant to further.

1. Settlement Funds

The tax treatment of environmental cleanup costs is complex and, at present, unclear. The tax treatment becomes more complicated when there are multiple PRPs or when a PRP is no longer the owner of the

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254. *Cleanup Deductibility*, *supra* note 52.

255. *Cleanup Deductibility*, *supra* note 52.

256. *Cleanup Deductibility*, *supra* note 52. Practitioners criticized the ruling in TAM 93-15-004 both on general and specific grounds, saying, among other things, that the TAM violated the matching concept. *See Environmental Remediation*, *supra* note 64.

257. *See Cleanup Deductibility*, *supra* note 52.

258. For a detailed review of CERCLA's limited legislative history, see Frank P. Grad, *A Legislative History of the Comprehensive Environmental Response, Compensation and Liability ("Superfund") Act of 1980*, 8 COLUM. J. ENVTL. L. 1 (1982).

259. United States v. Alcan Aluminum Corp., 964 F.2d 252, 258 (3d Cir. 1992) (CERCLA is a remedial statute to be construed liberally when determining potential liability).

260. *TEI Contends*, *supra* note 94.

261. *TEI Contends*, *supra* note 94.

contaminated site. The non-owner PRP cannot recoup capitalized cleanup expenditures upon the sale of the property.

A settlement fund may be established to centralize the financing of the cleanup project, especially when multiple PRPs are involved.[262] A settlement fund may contain the contributions of hundreds of PRPs in a large multiparty remediation project.[263] The tax treatment of contributions into a qualified settlement fund is primarily governed by I.R.C. § 468B(g).[264] The final § 468B(g) regulations treat a CERCLA liability as a service liability[265] with regard to PRP contributions into a qualified settlement fund.[266] A CERCLA liability is deductible only if the contributing PRP's liabilities are "extinguished" by the payment into the settlement fund.[267]

Since PRP liability is rarely totally extinguished in environmental remediation, the IRS eased the extinguishment restrictions with Treasury Regulation section 1.468B-1(f)(2).[268] The regulation deems a PRP's CERCLA liability extinguished if, after payment into a qualified settlement fund, "the transferor's only remaining liability to the Environmental Protection Agency, if any, is a remote, future obligation to provide services or property."[269] The IRS, however, will not accept a "private hold harmless agreement" between PRPs without EPA approval as satisfaction of the CERCLA extinguishment requirement.[270]

Practitioners surveyed by the Bureau of National Affairs project that the IRS's position on extinguishment will effectively eliminate the

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262. *Superfund Cleanups Seen as More Costly Under IRS' Reading of Section 468B(g) Rules*, Daily Tax Report (BNA) No. 91, at G-5 (May 13, 1993) [hereinafter *Superfund Cleanups*].

263. Moan, *supra* note 25, at 20. The Treasury Department recently finalized regulations creating CERCLA-specific qualified settlement funds into which some PRPs may contribute their portion of cleanup costs. Treas. Reg. § 1.468B-1 (1993); Moan, *supra* note 25, at 25. These new provisions control satisfaction of economic performance requirements for CERCLA liabilities, and are especially relevant to smaller PRPs who wish to "buy" their way out of the cleanup process by contributing an amount of cash roughly equal to their proportionate share of the environmental damage. Moan, *supra* note 25, at 21, 25.

Should the PRPs choose to form a corporation to handle the cleanup, the IRS may treat payments to the corporation as nondeductible capital contributions. Thomas H. Yancey et al., *Tax Consequences of Environmental Cleanups*, *in* THE GREENING OF AMERICAN BUSINESS: MAKING BOTTOM-LINE SENSE OF ENVIRONMENTAL RESPONSIBILITY 243 (Thomas F. P. Sullivan ed., 1992).

264. *See Superfund Cleanups*, *supra* note 262; *see generally* I.R.C. § 468B(g) (1988).

265. For a discussion of CERCLA liabilities as service versus payment liabilities, see *supra* notes 90-91 and accompanying text.

266. *See Superfund Cleanups*, *supra* note 262; *see also* Moan, *supra* note 25, at 27.

