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Issue Contents

Animals

Gift of livestock **187**

Bankruptcy

General

Exemptions

Earned income credit **187**

Plan **187**

Chapter 12

Plan **187**

Federal tax

Discharge **187**

Earned income credit **187**

Post-petition interest **188**

Contracts

Arbitration **188**

Breach of warranty **188**

Constructive fraud **188**

Federal Agricultural Programs

Livestock **188**

Meat inspection **188**

PACA **189**

Tuberculosis **189**

Federal Estate and Gift Tax

Valuation **189**

Federal Income Taxation

Depreciation **189**

Interest rate **189**

Like-kind exchanges **189**

Limited liability companies **190**

Passive activity losses **190**

Pension plans **190**

Rent paid to employees **190**

S corporations

Passive activity losses **190**

Subsidiaries **190**

Safe harbor interest rates

December 2000 **190**

Small ethanol producer **190**

Travel expenses **190**

Withholding taxes **191**

Landlord and Tenant

Termination of lease **191**

Partnerships

Definition **191**

State Taxation

Agricultural use **191**

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DEDUCTING ENVIRONMENTAL CLEANUP COSTS

— by Neil E. Harl*

For nearly a decade, there's been a great deal of uncertainty over how to handle environmental cleanup costs.¹ Two developments this year have cast new light on the problem, one confirming the direction we have been taking on the issue² and the other raising some question about the reliance on a 1992 U.S. Supreme Court case³ in requiring the capitalization of some environmental cleanup costs.⁴

Early authority

Based in part on the U.S. Supreme Court's decision in *INDOPCO, Inc. v. Commissioner*,⁵ which required capitalization of costs associated with the merger of large food companies on the grounds that the expenses created an asset of long term value, the Internal Revenue Service in 1992 began a series of private letter rulings addressing the deductibility of environmental cleanup expenditures.⁶ IRS ruled that the costs incurred as part of a general rehabilitation of property with respect to environmental contaminants were not deductible but instead had to be amortized over some unspecified time period.⁷ That was the outcome for the costs of removing and replacing asbestos insulation⁸ and the costs of PCB cleanup.⁹ In a 1993 ruling, IRS specified that capitalized expenditures were properly amortizable over the period for depreciating the assets in question—31.5 years.¹⁰

Current deductions were allowed for legal fees, engineering charges and other costs relating to contesting liability.¹¹

In 1994, IRS issued *Rev. Rul. 94-38*¹² which held that the costs incurred to clean up land contaminated by the taxpayer and to treat groundwater that had been contaminated by a business could be deducted as ordinary and necessary business expenses.¹³ In the ruling, soil remediation activities included excavating the contaminated soil, transporting the soil to a waste disposal facility and backfilling with uncontaminated soil.¹⁴ The same ruling held that costs attributable to groundwater treatment facilities (wells, pipes, pumps and other equipment to extract, treat and monitor contaminated groundwater) were capital expenditures.¹⁵ Later, IRS officials stated informally that the ruling did not necessarily apply to costs to clean up land acquired by the taxpayer in contaminated condition.

United Dairy Farmers, Inc.

In a 2000 federal district court case, the taxpayer purchased from Southland Corporation 60 7-Eleven convenience stores.¹⁶ For two of the stores, the seller was not conducting retail gasoline sales but retail gasoline stations had been operated

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Happy Holidays to you and yours.**

previously at both locations. In both locations, the gasoline tanks had leaked, causing the soil to become contaminated.¹⁷ United Dairy Farmers, Inc., the purchaser, spent more than \$260,000 to remediate the soil. The costs were deducted as business expenses.

The court noted that, in *Rev. Rul. 94-38*,¹⁸ the expenditures merely restored the property to its approximate condition before the taxpayer's operations caused the contamination.¹⁹ Thus, the 1994 ruling was based on a "restoration" principle in which one compares the restored condition of the land to the uncontaminated condition of the land when the taxpayer acquired it. The restoration principle envisions that the taxpayer acquired the property in an uncontaminated condition, contaminated the property in the course of its everyday operations, and incurred cost to restore the property to its condition at the time the property was acquired by the taxpayer.²⁰

