8-5-1994

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HANDLING ENVIRONMENTAL CLEANUP COSTS

— by Neil E. Harl*

For several years, it was generally believed that environmental cleanup expenses were deductible for income tax purposes as an ordinary and necessary business expense. However, the issuance of three private letter rulings beginning in 1992 indicated that the Internal Revenue Service view was that such expenditures should be capitalized and amortized over some unspecified time period. Now, IRS has shifted its position in response to widespread criticism of the position taken in the private letter rulings and is willing to accept current deductibility of some environmental cleanup costs.

Private rulings

The position taken by IRS in the private letter rulings issued in 1992-1993 was that costs incurred as part of a general rehabilitation of property with respect to environmental contamination were not deductible but instead had to be amortized over some unspecified time period. The first of the three rulings involved the costs of removing and replacing asbestos insulation. The second ruling, with similar reasoning, focused on the costs of PCB cleanup. That ruling, interestingly enough, allowed current deductibility for the legal fees involved. The third ruling also related to asbestos and involved the costs of removing asbestos from a building converted to a garage and office space. The ruling states that the costs were depreciable over 31.5 years under the straight line method. That period (31.5 years) was then the time for depreciating nonresidential real property. Only straight line depreciation is allowed for that class of property. The same ruling allowed a deduction for the cost of encapsulating exposed and damaged asbestos-containing pipe insulation in a warehouse as an ordinary and necessary business expense. In the ruling, soil remediation activities included excavating the contaminated soil, transporting the soil to a waste disposal facility and backfilling with uncontaminated soil. The same ruling held that the costs attributable to groundwater treatment facilities (wells, pipes, pumps and other equipment to extract, treat and monitor contaminated groundwater) were capital expenditures.

Under the facts of Rev. Rul. 94-38, a corporation owned and operated a manufacturing plant the corporation had built on land acquired in 1970. At the time of purchase, the land apparently was not contaminated. The land became contaminated from hazardous waste (from manufacturing operations) that was buried on the tract of land. To comply with current environmental requirements, the corporation undertook a project to remediate the soil that had become contaminated. The corporation also decided to install a system of monitoring of the groundwater to ensure that all hazardous waste had been removed.

The ruling recites that the effect of the cleanup will be to restore the corporation's land to the same physical condition existing before the contamination occurred.

The ruling states that in determining whether current deduction or capitalization is the appropriate tax treatment for any particular expenditure, it is important to consider the extent to which the expenditure will produce "significant future benefits." IRS concluded that the soil cleanup expenditures and the ongoing groundwater treatment expenditures did not produce permanent improvements to the corporation's land. The corporation was merely restoring its soil and groundwater to their condition before contamination by manufacturing operations.

With respect to the groundwater treatment facilities, the ruling points out that the facilities have a useful life substantially beyond the tax year in which the facilities were constructed. Those capitalized costs would be recoverable "under applicable law," presumably by depreciation.

Possible legislation

Although Rev. Rul. 94-38 goes a long way toward clarifying the issue of environmental cleanup costs, Congress is working on legislation that would provide additional statutory guidance in the area.

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FOOTNOTES
1 I.R.C. § 162(a).
4 See n. 2 supra.
7 Id.
9 Id.
10 I.R.C. § 168(c)(1).
14 Id.
15 Id.
17 Id.
18 Id.

CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

ADVERSE USE. The plaintiff’s land was separated from the defendant’s land by a road but the plaintiff’s land actually extended several feet onto the defendant’s side of the road. The defendant had built a driveway across the disputed land to the road, maintained a shed on the disputed land, and grew crops on the disputed land as close as possible to the road. The plaintiff argued that the defendant’s use of the land was permissive; therefore, no adverse possession could occur. The court held that permission was not supported by the evidence because the plaintiffs never objected to the defendant’s predecessors in title use of the disputed land and the plaintiff had asked the defendant for permission to use the shed on the disputed land. The court held that the defendant’s construction of the driveway, mowing and growing of crops were sufficient use of the disputed land to support acquisition of the land by adverse possession. Sierens v. Frankenreider, 632 N.E.2d 1055 (Ill. Ct. App. 1994).

The plaintiff had cleared timber from the defendant’s property and filed suit to quiet title by adverse possession to the area where the trees were cut. The plaintiff claimed to have built a fence around the area, cleared the area, built a shed on the property, maintained a garden and constructed a pond. Expert witnesses, however, testified that aerial photographs did not indicate any activity on the disputed land until the timber cutting operation began. The court held that the trial court’s decision for the defendant was supported by the evidence. In addition, the trial court’s failure to award damages for the cut trees was also upheld because the defendant failed to show how many trees were cut. Phillips v. Fisher, 634 So.2d 1305 (La. Ct. App. 1994).

BANKRUPTCY

GENERAL-ALM § 13.03,*

DISCHARGE. The debtors operated a dairy farm and filed for Chapter 7. The debtors had leased cows and calves from the creditor and had entered into a purchase contract for cows and calves in which the creditor retained a security interest until the contract payments were made. The debtor/husband sold most of the leased and contract animals without the permission of the creditor and without remitting the proceeds to the creditor or making the lease or contract payments. The debtor/wife did not participate in the sale of the animals but was found to have participated in the dairy as a partner with the debtor/husband. The court held that the debtor/husband’s sale of the leased and contract animals was a willful and malicious injury of the creditor’s rights in the property; therefore, the creditor’s claim for the rent and contract price was nondischargeable under Section 523(a)(6). The claim was also held nondischargeable as to the debtor/wife because the wife was a partner in the business. In re Bullington, 167 B.R. 157 (Bankr. W.D. Mo. 1994).

EXEMPTIONS

CATTLE. The debtor dairy farmer claimed three bulls as exempt tools of the trade under Vt. Stat. § 2740(2). In denying the exemption, the Bankruptcy Court distinguished the Vermont exemption as much narrower than the exemption statutes involved in the cases which allowed such an exemption. The court also noted that an exemption for cattle was otherwise provided; thus, indicating that cattle were not intended by the legislature to be exempt as tools of the trade. The appellate court reversed, citing precedent from other circuits that farm animals can qualify as tools of the trade for farmers. The appellate court noted that other tools of the trade were also eligible for other specific exemptions, e.g., trucks were tools of a trade and eligible for the motor vehicle exemption. The court also noted that the value limitation on exempt tools of a trade would prevent abuse by debtors and limit the detrimental effect on creditors. In re Parrotte, 22 F.3d 472 (2d Cir. 1994), rev’g unrep. D. Ct. dec. aff’g, 143 B.R. 622 (Bankr. D. Vt. 1992).

LIFE INSURANCE. The debtor claimed an exemption for the proceeds of a life insurance policy in an access account established on the pre-petition death of the debtor’s spouse. The trustee argued that the exemption was available only as to unmatured policies and that once the proceeds were paid, the money no longer qualified as an insurance policy. The court held that the exemption covered the proceeds of the insurance policy access account established

*Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.