267. *Superfund Cleanups*, *supra* note 262.

268. *See* Treas. Reg. § 1.468B-1(f)(2) (1993); *see also Superfund Cleanups*, *supra* note 262.

269. Treas. Reg. § 1.468B-1(f)(2) (1993); *see also Superfund Cleanups*, *supra* note 262.

270. *Superfund Cleanups*, *supra* note 262.

usefulness of the settlement fund rules.[271] The IRS's position will affect the majority of PRPs in multiparty remediation projects since the EPA rarely signs off on CERCLA liabilities.[272] Furthermore, the IRS's interpretation and application of the settlement fund rules will probably eliminate an immediate tax deduction for smaller cash-out PRPs and will substantially increase administrative costs for all PRPs.[273] Practitioners noted that the IRS position "appears contrary to the policy that the EPA is trying to foster in CERCLA cleanups," and commented that the IRS construction of the rule was an unreasonable one.[274]

2. Shrinking Insurance Coverage

The number of lawsuits brought by governmental entities and private parties against the various categories of PRPs — generators, disposers, and transporters of hazardous waste — has increased dramatically.[275] These PRPs have looked to their insurance companies for coverage. The PRPs' initial concerns focus on insurance coverage for costs to defend or contest CERCLA liability.[276] Additionally, PRPs are concerned about whether coverage exists under their insurance policies for payment of cleanup costs or damages if a PRP did indeed contaminate the environment.[277] A distinct, but significant, complication is that the insurance industry is imposing excessive premiums and restrictive coverage on firms hired to clean up hazardous waste sites.[278] Declining insurance coverage to PRPs and hazardous waste removal contractors, combined with unfavorable tax treatment of CERCLA cleanup costs, severely affects the financial likelihood of a successful environmental remediation effort.

PRPs typically seek insurance indemnification for hazardous waste costs with regard to property damage, natural resources damages, and

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271. *Superfund Cleanups*, *supra* note 262.

272. *Superfund Cleanups*, *supra* note 262.

273. *Superfund Cleanups*, *supra* note 262. Under the new qualified settlement fund rules, smaller (de minimis and "cash-out") PRPs who are liable for a proportionately minor share of the cleanup costs theoretically qualify for current deductions by payment into a qualified settlement fund. Yancey, *supra* note 263, at 247; *see generally* I.R.C. § 468B (1988 & Supp. IV 1992); Treas. Reg. §§ 1.468B-1, B-2 (1993).

274. *Superfund Cleanups*, *supra* note 262.

275. Jerold Oshinsky, *Insurance Coverage for Environmental Liability Claims: A Policyholder's Overview* (Practicing Law Inst. Corp. Law & Practice Course Handbook Series No. B4-6918, 1990).

276. *Id.*

277. *Id.*

278. Michael K. Yates, *Allocating Risk for Hazardous Waste Cleanups*, USA Today, Jan. 1993, at 60.

toxic tort claims by individuals.[279] PRPs claim that the insurer is liable for these CERCLA response costs under the vague "damages" term that limits the scope of liability coverage in the PRPs' Comprehensive General Liability (CGL) Policy.[280] The Federal Courts of Appeals are divided as to whether CERCLA response costs are "damages" under CGL policies.[281] This division leaves the issue unsettled and suggests that some PRPs will be forced to bear not only the actual cleanup costs themselves, but also substantial litigation costs.

Furthermore, other policies deny PRPs insurance coverage due to "pollution exclusion" clauses. "Pollution exclusion" clauses, included in most CGL policies since the early 1970s, exclude coverage for damages "arising out of the discharge, dispersal, release or escape of . . . pollutants into or upon land."[282] The "pollution exclusion," however, does not apply if "such discharge, dispersal, release, or escape is sudden and accidental."[283] Some courts have found the words "sudden and accidental" to be ambiguous and, therefore, construe the terms to favor coverage for the insured.[284] Insurance companies have prevailed more fre-

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279. Thomas C. Mielenhausen, *Insurance Coverage for Environmental and Toxic Tort Claims*, 17 WM. MITCHELL L. REV. 945, 946 (1991).

