Court Rules Pre-1997 Cleanup Costs Are Not Deductible Business Expenses

The U.S. Court of Appeals for the Sixth Circuit has affirmed a district court's decision that a dairy company could not deduct soil remediation costs as ordinary business expenses under 26 U.S.C. §162 of the Internal Revenue Code (the Code). The dairy company claimed that its soil remediation costs at two separate properties were ordinary and necessary business expenses allowing the continued use of the property, but the government claimed that the remediation resulted in permanent improvements that allowed a different use of the property and, therefore, must be capitalized under 26 U.S.C. §263(a) of the Code.

United Dairy Farmers, Inc. (UDF), an Ohio corporation, manufactures and distributes milk and ice cream products to its own convenience stores, and sells its products to over 1,000 wholesale accounts throughout a six-state area. In 1989, UDF purchased two stores, store #649 in Columbus, Ohio and store #140 in Cincinnati, Ohio, both which contained underground gasoline storage tanks left behind by former occupants. On both properties, the tanks had leaked, causing soil contamination. UDF, although aware of soil contamination at both sites, paid more for the sites than they were worth in their contaminated state.

In 1990, UDF spent $136,864 on soil remediation for the store #649 property. In 1991, UDF spent $123,698 on soil remediation for the store #140 property. Subsequently, in 1993 UDF took a $259,980 deduction pursuant to § 162 of the Code for the cleanup costs. On audit, the Internal Revenue Service (IRS) determined that these costs could not be deducted, and the district court affirmed this decision. UDF appealed.

At a trial hearing, UDF had the burden of proving, by a preponderance of the evidence, 1) that any assessments imposed by the IRS were arbitrary and erroneous, and 2) the amount of deduction to which it was entitled. Section 162(a) of the Code allows deduction of all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." However, under § 263(a)(1) of the Code, an expense cannot be deducted if it is capital in nature, meaning an expense "paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." So, if an expense were to fall under the language of § 263(a), that section would "trump" the deductibility provision of § 162(a), and the expense would have to be capitalized. Therefore, in order to be deductible, the expense must be both "ordinary and necessary" within the language of § 162(a) and fall *outside* the group of capital expenditures covered by § 263(a). Because the Code describes what should be capitalized generally, but enumerates allowable deductions specifically, "deductions are strictly construed and allowed only as there is a clear provision therefor."

UDF claimed that its soil remediation costs were deductible as ordinary and necessary business expenses under § 162. However, the government then responded that the expenditures resulted in permanent improvements to UDF's property and therefore must be capitalized under § 263.

The Fourth Circuit has recently addressed the issue of deductibility of environmental cleanup costs under § 162. In *Dominion Resources, Inc. v. United States,* the court considered whether environmental cleanup costs were simply repairs, and thus deductible under § 162, or permanent improvements, which must be capitalized under § 263. The Fourth Circuit's analysis relied on a test that focused on the nature of the improvement, rather than on the value added by the improvement. Under *Dominion Resources*, costs that simply restore value to property "that existed prior to deterioration or to a discrete event that damaged the property" are deductible as repairs under § 162, while costs that allow the property to be used "in a different way" must be capitalized under § 263.

To determine whether UDF's environmental cleanup costs allowed the property to be used “in a different way”, the court had to decide whether UDF’s property conditions should have been evaluated prior to contamination of the soil, as UDF claims it should have been, or after the contamination, as the government contends it should have been.

UDF, contended that property conditions should have been evaluated “prior to the condition necessitating the expenditure.” However, the district court declined to apply this analysis to the UDF issue because the district court considered this to apply only to “restoration cases,” in which a taxpayer acquires property in a clean condition, then contaminates it in the order of everyday business operations. In contrast, UDF purchased both properties *after* they had been contaminated. The Sixth Circuit agreed.

In addition, UDF offered no comparisons of its property use before and after the soil remediation was completed, and offered no arguments or testimony that its property use after the cleanup was unchanged, or, in other words, that its post-cleanup property use was not being used in a “new and different” way. Therefore, UDF failed to show that it had a right to the § 162 deduction.

Furthermore, the court found that the large environmental cleanup costs incurred by UDF, relative to the two properties’ value, make UDF’s claim of simply making incidental repairs to clean up the properties and keep them running efficiently seem suspect. In this case, UDF incurred nearly $260,000 in cleanup costs for the two properties that it actually purchased for only $765,000.

UDF made a last argument that it was entitled to deduct the remediation expenses as bad debt expenses, because the prior owners had a legal obligation to reimburse UDF for the expenses and did not. Because this issue was brought up for the first time on appeal, the court found the argument meritless.

Therefore, for the reasons stated above, the Sixth Circuit affirmed the district court's decision dismissing UDF's claims that they were due a readjustment by the IRS.

However, the lessons of this case may have limited practical application as a result of the enactment by Congress of the Federal Taxpayer Relief Act (TRA) in 1997 (the expenditures at issue by UDF were all incurred prior to 1997). Under the TRA, environmental cleanup costs for brownfield properties are fully deductible business expenses in the year in which the costs are incurred and do not have to be capitalized. These provisions apply to eligible costs incurred or paid from the date of enactment (August 5, 1997) of the TRA. Under the original provisions of the TRA, eligible property must have been located in "targeted areas" based on several factors including poverty level, zoning and population, among other factors. In 2000, Congress expanded the TRA and extended the sunset to January 1, 2004. As a result of the 2000 amendments, it is no longer necessary that an eligible property be within a "targeted area" as long as the "State Environmental Agency" confirms in writing that the property "is an area at or on which there has been a release (or threat of release) or disposal of a hazardous substance" and the site is not on, or proposed for, the Federal National Priorities List. A site that is contaminated solely from a petroleum release is also not eligible.

Clearly, prudent remediation project planning requires consideration of the potential deductibility of remediation costs and the deductibility may be a factor in committing funds to a remediation activity. Specific information about certification of eligible properties in Michigan can be obtained from Mr. James Linton of MDEQ at 517-373-9540 (lintonj@michigan.gov).

Consult your environmental counsel or tax advisor for more specific guidance on determining the deductibility of site specific costs.

United Dairy Farmers v. U.S.

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