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WATER QUALITY CONTROL

- The U.S. Supreme Court has held that a minimum stream flow requirement is a permissible condition for state certification under Clean Water Act § 401 (p. 213)
- A Special Topics Column considers the conflicts between water rights and water quality (p. 216)

HAZARDOUS WASTE AND TOXIC SUBSTANCE CONTROL

- The U.S. Supreme Court has held that attorneys' fees are not recoverable as private party response costs under CERCLA (p. 222)

LAND USE AND ENVIRONMENTAL PLANNING

- The California Supreme Court has held that the Subdivision Map Act merger provisions preempt local zoning ordinances requiring merger (p. 227)

SOLID WASTE MANAGEMENT

- The U.S. Supreme Court has held that a local flow control ordinance discriminates against interstate commerce and therefore violates the Commerce Clause (p. 233)



Matthew Bender

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Books

Has the Insanity Stopped? IRS Partially Reverses Punitive Policy Denying Deductibility of Clean-up Costs — But Questions Remain

by Marilyn Barrett, Esq.*

The need for clean up of hazardous waste is painfully apparent and politicians in recent years have made this a priority of their public agenda. Former President Bush wanted to be known as the "environmental" president. President Clinton referenced the need for environmental protection in his 1994 State of the Union address. Despite the overwhelming support for policies to encourage clean up of hazardous waste, the Internal Revenue Service ("IRS") adopted a position that penalizes taxpayers who cleaned up hazardous waste by denying deduction of their clean-up costs for federal income tax purposes, and encourages taxpayers to contest their liability instead, a glaring example of the IRS's willingness to forsake critical social and health needs in order to maximize tax revenues.

Numerous protests were lodged by taxpayers and tax practitioners, and a working group of tax advisors from the U.S. Department of Treasury and Internal Revenue Service was formed to issue guidance as to when environmental clean-up costs will be deductible.¹ Finally, on June 2, 1994, the IRS issued Revenue Ruling 94-38,² which in part reverses its prior

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policy of nondeductibility when dealing with contaminated land and ground water. Unfortunately, many questions remain and it is unclear how far the IRS will extend this more favorable treatment.

Prior Rulings

The IRS's prior policy that prohibited deduction of clean-up costs was contained in two technical advice memoranda ("TAMs")³ and one private letter ruling ("PLR").⁴

In TAM 9315004 (issued December 17, 1992), the taxpayer cleaned up PCB contamination on its property by removing the contaminated soil and replacing it with clean soil pursuant to a settlement agreement with the Environmental Protection Agency ("EPA"). The taxpayer also paid for the initial investigation to determine potential hazardous waste contamination and paid considerable legal fees in litigation against the EPA, insurance carriers, and potentially liable third parties. The taxpayer deducted all of these costs for federal income tax purposes.

In TAM 9240004 (issued June 29, 1992), the taxpayer removed asbestos insulation from manufacturing equipment, replaced it with another, less effective substance, and deducted the costs of removal and replacement of the asbestos for federal income tax purposes.

The IRS ruled in both cases that the clean-up costs are not immediately deductible by the taxpayers. In TAM 9351004, it also ruled that the cost of investigating property for hazardous waste is deductible if the property is clean and requires no clean up, but is not deductible if the property contains hazardous waste and requires clean up. In addition, it ruled that costs incurred in litigation against the EPA, insurance carriers and potentially liable third parties are deductible in full. In other words, under the rationale of TAM 9351004, taxpayers who contest their liability for hazardous waste will benefit from deductibility of the associated litigation costs whereas taxpayers who simply undertake the required clean-up without contesting their liability will not be able to deduct their clean-up costs.

To support its conclusion that clean-up costs are not deductible, the IRS focused on tax law principles that distinguish between repairs, which are deductible under Section 162 of the Internal Revenue Code ("IRC"),⁵ and capital improvements, which are not deductible and must be capitalized under IRC §§ 263⁶ and 263A⁷ and depreciated over the recovery period for that type of asset. Generally, repairs are incurred to keep the property in an ordinarily efficient operating condition, whereas capital improvements materially add to the value of the property, prolong the useful life of the property, or make the property adaptable to new or different uses. In *Plainfield-Union Water Co. v. Comm'r* [(1962) 39 T.C. 333, nonacq., 1964-2 C.B. 8], the United States Tax Court held that to determine whether the value, use, or life expectancy of an asset has materially increased, the value of the property after the repair must be

compared to the value, use, and life expectancy of the property *before* the condition necessitating the repair.

In the TAMs described above, the IRS concluded that cleaning up hazardous waste increases the value of the taxpayer's entire property and business by (1) eliminating the safety and health risks of employees and third parties; (2) making the property more marketable and attractive to buyers, lenders, and investors; and (3) eliminating possible downtime that might occur and penalties that might be imposed due to environmental violations. The IRS compared the value of the improved property to the value immediately before clean up, apparently rejecting the *Plainfield-Union* test. In other words, the IRS compared the cleaned-up value of the property to its value after the contamination was generated but before it was cleaned up, and did not compare the cleaned-up value to the value of the property before the contamination was generated.⁸

The TAMs did not address whether clean-up costs could be amortized or depreciated or, if so, over what recovery period.⁹ If the costs improve real property or equipment, presumably the costs are added to the basis of such property and depreciated over the recovery period prescribed for that type of property.¹⁰ However, as the IRS in its TAMs seemed to attribute the increased value to the taxpayer's business, and not only to the property cleaned up, some practitioners believe that the IRS might assert that the taxpayer realizes an intangible, goodwill-type asset that, under new IRC § 197, must be amortized over 15 years.

