199952075

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

AUG 28 1999

Index (UIL) No.: 162.38-00
CASE MIS No.: TAM-105979-99
cc: DOM:IT&A:BS

District Director

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Years Involved:

Date of Conference:

LEGEND:

State =

Address =

City =

State Agency =

Report =

A =

B =

C =

D =

E =

457

TAM-105979-99

F	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
Year 8	=
Year 9	=
Year 10	=
Month 1	=
Month 2	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=

Date 9 =

Date 10 =

Date 11 =

Date 12 =

Date 13 =

Date 14 =

Date 15 =

Date 16 =

Date 17 =

Date 18 =

Date 19 =

Date 20 =

x =

y =

z =

ISSUE:

Whether Taxpayer may currently deduct under § 162 of the Internal Revenue Code the costs of cleaning up environmental contamination on its property or whether such costs must be capitalized under §§ 263 and 263A.

CONCLUSION:

Taxpayer may currently deduct under § 162 the costs of cleaning up environmental contamination on its property to the extent that these costs are allocable to contamination that occurred during Taxpayer's ownership of the property. To the

extent Taxpayer's cleanup costs are allocable to contamination that occurred prior to Taxpayer's acquisition of the property, Taxpayer must capitalize those costs under § 263 and the applicable rules under § 263A.

FACTS:

Taxpayer is a public utility company engaged in the distribution and sale of gas and electricity in State. During the tax years at issue, Taxpayer owned land, buildings, and other facilities at Address in City (the "Site"). This property was the site of a manufactured gas plant and electrical power plant that were no longer in operation.

The use of manufactured gas for household and industrial purposes was common practice between 1889 and 1950. To manufacture gas, coal was heated to release volatile compounds that were used as energy sources. Along with the production of large volumes of gas, manufactured gas plants also yielded large quantities of by-products, including complex mixtures of tars, sludges, oils and other chemicals. During the time that these plants operated, the waste products were often disposed of on the plant site in unlined pits.

The manufactured gas plant ("the plant") at the Site originally was owned by A, which began operating the plant in year 1. Around year 2, the plant was purchased by B, which operated it in its gas and electric distribution business. In year 3, Taxpayer purchased the plant from B. Taxpayer operated the manufactured gas plant through year 4, when it switched over to supplying natural gas. Prior to the tax years at issue, Taxpayer used the plant for varying functions and for central storage. Because of the age and condition of the original buildings, Taxpayer intended to relocate many of the functions and decommission the buildings beginning sometime after Year 6.

In year 7, the United States Environmental Protection Agency ("EPA") issued Report, identifying several former manufactured gas plants, including Taxpayer's former plant at the Site. Consequently, in year 8, the EPA employed C to conduct site reconnaissance at the Site. C did not observe any contamination and concluded that the Site posed no immediate threat to the environment. However, C's report noted that circumstantial evidence suggested that coal tar and other wastes may have been deposited on the Site. On date 1, the EPA added the Site to the Comprehensive Response, Compensation, and Liability Information Systems ("CERCLIS") list. The CERCLIS list is used by the EPA to identify sites that may require future cleanup. The inclusion of a site on the CERCLIS list does not indicate that the site must be cleaned up, but indicates that the site must be further investigated. Before EPA did any further investigation at the Site, Taxpayer began its own investigation of possible environmental contamination.

In early year 8, Taxpayer contracted D to survey and audit all Taxpayer's plants, buildings, and offices to assist in developing a "conceptual model" to address Taxpayer's short and long-term facilities needs. On date 2, D presented a study to Taxpayer recommending that Taxpayer consolidate its widely-scattered building space into one multi-use facility. D suggested two alternative sites for the location of the proposed facility, one of which was the Site. D finalized and presented a corporate facilities plan to Taxpayer on date 3, which included detailed estimates of environmental cleanup costs and cost savings that would result from a decision to build on the Site. On date 4, Taxpayer entered an agreement with D to perform project services for the implementation of the corporate facilities plan. This agreement incorporated drawings for a new facility located at the Site.

Around the same time that Taxpayer initially contracted with D to develop a facilities plan, Taxpayer also was considering constructing a new propane air peak shaving plant. On date 5, Taxpayer executed contracts for the construction of a new propane air peak shaving plant at another site near City. As part of the construction of this plant, in month 1, year 8, Taxpayer moved existing propane tanks from the Site to the location of the new peak shaving plant. Taxpayer used heavy equipment to move these tanks from their concrete saddles onto transport vehicles. As a result of this work, the soil at the Site was disturbed and wood chips containing contaminant residues may have been brought to the ground surface.

