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COMMENT

Revenue Ruling 94-38: The Uncertainty Continues — A Look at Using the Tax Code to Effectuate Environmental Remediation

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I. Introduction

Environmental remediation costs have a significant financial impact on both industry and government. It has been estimated that the costs of complete environmental remediation could run as high as one trillion dollars.[1] Furthermore, "the tax treatment of these costs may vary the total cost by more than a third."[2] Thus, the tax treatment of environmen-

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1. J. Andrew Hoerner, *Tax Treatment of Environmental Cleanup Costs: An Environmental View*, Tax Notes Today, Aug. 24, 1994, *available in* LEXIS, FEDTAX Library, 94 TNT 166-44.

2. *Id.*

tal clean-up costs will have a tremendous financial impact on both the taxpayer and the United States Treasury.

In an attempt to alleviate uncertainty surrounding the tax treatment of environmental remediation costs, the Internal Revenue Service (IRS) issued Revenue Ruling 94-38 on June 3, 1994.[3] However, since its issuance, there has been a question whether Revenue Ruling 94-38 was a step in the right direction with respect to the tax treatment of environmental clean-up costs, leaving behind the uncertainty created by Technical Advice Memoranda (TAMs)[4], also known as Private Letter Rulings, 92-40-004, 93-15-004, and 94-11-002. However, Revenue Ruling 94-38 did not accomplish this, so the question remains and the uncertainty lingers.

3. *See* Rev. Rul. 94-38, 1994-1 C.B. 35. Revenue Rulings are the Treasury Department's "answer to a specific question raised by the taxpayer concerning his tax liability. In the interest of a uniform application of the tax laws, they are published to provide precedents for use in the disposition of like cases. While they do not have the force and effect of regulations, they do at least reflect the current policies of the Internal Revenue Service." JAMES J. FREELAND, ET AL., FUNDAMENTALS OF FEDERAL INCOME TAXATION 26 (8th ed. 1994)[hereinafter FREELAND]. Furthermore, since Revenue Rulings are issued at a higher level in the IRS and are intended to resolve greater questions and to guide all IRS employees, more time is spent drafting a Revenue Ruling than a Technical Advice Memorandum (TAM). *Id.*at 26. Although the IRS has the power to retroactively revoke a Revenue Ruling, a Revenue Ruling that has not been revoked reflects the current policies of the IRS. *Id.* at 26.

Similar to Revenue Rulings, Treasury Regulations also help explain what a provision of the Internal Revenue Code (IRC) actually says. A Treasury Regulation, which is subordinate to the IRC, is a form of guidance that provides specific examples of the application of the IRC. *Id.*at 25-27. Treasury Regulations do not discuss environmental cleanup costs; instead, they focus on the distinction between repairs and replacements in explaining the difference between current deductions and capital expenditures. *See* Treas. Reg. § 1.162-4 (1994).

Although Treasury Regulations and Revenue Rulings are not statutory law, they both help explain the intent of the IRC and are likely to provide guidance as to how the IRS will decide a case involving a similar issue. Therefore, although Revenue Rulings and Treasury Regulations are not statutory law, they can have the effect of statutory law. FREELAND, *supra*, at 25-27.

4. A TAM is issued when an IRS Regional or District Office employee or a taxpayer asks the IRS National Office for advice on a tax question. This question relates to some ambiguity in the tax law. I.R.C. § 6110 (1994) (entitled "Public Inspection of Written Determinations"); *See also* FREELAND, *supra* note 3, at 26-27.

Revenue Ruling 94-38 specifically provides that environmental cleanup costs relating to soil and groundwater remediation can be currently deductible, rather than capitalized and depreciated over the life of the benefit provided by the expenditure.[5] Revenue Ruling 94-38 responded to taxpayer concerns regarding the treatment of environmental cleanup costs. However, Revenue Ruling 94-38 ignored concerns regarding the tax treatment of asbestos and pre-purchase pollution cleanup costs, and it created uncertainty as to the IRS's position in the case of depreciable property.[6] The IRS should clarify this matter by issuing Revenue Rulings which address asbestos abatement costs, pre-purchase pollution cleanup costs,[7] and set forth its position on the applicability of Revenue Ruling 94-38 to depreciable property.[8]

Although the IRS could issue TAMs to individual taxpayers who request guidance on a particular issue, the IRS may avoid the time and expense of such issuances by simply rendering another Revenue Ruling on the matter.[9] Revenue Rulings give guidance to all IRS employees, and are precedent