280. Stephen Mountainspring, Comment, *Insurance Coverage of CERCLA Response Costs: The Limits of "Damages" in Comprehensive General Liability Policies*, 16 ECOLOGY L.Q. 755, 759 (1989). The majority of CERCLA response claims involve CGL policies. *Id.* at 758. The CGL policy is a standardized insurance contract that insurers have prominently used since the late nineteenth century. *Id.* Typical damages language in an insurance contract requires an insurer to "pay on behalf of the insured all sums which the insured shall become legally obligated to pay as damages because of [property damage]." Aetna v. Pintlar, 948 F.2d 1507, 1511 (9th Cir. 1991).

281. *Aetna*, 948 F.2d at 1511. The Courts of Appeals for the First, Fourth, and Eighth Circuits have held that CGL policies do not cover CERCLA response costs under "damages." *Id.* at 1511-12 (citing A. Johnson & Co. v. Aetna Casualty & Sur. Co., 933 F.2d 66, 69 (1st Cir. 1991); Cincinnati Ins. Co. v. Milliken & Co., 857 F.2d 979, 981 (4th Cir. 1988); Continental Ins. Co. v. Northeastern Pharmaceutical & Chem. Co., 842 F.2d 977, 985 (8th Cir.) (en banc), *cert. denied*, 488 U.S. 821 (1988)). In contrast, the Courts of Appeals for the Second, Third, Ninth, and District of Columbia Circuits have held that CERCLA response costs are covered "damages" under CGL policies. *Aetna*, 948 F.2d at 1512 (citing Independent Petrochemical Corp. v. Aetna Casualty & Sur. Co., 944 F.2d 940, 947 (D.C. Cir. 1991); New Castle County v. Hartford Accident & Indemnity Co., 933 F.2d 1162, 1188 (3d Cir. 1991); Avondale Indus., Inc. v. Travelers Indem. Co., 887 F.2d 1200, 1207 (2d Cir. 1989), *cert. denied*, 496 U.S. 906 (1990); Port of Portland v. Water Quality Ins. Syndicate, 796 F.2d 1188, 1194 (9th Cir. 1986)).

282. Broderick Inv. Co. v. Hartford Accident & Indem. Co., 954 F.2d 601, 604 (10th Cir.), *cert. denied*, 113 S. Ct. 189 (interim ed. 1992) (citing language in Hartford Policy); *see also* John O'Leary, *Coming Full CERCLA: The Release of Superfund Insurance Coverage Decisions From State Supreme Courts*, 1992 A.B.A. SEC. NAT. RESOURCES & ENVTL. 31, 32.

283. *Broderick*, 954 F.2d at 604 (citing language in Hartford Policy); *see also* O'Leary, *supra* note 282, at 32.

284. The Courts of Appeals for the Third and Eighth Circuits have upheld coverage for the policyholder on this issue. *See, e.g.*, *New Castle County*, 933 F.2d 1162 (applying Delaware law); Benedictine Sisters of St. Mary's Hosp. v. St. Paul Fire & Marine Ins. Co., 815 F.2d 1209 (8th Cir. 1987) (applying South Dakota law); *see generally* O'Leary, *supra* note 282, at 32-33.

quently in excluding coverage using the pollution exclusion clause.[285] The pollution exclusion clause, therefore, provides yet another means by which insurance companies escape liability for CERCLA response costs.

Moreover, a more restrictive "absolute" pollution exclusion clause replaced the "standard" pollution exclusion clause in CGLs in the mid-1980s.[286] The new "absolute" pollution exclusion clause completely excludes coverage for pollution claims.[287] This trend toward an "absolute" bar to insurance coverage for pollution claims, combined with inconsistent coverage under the "damages" clause of CGL policies, leaves a large number of PRPs liable for the full litigation and remediation costs of a CERCLA cleanup project.