In month 2, year 9, prior to the discovery of the contaminated wood chips, Taxpayer's legal department was asked to retain an environmental engineering consulting firm to evaluate the environmental conditions at Taxpayer's former manufactured gas plants, beginning with the Site. On date 6, Taxpayer contacted E, an environmental engineering consulting firm, to do a site investigation at the Site. Approximately date 7, E performed its preliminary investigation of possible environmental contamination at the Site. At the same time, Taxpayer asked E to conduct a geotechnical site investigation to evaluate the strength of soils for computation of bearing capacity for a possible new building on the Site. As a result of its preliminary investigation, E determined that a discharge of a regulated substance had occurred on Taxpayer's property in the vicinity of the Site. In accordance with State law, on date 8, Taxpayer contacted State Agency by telephone to report that a release of contaminated substances had occurred. Under State law, if a discharge of a regulated substance occurs, the responsible party is required to take corrective action.

Later that year, Taxpayer discovered additional contamination at the Site. Around date 9, personnel from Taxpayer's electric division removed the concrete saddles that were previously used to hold the relocated propane tanks and, as a result, brought additional coal tar residues to the Site's surface. On date 10, a contractor employed by another of Taxpayer's divisions removed equipment from the old power

plant and uncovered additional coal tar at the Site. A few months later, Taxpayer discovered the existence of an old coal tar pit on the north side of the Site and coal tar overflow area directly west of the Site.

During this period, Taxpayer continued to press forward with its corporate facilities plan. On date 11, Taxpayer submitted a variance application to City requesting permission to build an operations building at the Site. On date 12, Taxpayer formally executed a contract with D for architectural and engineering services with respect to a new operations building to be built on the Site. Demolition of the manufactured gas plant and power plant buildings began a few days later. In order to begin construction of the new operations building and in order to comply with State law, Taxpayer had to implement a plan to excavate and dispose of the regulated substances that had been found on the Site. State Agency allowed Taxpayer to address the contamination in different phases beginning with the removal of contaminated soils in the area under and immediately around the planned operations building. Accordingly, after several meetings between E, Taxpayer, and State Agency, Taxpayer submitted a site investigation report and conceptual response action plan for the area to be occupied by the new operations building. The purpose of this plan was to clean the portion of the Site where the operations building was to be built and render that part of the Site suitable for construction. On date 13, this plan was approved by State Agency.

On date 14, F, the remediation contractor, began preparing the Site for the cleanup. On date 15, F began excavating and stockpiling soil, and treating water as necessary, in the footprint vicinity of the proposed operations building. By date 16, the first phase of the cleanup, addressing the coal tar materials within x feet of the building footprint, was completed. On date 17, E, on behalf of Taxpayer, submitted to State Agency a copy of the remedial action plan for the second phase of the Site cleanup project. This second phase addressed the cleanup of contaminated substances located beyond the scope of phase one. This second phase included cleanup of the coal tar overflow area west of the Site. On date 18, the second phase of the cleanup was completed. On date 19, the cleanup was approved by the EPA.

During the cleanup operations, Taxpayer proceeded with the construction of the new operations building at the Site. Taxpayer began construction of the new operations building on approximately date 16, as soon as the first phase of the environmental cleanup plan was completed. The new operations building was completed on date 20.

For its year 9 and year 10 tax years, Taxpayer claimed a deduction of $y and $z, respectively, for environmental cleanup of the Site. These costs included amounts paid or incurred for site investigations and reports, preparation and implementation of remediation actions plans, site remediation, and amounts paid or incurred for

associated legal fees. The examining agent requested technical advice regarding whether Taxpayer's current deduction of these costs was appropriate or whether such costs should have been capitalized under §§ 263 and 263A.

LAW AND ANALYSIS

Section 162 allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 1.162-4 of the Income Tax Regulations allows a deduction for the cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its useful life, but keep it in an ordinarily efficient operating condition.

Section 263(a) provides that no deduction is allowed for any amount paid out for permanent improvements or betterments made to increase the value of any property or for any amount expended in restoring property or for making good the exhaustion thereof for which an allowance is or has been made.

Section 1.263(a)-1(b) provides that capital expenditures include amounts paid or incurred to (1) add to the value, or substantially prolong the useful life of property owned by the taxpayer, or (2) adapt property to a new or different use.

