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Law & Accounting

Some Remediation Costs Deductible

A recent Internal Revenue Service memorandum further clarifies that certain environmental remediation costs can be fully deducted in the year incurred.

Technical Advice Memorandum 199952075, issued Dec. 29, concludes that a taxpayer may deduct in the current tax year the costs of cleaning up environmental contamination occurring on its property during, but not prior to, its ownership of the property. Under the ruling, such costs need not be capitalized, even if they are incurred in the course of site preparation for new capital improvements. This decision has important tax saving implications for property owners considering the redevelopment of contaminated property, but who fear potentially high initial cleanup costs.

It should be recognized up front that TAMs, in contrast to IRS Revenue Rulings, have no binding precedential authority. As a practical matter, however, TAMs are widely and routinely relied on in taxpayer contests, since TAMs are strong evidence of IRS policy. In addition, TAMs provide valid authority for avoiding taxpayer penalties. Therefore, to the extent that TAMs address previously unresolved taxation issues, they can be highly significant.

The TAM at issue here focused on the distinction between Sections 162 and 263(a) of the Tax Code, as the distinction relates to environmental cleanup costs for business properties. Section 162 allows a current deduction for all ordinary and necessary expenses incurred during the taxable year in carrying on any trade or business. In turn, Section 1.162-4 of the Tax Regulations allows a deduction for the cost of incidental repairs that neither materially add to the value nor appreciably prolong the useful life of business real property.

Section 263(a) and the associated regulations require the capitalization of costs for permanent improvements made to increase the value of any property. The deductibility of these costs must be capitalized, or spread out, over the useful life of the improvements constructed, thus diminishing the present value of the deduction.

The TAM resolves the issue whether the IRS will treat soil cleanup costs incurred during site preparation for new construction as land repair costs, in which case they are fully deductible when incurred, or as part of building construction and land improvement costs, in which case they need to be capitalized. In its decision, the IRS split the taxpayer's cleanup costs between the two categories.

The IRS ruled that the fraction of costs attributable to contamination occurring after the taxpayer took title to its property was associated with restoring or repairing the property to its pre-ownership state. Accordingly, these costs were found to be deductible. This decision was in accordance with a prior IRS ruling, Revenue Ruling 94-38, which allows a current deduction for cleanup costs for business-related

property contamination.

In contrast, the IRS viewed the taxpayer's costs of cleaning up pre-ownership contamination as part of the improvement or betterment, and not the restoration, of its property. The IRS therefore required the taxpayer to capitalize this portion of its cleanup costs.

The IRS thus used the environmental condition of the property at the time the taxpayer took possession to determine the taxpayer's basis in the property. Costs for restoring the property to that basis were deductible, whereas incremental costs for improving the environmental condition of the property had to be capitalized.

This decision points out the importance of diligently determining the environmental condition of a property at the time of acquisition. Obviously such determinations are critical to defining potential future environmental liability. The TAM points out that the IRS also may define the extent to which site cleanup costs can be currently deducted. A property owner will only be able to deduct its costs for post-acquisition contamination cleanup only if it can reasonably differentiate the pre- and post-ownership condition of the property. Depending on the nature and expense of a site cleanup, the cost savings from a current deduction, as compared to a capitalization, may be substantial.

Perhaps more significant than the TAM's distinction between costs for pre- and post-acquisition contamination, is the IRS' statement that "we do not believe that Taxpayer's intent to build a new building on the site would change the tax treatment of cleanup costs to which Rev. Rul. 94-38 would otherwise apply." Remediation costs for post-acquisition contamination currently are deductible, notwithstanding the fact that the taxpayer is conducting the remediation in connection with the construction of a new building.

The IRS completely differentiated the taxpayer's soil cleanup efforts from its construction of capital improvements on the remediated property. The IRS stated that the taxpayer's cleanup costs, by themselves, were merely restorative and did not adapt the property for a new or different use. Therefore, they were deductible as land repair costs and did not have to be capitalized as part of the taxpayer's capital improvement costs. The IRS took the position that the taxpayer's cleanup costs related only to the restoration of the land, "an asset separate and apart from the new building."

In addition, the IRS found that the cleanup costs did not have to be capitalized as land preparation costs. Ordinarily, costs for general clearing, grading and excavating must be capitalized because such expenditures add to the value of land. However, the TAM indicates that if such activities are conducted for the purpose of removing or remediating contaminated soil, the associated costs are deductible (at least to the extent that such activities target post-ownership contamination).

The TAM provides a potentially strong financial incentive for current owners of contaminated properties to remediate and redevelop their land. The IRS' decision indicates that site cleanup will be viewed wholly independently of construction plans. Therefore, cleanup costs will be currently deductible, even if incurred as part of a process to build capital improvements.

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