A PRP's ability to soften the financial impact of these cleanup costs through favorable tax treatment thus becomes increasingly critical to the financial survival of a cleanup project. The financial survival of the cleanup project, in turn, is a major factor in eliminating the hazards of environmental waste. Congress should look beyond modest expectations of increased current revenue under forced capitalization of cleanup costs, and consider the bigger picture. Current deduction of CERCLA cleanup costs, as opposed to capitalization, decreases immediate revenue to the IRS. Forcing a PRP to perhaps discontinue or avoid the cleanup totally because of harsh tax treatment, however, is even more counterproductive to the cleanup effort. Neither the environment nor the IRS receives any benefit. Therefore, in the 1994 re-enactment of CERCLA, Congress should specifically designate CERCLA cleanup costs as presently deductible expenses under I.R.C. § 162.

3. Bankruptcy versus Environmental Considerations

Bankruptcy Code § 554(a) provides that "[a]fter notice and a hearing, the trustee may abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate."[288] Substantial environmental and legal obligations

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285. *See* O'Leary, *supra* note 282, at 33. Insurers have prevailed regarding exclusion of coverage under the pollution exclusion clause in the First, Second, Third and Sixth Circuits. *Id.*; *see, e.g., A. Johnson*, 933 F.2d 66 (applying Maine law); New York v. AMRO Realty Corp., 936 F.2d 1420 (2d Cir. 1991) (applying New York law); Northern Ins. Co. of N.Y. v. Aardvark Assoc., Inc., 942 F.2d 189 (3d Cir. 1991) (applying Pennsylvania law); FL Aerospace v. Aetna Casualty & Sur. Co., 897 F.2d 214 (6th Cir.) (applying Michigan law), *cert. denied*, 498 U.S. 911 (1990).

286. O'Leary, *supra* note 282, at 33.

287. O'Leary, *supra* note 282, at 33.

288. 11 U.S.C. § 554(a) (1988). The abandoned property then reverts to the party or parties exhibiting a valid possessory interest. *See* Losch, *supra* note 33, at 145 n.71. The bankruptcy trustee may alternatively opt to return the contaminated and burdensome property to the debtor. *See* 11 U.S.C. § 554(a) (1988).

render environmentally contaminated property both burdensome and of inconsequential value.[289] A bankruptcy trustee's abandonment of the contaminated property shifts the burden of cleanup to the EPA, and thereby, to the taxpayers.[290] Furthermore, abandonment removes the trustee's incentive to take even the most basic and inexpensive measures to limit public and environmental harm from the contamination, such as sealing barrels or other containment measures.[291]

Prohibiting abandonment, however, may force the trustee to dissipate any remaining bankruptcy estate assets on property of little or no value.[292] This dissipation "frustrate[s] the 'fresh start' policy of bankruptcy and impair[s] the trustee's role of maximizing assets."[293] Faced with choosing between cleaning the environment and providing a "fresh start" for a party declaring bankruptcy, some commentators have suggested that protecting the environment, and thereby the public, should be paramount over the "narrow interests" of the parties in bankruptcy.[294]

Unfortunately, requiring capitalization of environmental cleanup costs may increase the likelihood that courts and bankruptcy trustees will have to make a choice between environmental and bankruptcy considerations. A PRP, often no longer the owner of a contaminated site, may be faced with declaring bankruptcy as the only viable option. If environmental cleanup costs drive a PRP into bankruptcy, perhaps due to the lack of insurance coverage or a stringent application of tax rules, the public's health and safety concerns will also be severely affected. Since the bankrupt PRP will be financially unable to clean up the contamination, the public will then have little choice but to rely on the EPA to expend Superfund monies to clean up the contaminated property. In the Bankruptcy Code's prioritization plan for creditors' claims, a claim by the EPA for reimbursement of Superfund expenditures may be categorized as an ordinary unsecured claim, payable to the EPA after claims by other categories of claimants.[295] Typically, in a bankruptcy action, however, few assets remain for distribution to unsecured

289. Losch, *supra* note 33, at 145.

290. Losch, *supra* note 33, at 145. Aside from the Superfund, the sole alternative source of funding for the EPA's cleanup burden may be a solvent PRP who is forced to assume the defaulted share of the costs under CERCLA's joint and several liability provisions. *Id.*

291. Losch, *supra* note 33, at 145.

292. Losch, *supra* note 33, at 145. The Bankruptcy Code does not limit a trustee's power to abandon burdensome property. *See* Klerman, *supra* note 30, at 801. *But see* Midatlantic Nat'l Bank v. New Jersey, 474 U.S. 494, 507 (1986) (trustee prevented from abandoning contaminated property because of the imminent danger to the public).