Section 1.263(a)-2(a) provides that capital expenditures include the costs of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

Section 263A generally requires that taxpayers producing real or tangible personal property must capitalize direct material costs, direct labor costs and the indirect costs properly allocable to property produced. Indirect costs are allocable to produced property if they directly benefit, or are incurred by reason of, the performance of production activities. Section 1.263A-1(e)(3)(i). These production activities include construction, building, installing, creating, developing, or improving property. Section 263A(g)(1); § 1.263A-2(a)(1)(i). A taxpayer need not actually perform the production activity to be viewed as producing property. A taxpayer will still be viewed as producing property if the property is actually produced for the taxpayer under a contract with the taxpayer. Section 263A(g)(2); § 1.263A-2(a)(1)(ii)(B).

Taxpayer takes the position that all the costs incurred in connection with the cleanup of the Site may be deducted as ordinary and necessary business expenses under § 162. More specifically, Taxpayer argues that its environmental cleanup costs may be deducted under § 1.162-4 as incidental repair costs which neither materially add to the value of its property nor appreciably prolong its useful life, but keep its

property in an ordinarily efficient operating condition. For further support, Taxpayer cites to Rev. Rul. 94-38, 1994-1 C.B. 35, in which the Service permitted a taxpayer to currently deduct under § 162 certain costs incurred for the environmental cleanup of property that the taxpayer had contaminated with hazardous wastes from its business.

In contrast, the examining agent takes the position that Taxpayer may not currently deduct its environmental cleanup costs under § 162. Rather, the examining agent contends that Taxpayer's environmental cleanup costs must be capitalized under §§ 263 and 263A. The agent reasons that, because Taxpayer's environmental cleanup costs were incurred in connection with the construction of a new building on the Site, these expenditures were incurred to adapt this property to a new or different use under § 1.263(a)-1(b). Accordingly, the agent contends that Rev. Rul. 94-38 would not apply to Taxpayer's situation. Alternatively, the agent argues that these costs must be characterized as part of the costs of constructing Taxpayer's new operations facility and must be capitalized under § 1.263(a)-2(a) as costs incurred for the construction of an asset with a useful life extending substantially beyond the taxable year. As additional support, the agent cites to the plan of rehabilitation doctrine, which generally requires taxpayers to capitalize otherwise deductible repair costs if they are incurred pursuant to a general plan of rehabilitation, modernization, or improvement of the taxpayer's property. See, e.g., United States v. Wehrli, 400 F.2d 686 (10th Cir. 1968).

Based on the facts provided to us, we believe that Taxpayer may currently deduct the portion of its costs allocable to the cleanup of contamination that occurred during Taxpayer's ownership of the Site. We believe this portion of the overall cleanup cost is analogous to the expenses addressed in Rev. Rul. 94-38. In that ruling, the Service allowed a taxpayer to currently deduct the costs of cleaning up property that was contaminated by the taxpayer during its ownership of the property. Under the facts of the ruling, the taxpayer owned and operated a manufacturing plant on land it had purchased in an uncontaminated condition. During the course of its operations, the taxpayer buried hazardous wastes on its land. Later, to comply with federal, state, and local requirements, the taxpayer decided to remediate the soil and groundwater that had been contaminated by the buried hazardous waste. Accordingly, the taxpayer incurred costs for the excavation, transportation, and disposal of the contaminated soil, and for its replacement with clean soil. The taxpayer also incurred costs for treatment of groundwater and the construction of groundwater treatment facilities.

While Rev. Rul. 94-38 held that the taxpayer must capitalize the costs of constructing the groundwater treatment facilities under § 263, it also concluded that the taxpayer was permitted to currently deduct the costs of its soil and ongoing groundwater remediation as ordinary and necessary business expenses under § 162. The Service determined that the taxpayer's soil and groundwater remediation expenditures did not produce permanent improvements or betterments or otherwise

produce significant future benefits within the scope of § 263. Specifically, the revenue ruling cited Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333 (1962), non-acq. on other grounds, 1964-2 C.B. 8, for the proposition that the appropriate test for determining whether an expenditure increases the value of property is to compare the status of the property after the expenditure with the status of the property before the condition arose that necessitated the expenditure. Applying that test, the Service reasoned that the taxpayer's remediation activities merely restored the soil and groundwater to their approximate condition before they were contaminated by the taxpayer's manufacturing operations. Thus, the Service concluded that the remediation costs did not increase the value of the taxpayer's property. The Service also noted that these restoration activities did not prolong the useful life of the property or adapt the property to a new or different use. Accordingly, the taxpayer was not required to capitalize the costs of the soil and ongoing groundwater remediation under § 263.