5. Rev. Rul. 94-38, 1994-1 C.B. 35.

6. *See infra* Section III, Revenue Ruling 94-38: What does it say and what does it accomplish?, for a discussion of the facts and reasoning of Revenue Ruling 94-38. Revenue Ruling 94-38 appears to address TAM 93-15-004. However, it does not address TAMs 92-40-002 and 94-11-002, which address asbestos abatement costs. This raises the question whether the IRS intends to apply the logic of Revenue Ruling 94-38 to other TAMs that deal with environmental cleanup costs, such as TAMs 92-40-002 and 94-11-002. Furthermore, in a recently issued TAM the IRS only partially addresses whether Revenue Ruling 94-38 also applies to pre-purchase pollution and this issue was addressed in a subsequent TAM. *See infra* notes 197 and 208.

7. The IRS recently issued TAM 95-41-005 that partially addresses this matter. *See infra* notes 197 and 208.

8. Congressional response would be the best course of action, if the desired result is contrary to existing law. But, if it is merely a matter of interpretation, the IRS can act because the IRS has been given power to enforce the IRC. The United States Supreme Court recognized this power in *Bob Jones University v. United States*, 461 U.S. 574 (1983). Thus, if the IRS makes their position known, it would be sufficient to resolve some concerns. Prior to Revenue Ruling 94-38, the IRS apparently restricted itself to issuing TAMs as evidenced by TAMs 92-40-004, 93-15-004, and 94-11-002.

9. TAMs are issued because there is uncertainty on the matter. *See supra* note 4. *See also* FREELAND, *supra* note 3, at 26-27. If the IRS removes this uncertainty by issuing some helpful, binding guidance, there is likely to be less of a need for the IRS to issue TAMs.

for all taxpayers, while TAMs are binding only on a specific taxpayer. Therefore, a Revenue Ruling that states the IRS's position is essential to clarify the law in this area.[10] Upon reaching this conclusion, it is essential to determine what the Revenue Ruling should contain. The Ruling's contents cannot be contrary to existing tax law because only Congress has the power to change the existing law.

This comment contains five sections. In Section II, this comment will consider statutory and administrative pronouncements on this issue. It will review Internal Revenue Code (IRC) §§ 162 and 263. Revenue Ruling 88-57[11] and TAMs 92-40-004,[12] 93-15-004,[13] and 94-11-002[14] will also be reviewed.

Section III considers Revenue Ruling 94-38, focusing primarily on what this Revenue Ruling accomplished. This section examines the facts that form the basis of Revenue Ruling 94-38. It also considers the IRS's reasoning in allowing environmental cleanup costs that relate to soil and groundwater remediation to be currently deductible, while providing that costs incurred to build a new groundwater treatment facility be capitalized.[15]

Section IV will critique the IRS's position in Revenue Ruling 94-38 as well as its position in prior TAMs. This section will consider (1) whether the IRS's position with respect to soil and groundwater remediation is correct; (2) whether

10. However, some believe that no immediate guidance is necessary because "the long-standing principles and authorities of existing [tax] law governing deductibility and capitalization of expenditures are adequate to deal with the area of environmental remediation." Frederick L. Webber, *CMA Urges Treasury To Reverse Course On Environmental Remediation Costs*, Tax Notes Today, May 5, 1994, *available in* LEXIS, FEDTAX Library, 94 TNT 105-23. According to some, it would be sufficient to suspend TAMs 92-40-004, 93-15-004, and 94-11-002 because the TAMs "distort these established rules and are being applied by IRS personnel . . . to require capitalization of expenditures that are clearly deductible under the regulations and numerous judicial decisions." *Id.*

11. Rev. Rul. 88-57, 1988-2 C.B. 36.

12. Tech. Adv. Mem. 92-40-004 (June 29, 1992).

13. Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992).

14. Tech. Adv. Mem. 94-11-002 (Nov. 19, 1993).

15. Rev. Rul. 94-38, 1994-1 C.B. 35.

Revenue Ruling 94-38 provides adequate guidance to the taxpayer; and (3) further questions raised by Revenue Ruling 94-38.

Section V concludes that the IRS must issue another Revenue Ruling that addresses the issues neglected by Revenue Ruling 94-38.

II. The Law Prior to Revenue Ruling 94-38: Environmental Cleanup Costs - Current Deductibility or Capitalization

Prior to Revenue Ruling 94-38, there was no specific guidance as to the tax treatment of environmental cleanup costs. Although the tax law clearly distinguished between currently deductible and capital expenses, it did not specifically mention environmental cleanup costs.[16] Thus, a taxpayer had to examine the nature of the expense to determine whether it was to be classified as a capital expense or a currently deductible expense.

