Deduct or Capitalize?
The Tax Impact of Environmental Remediation
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It's a taxpayer's constant dilemma. The question of whether an expense is properly deductible or should be capitalized – that is, added to the basis of some asset – has long confused and frustrated taxpayers and tax professionals. This issue has no formulaic answer and the exact same expense can receive totally different treatment depending on subtle contextual differences.

The Internal Revenue Service has just released Revenue Ruling 2004-18, which poses the following question: Are costs incurred to clean up land that a taxpayer contaminated with hazardous waste by the operation of his manufacturing plant deductible or includible in inventory costs?

The facts of the ruling are as follows: A taxpayer owns and operates a manufacturing plant that produces property that is considered “inventory” in the taxpayer's hands for tax purposes. The taxpayer's operations discharge hazardous waste. In order to comply with applicable federal, state, and local environmental requirements, the taxpayer incurs costs to remediate the soil and groundwater that had been contaminated by the hazardous waste. The soil remediation and groundwater treatment restores the taxpayer's land to essentially the same physical condition that existed prior to the contamination.

During and after the remediation and treatment, the taxpayer continues to use the land and operate the plant in the same manner as the taxpayer did prior to the cleanup except that the taxpayer disposes of any hazardous waste in compliance with environmental requirements. Are these costs deductible?

Internal Revenue Code
Section 263 of the Internal Revenue Code is designed to prevent a distortion of taxable income through a current deduction of expenditures relating to the production of income in future years. As interpreted by the courts, §263 requires capitalization of expenditures to the extent that they provide a future, rather than a current, benefit.

Section 263A of the Code determines which costs are deductible in situations where property is "produced."

In an earlier ruling, Revenue Ruling 94-38, the Service looked at whether costs incurred to clean up land and to treat groundwater that a taxpayer contaminated with hazardous waste were capital expenditures. The ruling held that such costs are not capital expenditures because they do not prolong the useful life of the land or adapt the land to a new or different use.

Therefore, these costs were held deductible by the taxpayer as business expenses under §162 of the code. Costs properly allocable to constructing groundwater treatment facilities, however, were capital expenditures under §263.

Revenue Ruling 2004-18 analyzed the 1994 ruling as follows:

The holding of Rev. Rul. 94-38 that the costs to construct a groundwater treatment facility must be capitalized under §§263(a) and 263A rather than deducted under §162 demonstrates the distinction between capital expenditures and costs that are more in the nature of repairs than capital improvements. As with other types of deductible business costs, such as labor costs, taxes, rent, and supplies, once repair costs are determined to be deductible under §162, a taxpayer with inventories must still apply the rules of §263A to determine whether the repair costs must be included in inventory. … In addition, if repair costs must be capitalized under §§263(a) and 263A to a depreciable asset, a taxpayer with inventories must still apply the rules of §263A to determine whether the depreciation expense must be included in inventory. …

In this situation, [the taxpayer] incurs environmental remediation costs to clean up land that was contaminated as part of the ordinary business operations of [the taxpayer's] manufacturing of inventory. … The costs are properly allocable to property produced by [the taxpayer] that is inventory in [the taxpayer's] hands under §1.263A-
Accordingly, [the taxpayer] must capitalize the otherwise deductible environmental remediation costs by including the costs in inventory costs.

In other words, §263 provides the basic set of rules to determine what may be deductible, but when a taxpayer is "producing" something (i.e., manufacturing inventory or, under the statutory definition, constructing a building) §263A requires that the costs of production be included in inventory costs or capitalized, even when they would otherwise be deductible.

Therefore, Revenue Ruling 2004-18 holds that the (otherwise deductible) expenses of environmental remediation were required to be included in the cost of the taxpayer's manufactured inventory.

Another Scenario

These issues commonly arise in traditional real estate settings as well. Change the facts slightly: The factory and environmental woes are the same, but the manufacturer rents rather than owns the real estate and his landlord is the one remediating the environmental problem. Although the same workmen come and dig up the hazardous material, the cost is now deductible because the landlord is not producing anything and, therefore, the cost (which is in the nature of a repair) can be deducted.

Change the facts again: The Landlord has not yet completed the factory that he will rent to the manufacturer; before construction is completed, he must eliminate environmentally hazardous material.

In this case, since he is "producing" the building, the environmental remediation cost (along with most other construction period costs, such as interest expense and real estate taxes) must be capitalized into the cost of the building. (The precise period during which these costs must be capitalized is the subject of detailed regulations under §263A.)

In recognition of the complex state of the law in this area, the Internal Revenue Service has recently issued Notice 2004-6, in which the IRS invites comments on issues relating to the determination of what is a repair and what is an improvement required to be capitalized.

This notice, which deals with myriad factual situations and poses questions with respect to a variety of legal issues, may be the subject of a future article.

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