In the present case, to the extent that Taxpayer's environmental cleanup costs are allocable to contamination that occurred during Taxpayer's ownership of the Site, the costs are similar to the remediation costs addressed in Rev. Rul. 94-38. Like the facts in Rev. Rul. 94-38, Taxpayer owned and operated the manufactured gas plant for an extended period of years and, during the course of these operations, discharged hazardous waste byproducts onto the Site. As in Rev. Rul. 94-38, the costs of cleaning up hazardous wastes discharged during this period did not increase the value of the Site or prolong its useful life as compared to the value or life of the Site before it was contaminated in Taxpayer's business operations. These costs merely restored the Site to the condition that existed at the time that Taxpayer acquired it. Therefore, under the analysis applied in Rev. Rul. 94-38, this portion of the remediation expenses does not appear to represent capital improvements.

The agent takes the position that Rev. Rul. 94-38 does not apply to a situation, like the present one, in which Taxpayer is cleaning up property upon which it intends to construct a new building. The agent notes that the facts of Rev. Rul. 94-38 specifically provide that the taxpayer would continue to use the land and operate the plant in the same manner as it did prior to the cleanup. Thus, the agent argues that Taxpayer's situation is not analogous to the situation addressed in Rev. Rul. 94-38. Rather, in Taxpayer's case, the cleanup enables Taxpayer to adapt the land to a new and different use.

While Rev. Rul. 94-38 does anticipate that the taxpayer will continue to use the property in the same manner that it did prior to the cleanup, 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. Specifically, these cleanup costs, by themselves, do not adapt the Site to a new or different use. As discussed above, to the extent Taxpayer's environmental cleanup costs are allocable to

116

contamination that occurred during Taxpayer's ownership and operation of the plant property, these costs merely restore the Site to the condition that existed at the time the Taxpayer acquired the property. Because these remediation costs merely are restorative in nature, they do not adapt the property to a new or different use.

For the same reasons, we also find that these cleanup costs need not be capitalized as land preparation costs. Courts and the Service have required taxpayers to capitalize the costs of general clearing, grading, filling, and excavating land, because such expenditures improve and add value to the land. See Coors v. Commissioner, 60 T.C. 368 (1973), acq. 1974-2 C.B. 2 (costs of relocating street, moving landfill, and straightening portion of creek must be treated as capital expenditures for the improvement of land); Huber v. Commissioner, T.C. Memo. 1984-593 (costs for land preparation and rockpiling must be treated as capital expenditures); Rev. Rul. 65-265, 1965-2 C.B. 52, clarified by Rev. Rul. 68-193, 1968-1 C.B. 79 (costs of grading and excavating land for general purposes are capital expenditures). In contrast, to the extent that Taxpayer's cleanup operations related to contamination that occurred during Taxpayer's ownership of the Site, these cleanup operations did not improve or substantially change the Site, but instead merely restored it to the condition that existed when Taxpayer acquired it. Rev. Rul. 94-38 supports the conclusion that this restoration did not improve or add value to the Site as land preparation activities would have, and as such need not be capitalized.

The agent also argues that, even if Taxpayer's environmental cleanup costs generally would be deductible under §162, they must be capitalized in this instance as part of a general plan of rehabilitation of Taxpayer's manufactured gas plant property. For support, the agent cites Norwest Corp. v. Commissioner, 108 T.C. 265 (1997), which she believes is analogous to Taxpayer's facts. In Norwest, the petitioner incurred costs to remove and replace asbestos insulation in the process of completely renovating its building. The petitioner was not required under applicable law to remove asbestos that remained in place. However, because the petitioner's extensive remodeling work would disturb the asbestos fireproofing in the building, the petitioner had no practical alternative but to remove the asbestos. Thus, the court determined that but for the remodeling project, the asbestos removal would not have occurred. The court also concluded that the removal and remodeling project were part of one intertwined project, entailing a full-blown general plan of rehabilitation linked by logistical and economic concerns. Accordingly, the court reasoned that the removal of asbestos was part of the preparations for remodeling the building. As a result, the court held that the costs of removing the asbestos materials must be capitalized, because they were part of a general plan of rehabilitation and renovation that improved the petitioner's building.