The question of recovery period is partially answered in PLR 9411002 (issued November 19, 1993). In that ruling, the IRS reaffirmed its position that clean-up costs are generally nondeductible, and ruled that costs incurred by a taxpayer to remove asbestos-containing materials from the taxpayer's boiler house have to be capitalized. The IRS further ruled that the appropriate recovery period is that prescribed for nonresidential real property. The IRS allowed the taxpayer to currently deduct costs incurred to encapsulate asbestos-containing materials, concluding that such costs did not prolong the life or increase the value of the property, since encapsulation is only a temporary measure and the taxpayer will continue to have to monitor asbestos levels and re-encapsulate or remove insulation if the materials become worn or damaged. Since the asbestos had not been removed but only encapsulated, the adverse impact of asbestos on the taxpayer's business continues.

Impact of Prior Rulings

The IRS policy of prohibiting taxpayers from deducting hazardous waste clean-up costs is clearly antithetical to

President Clinton's official policy of encouraging such clean-up. While clean up of hazardous waste clearly adds value from a health, safety and quality-of-life perspective, the clean-up costs can be a severe and potentially ruinous financial burden to the owner of the contaminated property. The inability to deduct the costs for federal income tax purposes exacerbates that burden, and can increase the cost of clean up by California-based corporate taxpayers by as

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much as 41 percent¹¹ over what the cost will be if deduction is allowed. To add insult to injury, the IRS's paradoxical ruling that allows full deduction of litigation costs incurred in fighting liability for hazardous waste encourages taxpayers to litigate, rather than clean up. Not only is this bad social policy, but, under the Plainfield-Union doctrine, it is also wrong under prevalent tax law principles.¹² As stated earlier, to determine whether a repair increases the value of property and is a capital improvement, the Plainfield-Union doctrine provides that the value of property after a repair is compared to the value of the property before the condition necessitating the repair.

In the case of hazardous waste clean up, the *Plainfield-Union* doctrine should require comparison of the property's cleaned-up value to its value before the environmental hazard is generated, detected or known to be a hazard, i.e., before the condition necessitating the repair — in this case, before the contamination is generated, discovered, or otherwise determined to be hazardous.

For example, a taxpayer who purchased property 20 years before the dangers of hazardous waste were known, and before environmental laws were even contemplated, paid full value for the property without reduction for hazardous waste and potential clean-up costs. If that property is now determined to be contaminated, and the taxpayer incurs substantial clean-up costs, the clean up generally does not increase the property's value to that taxpayer or otherwise improve it beyond its market value before the contamination was known. To that specific taxpayer, removal of the hazardous waste serves primarily to preserve the value of the property. Without clean up, the taxpayer will likely suffer a substantial diminution in the property's value. In other words, instead of viewing the clean up of hazardous waste as adding value, as the IRS did in the TAMs, it could instead have viewed clean up as counteracting a reduction in value. A taxpayer who generates the contamination, but later cleans it up, should also be able to deduct the clean-up costs under this principle.

Moreover, the doctrine of capitalization of expenses derives from the pervading tax law principle of matching expenses with income generated from incurring such expenses. Costs incurred that will generate future income must be capitalized and depreciated or amortized over the period in which the related income is generated. *Newark Morning Ledger Co. v. U.S.* [(1993) 113 S. Ct. 1670]; *INDOPCO, Inc. v. Comm'r*, supra. Since income associated with hazardous waste generally has been realized prior to clean up of the waste, many commentators believe that clean-up costs are more properly matched with past revenues than with revenues to be generated in the future. This analysis

lends further support for current deduction of clean-up costs.¹³

The IRS's punitive policy disallowing deduction of clean-up costs resulted in a virtual storm of protest by taxpayers and tax practitioners. On February 14, 1994, fifteen members of the Senate Finance Committee and twenty-two members of the House Ways and Means Committee sent a letter to the Treasury Department asking for clarification of IRS and Treasury's policy on the tax treatment of environmental clean-up costs, the nature and timing of anticipated guidance, and recommendations as to whether legislation is needed.¹⁴

Revenue Ruling 94-38

The IRS partially reversed its policy of disallowing deduction of clean-up costs in Revenue Ruling 94-38, issued June 2, 1994. Revenue Ruling 94-38 considers whether costs incurred to clean up land and to treat groundwater that a taxpayer contaminates with hazardous waste from its business are deductible under IRC § 162 or subject to capitalization under IRC § 263. The specific facts assumed in the Revenue Ruling are as follows:

X, an accrual basis corporation, owns and operates a manufacturing plant. X built the plant on land that it purchased in 1970. The land was not contaminated by hazardous waste when X purchased it. X's manufacturing operations discharge hazardous waste and X has buried this waste on portions of its land.