293. Losch, *supra* note 33, at 145.

294. *See, e.g.*, Losch, *supra* note 33, at 145.

295. *See* Klerman, *supra* note 30, at 805.

creditors.[296] As a result, government claims for reimbursement of environmental cleanup costs frequently never get paid, thus depleting the Superfund monies and thereby reducing the likelihood that the EPA will have funding to undertake cleanups.[297]

Under the Bankruptcy Code's prioritization plan for payment of creditors' claims, secured creditors are given the first opportunity to satisfy their claim from the debtor's assets, to the extent of the collateral securing their claims.[298] Second priority status is accorded to the administrative expenses that are "the actual, necessary costs and expenses of preserving the estate."[299] Finally, the claims of unsecured creditors are paid if any assets remain in the bankruptcy estate.[300]

A controversy exists regarding whether environmental remediation costs should be categorized as low priority secured claims, as administrative expense priority claims, or as merely unsecured claims.[301] Most courts categorize cleanup costs as administrative priority expenses under Bankruptcy Code § 503(b)(1)(A) and § 507(a)(1), which allow these costs to be satisfied prior to unsecured claims.[302] A minority of courts, however, have declined to accord administrative priority status to cleanup costs.[303] In light of unsettled prioritization of an EPA bankruptcy claim for reimbursement of expended Superfund monies, Con-

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296. *See* Robert Funsten & Alejandro Hernandez, *The Toxic Waste Generator in Bankruptcy: Should Environmental Cleanup Costs Be Given a Priority?*, 6 STAN. ENVTL. L.J. 108, 126 (1987).

297. *Id.*

298. *See* 11 U.S.C. § 506(a), (d) (1988); *see also* Losch, *supra* note 33, at 162.

299. 11 U.S.C. § 503(b)(1)(A) (1988); *see also* Losch, *supra* note 33, at 162.

300. *See* Losch, *supra* note 33, at 162.

301. *See* Salerno, *supra* note 1, at 285-86. Some types of governmental unsecured claims have priority over general unsecured claims. Gary E. Claar, *The Case for a Bankruptcy Code Priority for Environmental Cleanup Claims*, 18 WM. MITCHELL L. REV. 29, 44-45 (1992). CERCLA grants authority for an EPA lien against a PRP's property. 42 U.S.C. § 9607(l) (1988); *see also* Claar, *supra*, at 44-45. The presence of this lien may affect the EPA's classification as a secured/unsecured creditor. Some state superfund statutes contain "superlien" provisions which elevate state environmental agencies' liens above all other liens on the debtor's assets. *See* Claar, *supra*, at 44-45. Furthermore, Bankruptcy Code § 506(c) provides for "superpriority" claims, which permit recovery ahead of certain secured creditors under specific circumstances. *Id.* These and other options contribute to the uncertainty regarding the status of EPA claims in a bankruptcy situation.

302. *See, e.g.*, In re Wall Tube & Metal Prods. Co., 831 F.2d 118 (6th Cir. 1987) (holding that cleanup costs were entitled to administrative priority because imminent public harm denied the trustee the option of abandonment). The majority of courts accord administrative priority status to cleanup costs under the theory that since the expenditures are made in compliance with laws protecting public health, the expenditures are a necessary cost of preserving the estate. *See, e.g.*, *In re* Peerless Plating Co., 70 B.R. 943 (Bankr. W.D. Mich. 1987); *In re* Pierce Coal & Constr., Inc., 65 B.R. 521 (Bankr. N.D. W. Va. 1986); *In re* T.P. Long Chem., Inc., 45 B.R. 278 (Bankr. N.D. Ohio 1985); *see also* Losch, *supra* note 33, at 162-63.