In Taxpayer's case, the cleanup of the Site also was necessary before the construction of the new operations building could begin. Nevertheless, we believe that Taxpayer's situation is distinguishable from Norwest and other cases in which the plan of rehabilitation doctrine has been applied. Unlike the asbestos removal costs in Norwest, which were directly related to the renovation of the building, Taxpayer's environmental cleanup costs were not directly related to the construction of the building. Rather, as discussed above, these costs relate to the restoration of the land, an asset separate and apart from the new building. In general, courts and the Service have been reluctant to apply the plan of rehabilitation doctrine to require capitalization of otherwise deductible expenses where they relate to an asset different from the asset that is being rehabilitated or improved. See, e.g., Moss v. Commissioner, 831 F.2d 833 (9th Cir. 1987) (the court refused to apply the plan of rehabilitation doctrine to the taxpayer's costs of repapering and repainting its hotel building where these repairs were performed pursuant to a renovation that involved the replacement of capital assets such as beds, chairs, tables, lamps, and carpets); Rev. Rul. 70-392, 1970-2 C.B. 33 (the Service held that the plan of rehabilitation doctrine did not apply to a utility's labor and transportation costs for relocating existing capital assets even though such costs were incurred in conjunction with the installation of new assets intended to increase the utility's distribution voltage). In Moss, the court noted that, to its knowledge, the plan of rehabilitation doctrine has only been applied in cases involving substantial capital improvements and repairs to the same specific asset. Thus, because Taxpayer's environmental cleanup costs relate to the restoration of its land, these costs cannot be considered part of a plan of rehabilitation or improvements to its building.

Similarly, although the cleanup arguably was undertaken to permit or at least to facilitate construction of the new building, we do not believe the cleanup expenses in the present case represent a cost of the new building. Instead, even assuming arguendo that Taxpayer's cleanup is properly characterized as a land preparation activity, the costs would relate to and be includible in the basis of the land, not the new building, because the "land preparation" in the present case will not be retired, abandoned, or replaced contemporaneously with the building. See Everson v. United States, 108 F.3d 234, 236 (9th Cir. 1997); Algernon Blair, Inc. v. Commissioner, 29 T.C. 1205, 1221 (1958), acq., 1958-2 C.B. 4; Rev. Rul. 80-93, 1980-1 C.B. 50; Rev. Rul. 77-270, 1977-2 C.B. 79; Rev. Rul. 72-96, 1972-1 C.B. 67; Rev. Rul. 68-193,1968-1 C.B. 79, clarifying Rev. Rul. 65-265, 1965-2 C.B. 52. As previously discussed, however, the costs are not properly characterized as land preparation costs, and so need not be capitalized under § 263(a) or § 263A either as costs of the new building or as land preparation costs incurred in connection with the construction.

Moreover, to the extent that Taxpayer's costs were incurred to clean up contamination that occurred during Taxpayer's ownership of the Site, these costs are

not required to be capitalized under § 263A. Section 263A generally requires that taxpayers producing real or tangible personal property must capitalize direct material costs, direct labor costs, and the indirect costs properly allocable to the property produced. Indirect costs are allocable to produced property under § 263A if they directly benefit, or are incurred by reason of, the performance of production activities. Section 1.263A-1(e)(3)(i). The term "produce" includes construct, build, install, create, develop, or improve. Section 263A(g)(1); § 1.263-2(a)(1)(i). As discussed in the forgoing analysis, to the extent that Taxpayer's cleanup costs are allocable to contamination that occurred as a result of Taxpayer's operation of the property, they are not allocable to the production of real or tangible personal property under § 263A.

However, to the extent Taxpayer's cleanup costs are allocable to the remediation of contamination that was present when Taxpayer acquired the Site, that portion of the overall cost may not be deducted under § 162. Unlike the environmental cleanup addressed in Rev. Rul. 94-38, the cleanup of pre-existing contamination does more than restore the Site to the condition that existed at the time Taxpayer purchased it. Rather, these costs constitute an improvement or betterment to the Site compared to its condition when acquired. Accordingly, this portion of the overall cleanup cost must be capitalized under §§ 263 and 263A.

In conclusion, based on the above analysis, Taxpayer may currently deduct under § 162 the costs of cleaning up environmental contamination on the Site to the extent that these costs are allocable to contamination that occurred during Taxpayer's ownership of the Site. To the extent that Taxpayer's cleanup costs are allocable to contamination that occurred prior to Taxpayer's acquisition of the Site, Taxpayer must capitalize these cleanup costs under § 263 and the applicable rules under § 263A.

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.

- END -