In 1993, X decided to comply with applicable environmental laws and remediate the soil and groundwater that had been contaminated by the hazardous waste, and to establish an appropriate system for continued monitoring of the groundwater to ensure that all contamination has been removed. X began excavating the contaminated soil, transporting it to appropriate waste disposal facilities, and backfilling the excavated areas with uncontaminated soil. X also began constructing groundwater treatment facilities which included wells, pipes, pumps, and other equipment to extract, treat, and monitor contaminated groundwater.

The effect of the soil remediation and groundwater treatment will be to restore X's land to essentially the same physical condition that existed prior to the contamination. During and after the remediation and treatment, X will continue to use the land and operate the plant in the same manner as it did prior to clean up

except that X will dispose of any hazardous waste in compliance with environmental laws.

In direct contrast to the TAMs and PLR discussed above, in Revenue Ruling 94-38 the IRS applied the *Plainfield-Union* doctrine, stating:

[T]he appropriate test for determining whether the expenditures increase the value of property is to compare the status of the asset after the expenditure with the status of that asset before the condition arose that necessitated the expenditure (*i.e.*, before the land was contaminated by X's hazardous waste). See *Plainfield-Union Water Co. v. Commissioner*....¹⁵

The IRS concludes that X's soil remediation expenditures and ongoing groundwater treatment expenditures do not produce permanent improvements to X's land within the scope of IRC § 263(a)(1) or otherwise provide significant future benefits. The IRS reasons that such costs do not result in improvements that increase the value of X's property because X has merely restored its soil and groundwater to their approximate condition before they were contaminated by X's manufacturing. Moreover, they do not prolong the useful life of the land, nor adapt the land to a new or different use. Further, since land is not a depreciable asset, the amounts expended to restore the land to its original condition are not subject to capitalization under IRC § 263(a)(2).

The IRS did conclude that the groundwater treatment facilities constructed by X have a useful life substantially beyond the taxable year and the costs of their construction must be capitalized, including not only direct construction costs but also a proper share of allocable indirect costs within the meaning of IRC § 263A. The costs are recoverable under applicable depreciation rules.

The IRS further states that the above results apply whether the taxpayer plans to continue its manufacturing operations that discharge the hazardous waste or to discontinue those manufacturing operations and hold the land in an idle state.

Uncertainties Remain

While Revenue Ruling 94-38 is a giant step towards encouraging clean up of hazardous waste, a number of questions remain. For example, the Treasury Department is apparently studying the issue of tax treatment of asbestos remediation and has not reached any final decisions on the proper tax treatment of associated costs. On June 8, 1994, a Treasury official warned that Revenue Ruling 94-38 does not apply to asbestos abatement, underground storage tank

removal, lead paint removal, or contaminated land purchased by a taxpayer.¹⁶ The Treasury Department stated earlier that it intended to issue a series of rulings providing guidance on deductibility of clean-up costs. However, upon issuance of Revenue Ruling 94-38, a Treasury official stated that the need for additional guidance is being reassessed.¹⁷

The IRS should issue additional guidance to clarify the tax treatment of clean-up costs in cases not directly covered by Revenue Ruling 94-38. Some of the questions that still need to be answered relate to:

- (1) Deductibility of clean-up costs relating to assets other than land. Revenue Ruling 94-38 specifically refers to the fact that land is not depreciable as one basis for its permitting deduction of soil remediation and ongoing groundwater treatment expenditures. It is not clear that the same tax treatment will be allowed where clean up involves a depreciable building or equipment.
- (2) Treatment of clean-up costs incurred by taxpayers who purchase property that was contaminated prior to purchase.¹⁸
- (3) Treatment of costs incurred by a taxpayer to clean up hazardous waste of an asset subsequent to the taxpayer's sale of that asset by the taxpayer where the taxpayer is still potentially liable for the clean-up; treatment of costs incurred by a parent corporation of a consolidated group to clean up a contaminated site after the group has disposed of the site by selling either the stock or assets of the subsidiary that owned the site.¹⁹

In addition, the IRS's more lenient posture towards deductibility of clean-up costs has not yet been extended to payments into "qualified settlement funds" established pursuant to court order. See IRC § 468B(g) and Treas. Reg. § 1.468B-3(c). "Qualified settlement funds" are generally established pursuant to a court order in multi-party cases for the purpose of settling claims against multiple defendants. Under Treas. Reg. § 1.468B-1(f)(2), payments to a qualified settlement fund in satisfaction of CERCLA²⁰ liabilities are deductible if, after such payment, the taxpayer's only remaining liability to the EPA is a remote, future obligation to provide services or property.²¹ This provision has been generally viewed as permitting potentially responsible parties ("PRPs") who cash out their liability by payment into the fund to deduct their payments in the year made, whereas working PRPs (parties that finance or conduct the actual remediation) are not able to deduct their share until the clean up is performed. IRS officials have stated, however, that the IRS may interpret this rule as permitting deduction only when a PRP directly settles its liability with the EPA, and