This determination can have a tremendous impact on a taxpayer's tax liability. For example, if a taxpayer earns $10,000,000 in income in a given year and incurs $2,000,000 in environmental cleanup costs, current deductibility would mean that the taxpayer would pay taxes on only $8,000,000 of income. If the expenses were capitalized and depreciated over the useful life[17] of the benefit provided, ten years, for example, then only $200,000 would be deductible in the current year, meaning that taxes would be paid on $9,800,000 of income in the current year. Thus, in this example, the taxpayer would pay taxes on an additional $1,800,000 of income if the expenses were capitalized rather than currently deducted. Assuming a tax rate of 33%, this taxpayer would pay an additional $600,000 in taxes in the current year.

16. *See* I.R.C. § 162 (1994) (entitled "Trade or Business Expenses"); I.R.C. § 263 (1994) (entitled "Capital Expenditures"); Treas. Reg. § 1.162-4 (1994); Rev. Rul. 88-57, 1988-2 C.B. 36.

17. For purposes of this paper, I am assuming that an asset's useful life is equal to its class-life for purposes of depreciation. Furthermore, for ease of illustration, I am assuming that depreciation is equal in each year.

Furthermore, since one dollar today is worth more than one dollar tomorrow, additional savings exist.[18] If a taxpayer is able to save one dollar today, he saves more than if he would save one dollar tomorrow.[19] This is because a current dollar can be invested and earn income.[20] Consider, for example, that the interest rate is five percent per year. In that case, one dollar today would be worth $1.05 next year. Therefore, since money can be invested and earn interest it is evident that most taxpayers would prefer current deductibility to reduce their tax burden immediately and to take advantage of the time value of money.[21]

However, before a taxpayer can treat environmental costs as currently deductible, the taxpayer must research the applicable tax law. The tax law may come in many forms. The IRS issues Revenue Rulings, Technical Advice Memoranda, and Treasury Regulations, while Congress promulgates the Internal Revenue Code.[22]

A. The Internal Revenue Code

Presently, the tax law does not favor the taxpayer. Current deductions are a matter of legislative grace, and thus the taxpayer must prove that he is entitled to a current deduc-

18. This concept is known as the time value of money. DAVID S. KIDWELL AND RICHARD L. PETERSON, FINANCIAL INSTITUTIONS, MARKETS, AND MONEY 46-49 (4th ed. 1990). *See also* HERBERT B. MAYO, FINANCE: AN INTRODUCTION 173 (3d ed. 1989).

19. KIDWELL AND PETERSON, *supra* note 18. *See also* MAYO, *supra* note 18.

20. MAYO, *supra* note 18, at 172.

21. Some taxpayers, however, may prefer to capitalize these expenses and depreciate them over the useful life of the benefit provided if they do not have enough income to offset the deduction and expect to incur losses in the future to the extent that the 3 year carryback and 15 year carryforward provisions for losses would not be helpful. *See* I.R.C. § 172(b) (1994) (entitled "Net Operating Loss Carrybacks and Carryovers"). In that case, the taxpayers would prefer to prorate the deduction over a period of years. For example, if a taxpayer earns $1,000,000 in income, but incurs $3,000,000 in environmental cleanup expenses, the taxpayer may prefer to prorate these expenses over a period of at least three years in order to take full advantage of the deduction for these expenses.

22. *See* FREELAND, *supra* note 3, at 21-27.

tion.[23] To determine deductibility, a taxpayer must look to the tax law.[24] After distinguishing between currently deductible expenses and capital expenses, and examining the nature of most environmental cleanup costs, these costs must be classified as either a currently deductible or capital expense. The overall statutory basis for this classification scheme is found within the Internal Revenue Code.

The IRC is statutory law which expresses congressional intent in the area of tax law. Revenue Rulings, Treasury Regulations, and TAMs, which the IRS issues under a grant of authority from Congress, merely explain how the IRS enforces the law.[25] Therefore, an analysis of the distinctions between currently deductible expenses and capital expenditures must begin with the Internal Revenue Code.

The IRC explains the distinctions between currently deductible expenses, Section 162 of the IRC, and capital expenditures, Section 263 of the IRC.[26] Section 162 defines a currently deductible expense[27] as an "ordinary[28] and neces-

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23. FREELAND, *supra* note 3, at 338, *citing* First National Bank and Trust Co. v. United States, 115 F.2d 194 (5th Cir. 1940).

