

Part I

Section 162. -- Trade or Business Expenses

26 CFR 1.162-1: Business Expenses.

(Also Sections 263, 263A, 461; 1.263(a)-1; 1.263(a)-2)

REV. RUL. 94-38

ISSUE

Are the costs incurred to clean up land and to treat groundwater that a taxpayer contaminated with hazardous waste from its business deductible by the taxpayer as business expenses under section 162 of the Internal Revenue Code, or must they be capitalized under section 263?

FACTS

X, an accrual basis corporation, owns and operates a manufacturing plant. X built the plant on land that it had purchased in 1970. The land was not contaminated by hazardous waste when it was purchased by X. X's manufacturing operations discharge hazardous waste. In the past X buried this waste on portions of its land.

In 1993, in order to comply with presently applicable and reasonably anticipated federal, state, and local environmental requirements ("environmental requirements"), X decided to remediate the soil and groundwater that had been contaminated by the hazardous waste, and to establish an appropriate system for the continued monitoring of the groundwater to ensure that the remediation had removed all hazardous waste. Accordingly, X began excavating the contaminated soil, transporting it to appropriate waste disposal facilities, and backfilling the excavated areas with uncontaminated soil. These soil remediation activities started in 1993 and will be completed in 1995. X also began constructing groundwater treatment facilities which included wells, pipes, pumps, and other equipment to extract, treat, and monitor contaminated groundwater. Construction of these groundwater treatment facilities began in 1993, and the facilities will remain in operation on X's land until the year 2005. During this time, X will continue to monitor the groundwater to ensure that the soil remediation and groundwater treatment eliminate the hazardous waste to the extent necessary to bring X's land into compliance with environmental requirements.

The effect of the soil remediation and groundwater treatment will be to restore X's land to essentially the same physical condition that existed prior to the contamination. During and after the remediation and treatment, X will continue to use the land and operate the plant in the same manner as it did prior to the cleanup except that X will dispose of any hazardous waste in compliance with environmental requirements.

LAW AND ANALYSIS

Section 162 generally allows a deduction for the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Even though a particular taxpayer may incur an expense only once in the lifetime of its business, the expense may qualify as ordinary and necessary if it is appropriate and helpful in carrying on that business, is commonly and frequently incurred in the type of business conducted by the taxpayer, and is not a capital expenditure. *Commissioner v. Tellier*, 383 U.S. 687 (1966); *Deputy v. du Pont*, 308 U.S. 488 (1940); *Weich v. Helvering*, 290 U.S. 111 (1933). Section 162 has been applied to allow business expense deductions for the costs of removing and disposing of waste materials produced in a taxpayer's business. See *H.G. Fenton Material Co. v. Commissioner*, 74 T.C. 584 (1980).

Section 263 generally prohibits deductions for capital expenditures. Section 263(a)(1) provides that no deduction shall be allowed for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property. Section 263(a)(2) provides that no deduction shall be allowed for any amount expended in restoring property or in making good the exhaustion thereof for which an allowance has been made in the form of a deduction for depreciation, amortization, or depletion. Section 1.263(a)-1(b) of the Income Tax Regulations provides that capital expenditures include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. Section 1.263(a)-2(a) provides that capital expenditures include the cost 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 provides that the direct costs and indirect costs properly allocable to real or tangible personal property produced by the taxpayer shall be capitalized. Section 263A(g)(1) provides that, for purposes of section 263A, the term produce includes construct, build, install, manufacture, develop, or improve.

Pursuant to section 461(h), in determining whether an amount has been incurred for any item during the taxable year for an accrual method taxpayer, the all events test shall not be treated as met any earlier than when economic performance occurs.

Through provisions such as section 162(a), section 263(a), and related sections, the Internal Revenue Code generally endeavors to match expenses with the revenues of the taxable period to which the expenses are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes. See, e.g., *INDOPCO, Inc. v. Commissioner*, ____ U.S. ____, 112 S. Ct. 1039, 1043 (1992); *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974). Moreover, as the Supreme Court has specifically recognized, the “decisive distinctions [between capital and ordinary expenditures] are those of degree and not of kind,” and a careful examination of the particular facts of each case is required. *Welch v. Helvering*, 290 U.S. at 114; *Deputy v. du Pont*, 308 U.S. at 496. 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. See *INDOPCO, Inc. v. Commissioner*, 112 S. Ct. at 1044-45.

The groundwater treatment facilities constructed by X have a useful life substantially beyond the taxable year in which they are constructed and, thus, the costs of their construction are capital expenditures under sections 263(a) and 1.263(a)-2(a). Moreover, because the construction of these facilities constitutes production within the meaning of section 263A(g)(1), X is required to capitalize under section 263A the direct costs and a proper share of allocable indirect costs of constructing these facilities. The costs of the groundwater treatment facilities are recoverable under applicable law (e.g., section 168).

Under these facts, X's soil remediation expenditures and ongoing groundwater treatment expenditures (i.e., the groundwater treatment expenditures other than the expenditures to construct the groundwater treatment facilities) do not produce permanent improvements to X's land within the scope of section 263(a)(1) or otherwise provide significant future benefits. Under the facts of this ruling, the appropriate test for determining whether the expenditures increase the value of property is to compare the status of the asset after the expenditure with the status of that asset before the condition arose that necessitated the expenditure (i.e., before the land was contaminated by X's hazardous waste). See *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333, 338 (1962), nonacq. on other grounds, 1964-2 C.B. 8. X's soil remediation and ongoing groundwater treatment expenditures do not result in improvements that increase the value of X's property because X has merely restored its soil and groundwater to their approximate condition before they were contaminated by X's manufacturing operations.

No other aspect of section 263 requires capitalization of X's ongoing soil remediation or ongoing groundwater treatment expenditures. These expenditures do not prolong the useful life of the land, nor do they adapt the land to a new or different use. Moreover, since the land is not subject to an allowance for depreciation, amortization, or depletion, the amounts expended to restore the land to its original condition are not subject to capitalization under section 263(a)(2). Accordingly, the expenses incurred by X for the soil remediation and ongoing groundwater treatment do not constitute capital expenditures under section 263.

The soil remediation and ongoing groundwater treatment expenditures incurred by X represent ordinary and necessary business expenses within the scope of section 162. They are appropriate and helpful in carrying on X's business and are commonly and frequently required in X's type of business. Therefore, the costs incurred by X to evaluate and remediate its soil and groundwater contamination (other than the costs of constructing the groundwater treatment facilities) constitute ordinary and necessary business expenses that are deductible under section 162.

HOLDING

Under the circumstances described above, costs incurred (within the meaning of the economic performance rules of section 461(h)) to clean up land and to treat groundwater that a taxpayer contaminated with hazardous waste from its business (other than the costs

attributable to the construction of groundwater treatment facilities) are deductible by the taxpayer as ordinary and necessary business expenses under section 162. Costs properly allocable to constructing the groundwater treatment facilities, as determined under section 263A and the regulations thereunder, are capital expenditures under section 263. These results are applicable whether the taxpayer plans to continue its manufacturing operations that discharge the hazardous waste or to discontinue those manufacturing operations and hold the land in an idle state.

EFFECT ON OTHER REVENUE RULINGS

Revenue Ruling 88-57, 1988-2 C.B. 36, is modified to the extent it implies that the value test applied by the Tax Court in *Plainfield-Union Water Co. v. Commissioner* cannot be an appropriate test in any case other than one in which there is sudden and unanticipated damage to an asset.

DRAFTING INFORMATION

The principal author of this revenue ruling is Merrill D. Feldstein of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Ms. Feldstein on (202) 622-4960 (not a toll free call).