303. *See, e.g.*, *In re* Dant & Russell, Inc., 853 F.2d 700, 706-09 (9th Cir. 1988) (denying administrative priority status to the EPA's CERCLA claim where the cleanup expenditures pro-

gress would fare best by avoiding forcing a PRP into bankruptcy.[304] Congress, therefore, should support its goal of cleaning up hazardous environmental waste under CERCLA by classifying environmental cleanup costs as currently deductible business expenses.

C. Similarities of Environmental Cleanup Costs to Petroleum Cleanup and Soil Reclamation Costs

Costs to clean up petroleum-contaminated soil and groundwater are currently deductible expenses under present tax law.[305] TAM 93-15-004 prompted Congressman William K. Brewster to introduce a bill in the United States House of Representatives to mandate the continued deductibility of business expenses incurred in cleaning up petroleum-contaminated soil and groundwater.[306] In his remarks, Congressman Brewster noted that "[t]he cost of cleaning up soil and groundwater is something that must continue to be viewed as a [currently] deductible expense."[307] Congressman Brewster further noted that many small businesses would be financially unable to undertake cleanup efforts if capitalization of petroleum cleanup costs was required, to the ultimate detriment of the safety, health, and finances of public taxpayers.[308] CERCLA cleanup costs are directly analogous to petroleum cleanup costs, the only distinction being the category of hazardous waste being addressed. Since Congress has permitted the present deductibility of petroleum cleanup costs, Congress should likewise allow present deductibility of CERCLA cleanup costs.

Another area of environmental repair analogous to CERCLA cleanup is surface mining reclamation. Reclamation involves the restoration of land previously used for mining.[309] Under I.R.C. § 468, taxpayers may currently deduct estimated mining and waste disposal site reclamation costs prior to economic performance.[310] This statutory treatment essentially recognizes that reclamation costs are not subject to capitalization.[311] Land reclamation costs are strikingly similar to environmental remediation costs as both return land to a usable condition.[312] Since Congress has deemed the costs associated with mining-

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vided no benefit to the estate and the CERCLA claim would totally deplete the estate, thus depriving all other unsecured creditors of the possibility to satisfy their claims).

304. *See supra* text accompanying note 5; *see also* Moan, *supra* note 25, at 12.
305. 139 CONG. REC. E2382-83 (daily ed. Oct. 7, 1993) (Statement of Rep. Brewster).
306. *Id.*
307. *Id.*
308. *Id.*
309. *See generally* 30 U.S.C. §§ 1201-1328 (1988 & Supp. IV 1992).
310. I.R.C. § 468 (1988 & Supp. IV 1992).
311. *See Cleanup Deductibility, supra* note 52.
312. *See Cleanup Deductibility, supra* note 52.

related land restoration to be currently deductible, an analogy can be drawn suggesting that CERCLA costs should also be presently deductible as land restoration costs.[313]

IV. CONCLUSION

Congress should act quickly to clarify tax treatment of environmental remediation costs. CERCLA's ultimate goal is to remove the threat to public health and safety that arises from hazardous waste. To place insurmountable obstacles in the path of those faced with the prospect of an expensive and difficult environmental cleanup may lead to further delay or abandonment of environmental cleanup efforts. Many PRPs practiced legally and scientifically acceptable methods of operation at the time the pollution occurred. Harsh tax treatment of environmental cleanup costs punishes the public and innocent polluters, as well as the intentional polluters, by potentially delaying or avoiding cleanup. Congress should focus on the bottom line: severe tax treatment of environmental cleanup costs minutely increases federal revenues at the expense of the safety and health of the American public.

Clearly, Congress should establish current deductibility of environmental cleanup costs in its re-enactment of CERCLA in 1994. Enduring expensive and complicated environmental cleanups is punishment enough for PRPs. By using favorable tax treatment as an incentive, Congress could minimize liability litigation and EPA oversight costs, while enticing the cooperation of PRPs to rid America of its environmental nightmares.

Mary Lou Hopun

313. *See Cleanup Deductibility*, *supra* note 52.