The court observed that the restoration principle did not apply in a highly publicized 1995 ruling, *Ltr. Rul. 9541005*.²¹ In the facts of that ruling, a corporation acquired a parcel of real property which became a site for disposal of industrial waste. Later, the corporation donated the land to the local county for a recreational park. After the land was deeded to the county, the county discovered that the land was contaminated and conveyed the land for \$1 back to a subsidiary of the original owner of the land which had contaminated the tract.²² Later, the Environmental Protection Agency required the subsidiary to remediate the soil. The corporation sought to deduct the costs involved but IRS ruled that the restoration principle did not apply because the subsidiary did not acquire the land in an uncontaminated condition. In part because of adverse commentary about the ruling, IRS later revoked the ruling and allowed a current deduction for hazardous waste site assessment costs, legal fees and consulting fees.²³

Nonetheless, the court in *United Dairy Farmers, Inc. v. United States*²⁴ found the facts in that case were comparable to the facts in *Ltr. Rul. 9541005*²⁵ on two grounds. First, the sites for the two stores were already contaminated when purchased; secondly, the taxpayer did not contaminate the properties through its normal business operations.²⁶ Moreover, the court found that the remediation expenditures increased the value of the two properties. The court concluded that the remediation expenditures resulted in an improvement of the condition of the properties and an increase in, and not restoration of, the values of the properties.²⁷ Therefore, the expenditures had to be capitalized.

Wells Fargo case

Although not involving environmental contamination, an Eighth Circuit Court of Appeals case, *Wells Fargo & Co. and Subs. v. Commissioner*,²⁸ has challenged the breadth of the *INDOPCO* decision²⁹ which provides underpinning for the IRS position on capitalization of expenditures. In *Wells Fargo*, the court held that officers' salaries and investigatory and due diligence fees incurred in a bank acquisition were currently deductible as ordinary expenses and did not have to be capitalized under the *INDOPCO* case.³⁰ Further litigation will be necessary, including probable appeal of the *Wells Fargo*

decision, before it is known what, if any, impact the line of cases may have on environmental cleanup.

In the meantime, attention is likely to be focused on the "restoration" principle, who contaminated the property and whether the expenditures increase the property's value.

FOOTNOTES

- ¹ See generally 4 Harl, *Agricultural Law* § 28.05[21][d] (2000); Harl, *Agricultural Law Manual* § 4.03[3][a] (2000). See also Harl, "Handling Environmental Cleanup Costs," 5 *Agric. L. Dig.* 113 (1994).
- ² See *United Dairy Farmers, Inc. v. United States*, 107 F. Supp.2d 937 (S.D. Ohio 2000).
- ³ *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79 (1992).
- ⁴ See *Wells Fargo & Co. and Subs. v. Comm'r*, 2000-2 U.S. Tax Cas. (CCH) ¶ 50,697 (8th Cir. 2000).
- ⁵ 503 U.S. 79 (1992).
- ⁶ E.g., *Ltr. Rul. 9240004*, June 29, 1992.
- ⁷ *Id.*
- ⁸ *Ltr. Rul. 9240004*, June 29, 1992; *Ltr. Rul. 9411002*, Nov. 19, 1993.
- ⁹ *Ltr. Rul. 9315004*, Dec. 17, 1992.
- ¹⁰ *Ltr. Rul. 9411002*, Nov. 19, 1993.
- ¹¹ *Ltr. Rul. 9315004*, Dec. 12, 1992.
- ¹² 1994-1 C.B. 35.
- ¹³ *Id.*
- ¹⁴ *Id.*
- ¹⁵ *Id.*
- ¹⁶ *United Dairy Farmers, Inc. v. United States*, 107 F. Supp.2d 937 (S.D. Ohio 2000).
- ¹⁷ *Id.*
- ¹⁸ 1994-1 C.B. 35.
- ¹⁹ *Id.*
- ²⁰ *United Dairy Farmers, Inc. v. United States*, 107 F. Supp.2d 937 (S.D. Ohio 2000).
- ²¹ September 27, 1995.
- ²² *Id.*
- ²³ *Ltr. Rul. 9627002*, Jan. 17, 1996.
- ²⁴ 107 F. Supp.2d 937 (S.D. Ohio 2000).
- ²⁵ September 27, 1995.
- ²⁶ See *United Dairy Farmers, Inc. v. United States*, 107 F. Supp.2d 937 (S.D. Ohio 2000).
- ²⁷ *Id.*
- ²⁸ 2000-2 U.S. Tax Cas. (CCH) § 50,697 (8th Cir. 2000).
- ²⁹ *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79 (1992).
- ³⁰ *Wells Fargo & Co. and Subs. v. Comm'r*, 2000-2 U.S. Tax Cas. (CCH) ¶ 50,697 (8th Cir. 2000).

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