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FURTHER WAFFLING ON DEDUCTING ENVIRONMENTAL CLEANUP COSTS

— by Neil E. Harl*

Although it was generally believed for many years that environmental cleanup costs were currently deductible for federal income tax purposes,[1] the issuance of a series of private letter rulings beginning in 1992 confirmed that the Internal Revenue Service was convinced that *INDOPCO, Inc. v. Commissioner*[2] required that such expenditures be capitalized and amortized over some time period.[3]

In 1994, IRS issued Rev. Rul. 94-38[4] which many thought would resolve the contentious issue of deductibility of cleanup costs. That, however, proved not to be the case. A 1995 technical advice memorandum[5] confirmed that fact, setting off more controversy. Now, IRS has revoked the 1995 TAM,[6] leaving some uncertainty as to the IRS position.

The 1994 revenue ruling

In Rev. Rul. 94-38,[7] IRS indicated that costs incurred to clean up land contaminated by a business could be deducted as ordinary and necessary business expenses. In the facts of the ruling, soil remediation activities included excavating the contaminated soil, transporting the soil to a waste disposal facility and backfilling with uncontaminated soil. The ruling, in addition to allowing deductibility for soil remediation expenses, held that costs attributable to groundwater treatment facilities (wells, pipes, pumps and other equipment to extract, treat and monitor groundwater) were capital expenditures to be depreciated.[8]

IRS warned, informally, that Rev. Rul. 94-38[9] applied only to situations where the taxpayer was responsible for the pollution.

The 1995 TAM

The technical advice memorandum issued in 1995[10] confirmed that the informal IRS warning as to the scope of Rev. Rul. 94-38[11] should be taken seriously. In the facts of the 1995 ruling, a company had acquired uncontaminated farm land which was later used as a site for the disposal of industrial waste.[12] Later, a subsidiary of the firm acquiring the land contributed the land to the county for a recreational park and claimed a charitable deduction.[13] Some time later, the county discovered that the land was contaminated and conveyed the land back to the subsidiary for $1.

Eventually, the state environmental agency designated the land as a superfund site with remediation costs assessed to the subsidiary.

IRS declared that Rev. Rul. 94-38[14] did not apply inasmuch as the taxpayer (the subsidiary) acquired contaminated property. The TAM explained that Rev. Rul. 94-38[15] only applied if a taxpayer acquired clean property and then contaminated the property through business operations.

The policy implications from the TAM were somewhat unusual if not perverse: a taxpayer acquiring clean property who contaminates it is entitled to a deduction; those who acquire contaminated property and clean it up are denied a deduction.

The 1996 TAM

The latest IRS pronouncement, in the form of another technical advice memorandum,[16] revoked the 1995 TAM[17] and allowed deductibility of consulting fees, legal expenses and environmental impact study costs. No actual work on site remediation had been done.

The TAM reached that conclusion by holding that "the interim break in ownership should not, in and of itself, operate to disallow a deduction under the general principles of section 162 of the Code."[18] Thus, the subsidiary was treated as though the land were still owned by the parent company. That is hardly earthshaking in light of (1) the obviously close relationship between subsidiary and parent and (2) the "purchase price" of $1 paid by the subsidiary to reacquire the land from the county.

Conclusions

So where does all of this leave the issue of deductibility? That is not entirely clear but some tentative conclusions can be drawn -

• A basic premise of Rev. Rul. 94-38[19] that deductibility is allowed if the taxpayer acquires clean land and contaminates it seems to have survived the TAMs.

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• Those acquiring contaminated land and wanting to (or forced to) clean it up apparently must capitalize remediation costs.

• Transfers of ownership in less than arm's length transactions, particularly where the consideration is nominal, are unlikely to affect deductibility.

