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ENVIRONMENTAL CLEANUP COSTS
— by Neil E. Harl*

In a Technical Advice Memorandum,¹ the Internal Revenue Service has ruled that the cleanup expenses associated with contaminated soil were not currently deductible as repairs.² Rather, the costs of testing, removing and replacing PCB contaminated land were capital expenditures.³

**Facts of the ruling**

In the facts of the ruling, a company for several years had dumped PCB-contaminated waste in pits on its property. Later, in an agreement with EPA, the company began to clean up the property by removing and replacing the contaminated soil. The company incurred sizeable costs for testing, removing and replacing the contaminated soil, oversight of the cleanup operations, environmental audits and a compliance manual and research expenses to determine an appropriate cleanup process.

The company claimed that most of the cleanup related expenses were currently deductible as repairs.⁴

**IRS analysis**

IRS stated in the ruling that for clean-up costs to be considered "repairs" and be deductible, it is necessary to look to the "nature of the work in relation to the taxpayer's operations, and not solely to the cost of the work performed."⁵ In looking at the "nature" of the work, IRS found the facts similar to those in *Wolfsen Land & Cattle Co.*, a 1979 Tax Court decision.⁶ In *Wolfsen*, the taxpayer cleaned irrigation ditches, which had a 50-year life, every 10 years rather than cleaning out the ditches annually. The court held that the cleaning process created an asset with an amortizable life of 10-years.

IRS in *Ltr. Rul. 9315004⁷* rejected the argument by the taxpayer that the expenses did not add to the value of the property and thus should be deductible. In *Plainfield-Union Water Co.*,⁸ the Tax Court determined that the test was whether the value of the property after the repair is materially greater than the property's value before the condition emerged necessitating the repair. The IRS, however, in the latest ruling said the "increase-in-value" test is only one of several factors to be considered.

Reasoning from *Wolfsen*, the IRS viewed the situation in the ruling as requiring extensive cleanup operations rather than annual maintenance. Moreover, the cleanup operation made the property more valuable. Thus, IRS concluded that the costs should be classified as capital expenditures.

IRS also determined that the costs related to assessing whether a property is contaminated are currently deductible if the investigation results in a finding that the site will not have to undergo rehabilitation as a consequence of the assessment. IRS also agreed that legal fees could be deducted currently to the extent incurred to defend the taxpayer's business or secure contractual rights. As IRS noted, "These costs did not contribute to or facilitate the environmental cleanup."⁹

Even though a substantial part of the cleanup expense had to be capitalized and involved land, IRS did not require the costs to be added to the income tax basis of the land. Rather, IRS held that the capitalized costs should be viewed as an addition to the costs of the non-land assets and could be depreciated or amortized. IRS did not specify the period over which the costs could be recovered as deductions.

**The asbestos ruling**

The IRS position in the latest ruling on environmental cleanup is not a surprise. Last year, in another ruling IRS held that asbestos removal costs would have to be capitalized rather than being deducted currently.¹⁰

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**FOOTNOTES**