FOOTNOTES

1 I.R.C. § 162(a).
2 112 S. Ct. 1039, 1043 (1992).
3 Ltr. Rul. 9240004, June 29, 1992; Ltr. Rul. 9315004, Dec. 17, 1992; Ltr. Rul. 9411002, Nov. 19, 1993. See generally 4 Harl, *Agricultural Law* § 28.05[21][d] (1996). See also Harl, "Environmental Cleanup Costs," 4 *Agric. L. Dig.* 117 (1993); Harl, "Handling Environmental Cleanup Costs," 5 *Agric. L. Dig.* 113 (1994).
4 1994-1 C.B. 35.
5 Ltr. Rul. 9541005, Sept. 27, 1995.
6 Ltr. Rul. 9627002, Jan. 17, 1996.
7 1994-1 C.B. 35.
8 *Id.*
9 1994-1 C.B. 35.
10 Ltr. Rul. 9541005, Sept. 27, 1995.
11 1994-1 C.B. 35.
12 *Id.*
13 *Id.*
14 1994-1 C.B. 35.
15 *Id.*
16 Ltr. Rul. 9627002, Jan. 17, 1996.
17 Ltr. Rul. 9541005, Sept. 27, 1995.
18 *Id.*
19 1994-1 C.B. 35.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-*ALM* § 13.03.*

CLAIMS. The debtor had granted to a lender a security interest in a tractor truck used in the debtor's business. The debtor filed for Chapter 13 and the plan provided for the debtor's retention of the truck for use in the business and for payment of the loan secured by the truck in the amount equal to the wholesale value of the truck on the date of the petition, using the cramdown provision of Section 1325(a)(5)(B). The lender argued that, under Section 506(a), the secured amount of the claim was equal to the replacement value of the truck at its full retail value. The debtor presented credible expert testimony as to the wholesale value of the truck and the lender provided weak expert testimony as to the retail value of the truck. The Court held that the amount of the secured portion of the claim was limited to the wholesale value of the truck as determined by the debtor's expert testimony. **Matter of Rash, 90 F.3d 1036 (5th Cir. 1996)**.

FEDERAL TAXATION-*ALM* § 13.03[7].*

AUTOMATIC STAY. The IRS filed a claim for unpaid income taxes, penalties and interest and unpaid employment taxes, penalties and interest. Prior to the filing for bankruptcy, the IRS had filed a notice of levy against the debtors' real property which was subject to an Illinois land trust. The notice was not filed with the trustee. After the bankruptcy filing, the IRS erroneously filed a duplicate notice of levy and sent the debtors a notice of audit of employment taxes for pre-bankruptcy tax years. The IRS later rescinded the duplicate notice of levy. The debtors first argued that the duplicate levy notice and audit notice violated the automatic stay, but the court held that the rescission of the duplicate notice removed any violation and that an audit notice was not a violation of the automatic stay. The debtors also argued that the rescission of the duplicate notice caused the initial levy to be rescinded because the second notice merged with the first. The court held that this argument failed because the debtors failed to provide any support for the merger theory in statute or case law. The debtors also argued that the assessed penalties and interest should have been abated because the debtors' failure to pay the taxes resulted from the high medical bills for their disabled child. The court held that the debtors had sufficient means to either pay the taxes from income or by borrowing the money against their substantial equity in the debtors' home. **Carlson v. U.S., 198 B.R. 949 (N.D. Ill. 1996)**.

DISCHARGE. The IRS filed a claim for 1986, 1987 and 1988 taxes owed by the debtors. The taxes were due more than three years before the bankruptcy petition was filed. The 1986 and 1987 taxes were assessed more than 240 days before the petition but the 1988 taxes were assessed 151 days before the petition. The debtors received a discharge in the case but, after the discharge, the IRS continued to seek payment of the taxes through levies, even after letters from the debtors were sent reminding the IRS of the discharge. The IRS argued that the three year period should have been equitably waived by the court but did not provide any reason for the equitable waiver. The court held that the IRS's failure to seek the equitable waiver before violating the automatic stay of the discharge prohibited applying equitable principles to the IRS's claims. Therefore, the court ruled that the IRS could continue assessments and collection only as to the 1988 taxes which were not discharged. ***In re* Gilmore, 198 B.R. 686 (Bankr. E.D. Tex. 1996)**.

DISMISSAL. The debtor filed for Chapter 11 with primarily federal income tax debts as claims in the case. The court found that the debtor failed to file the Chapter 11 operating reports in contravention of court orders, filed incorrect and misleading information with the court, and failed to file and pay post-petition income taxes. The court held that the debtor's actions demonstrated bad faith sufficient to warrant dismissal of the case. **Matter of Whitehurst, 198 B.R. 981 (Bankr. N.D. Ala. 1996)**.