24. The IRC is the major source of this law. Treasury Regulations help to explain this law by providing specific examples. Revenue Rulings provide guidance as to how the IRS is likely to view a particular matter. TAMs do not have a binding effect, but do provide technical advice on a particular matter to a particular taxpayer. *See generally* FREELAND, *supra* note 3.

25. *See supra* notes 4 and 9.

26. *See* I.R.C. § 162 (1994); I.R.C. § 263 (1994).

27. These expenses include:

> (1) a reasonable allowance for salaries or other compensation for personal services actually rendered; (2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

I.R.C. § 162(a) (1994).

28. An ordinary expense is one that is "commonly and frequently incurred" in the taxpayer's line of business. *See* Rev. Rul. 94-38, 1994-1 C.B. 35. The term "ordinary"

> does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. [For example,] [a] lawsuit affecting the safety of a business may happen

sary[29] expense" incurred "in carrying on any trade or business."[30]

A capital expenditure, however, is not deductible.[31] As a general rule, the IRC allows no deduction for the purchase of new buildings, permanent improvements, or "betterments to increase the value of any property or estate."[32] This general rule is inapplicable, however, to the situations provided in IRC §§ 263(a)(1)(A)-(E), (G).[33] In addition, the IRC does not allow deductions for restoring property to its ordinary use for

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> once in a lifetime .... None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack.

Welch v. Helvering, 290 U.S. 111, 114 (1933).

29. A necessary expense is one that is " 'appropriate and helpful for the development of [the taxpayer's] business.' " Indopco, Inc. v. Commissioner, 503 U.S. 79, 85 (1992) (quoting Welch, 290 U.S. at 113). *See also* Commissioner v. Tellier, 383 U.S. 687, 689 (1966) *cited in* Russell W. Sullivan, *The Deductibility of Environmental Cleanup Expenditures, Annual Meeting, ABA Environmental Taxes Committee*, Tax Notes Today, Aug. 12, 1994, *available in* LEXIS, FEDTAX Library, 94 TNT 158-44, Doc. 94-7526.

30. Such an expense is one that is incurred "in pursuit of" or "in connection with" a trade or business. Frank v. Commissioner, 20 T.C. 511, 513-14 (1953). The court in *Frank* held that:

> The word 'pursuit' in the statutory phrase 'in pursuit of a trade or business' is not used in the sense of 'searching for' or 'following after,' but in the sense of 'in connection with' or 'in the course of trade or business.' It presupposes an existing trade or business with which [the] petitioner is connected.

Id.

31. I.R.C. § 263 (1994).

32. I.R.C. § 263(a)(1) (1994).

33. These situations include:

> A) expenditures for the development of mines or deposits deductible under I.R.C. § 616;
> B) research and experimental expenditures deductible under I.R.C. § 174;
> C) soil and water conservation expenditures deductible under I.R.C. § 175;
> D) expenditures by farmers for fertilizer, etc., deductible under I.R.C. § 180;
> E) expenditures for removal of architectural and transportation barriers to the handicapped and elderly which the taxpayer elects to deduct under I.R.C. § 190; . . .
> G) expenditures for which a deduction is allowed under I.R.C. § 179.

I.R.C. § 263(a)(1)(A)-(E), (G) (1994).

which a deduction has previously been taken.[34] Thus, under the IRC, a capital expense, unlike a currently deductible expense, either increases the value or prolongs the life of the asset. Therefore, the question is not whether the expense is deductible, but rather *when* the expense is deductible, thereby reflecting the matching principle.[35]

The language of the IRC does not provide much guidance in determining whether environmental cleanup costs are currently deductible or capitalized. The language merely provides that any given cost is currently deductible if it is ordinary and necessary in carrying on a trade or business.[36] Furthermore, there is a presumption that costs are capitalized, unless grounds for current deductibility can be estab-

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34. I.R.C. § 263(a)(2) (1994).

35. The "matching principle," (also referred to as the "matching concept") an overriding principle in both accounting and taxation, seeks to match income with its related expense, in order to accurately reflect a taxpayer's financial position. LANNY G. CHASTEEN ET AL., INTERMEDIATE ACCOUNTING 51-52 (3d ed. 1989). Otherwise, income will not accurately reflect a taxpayer's financial position. Consider, for example, that a taxpayer purchases new machinery to be used in his business for $10,000 in a given year and that this machinery has a useful life of 10 years. Consider also that the machinery can generate $100,000 in income per year, and thus, it is expected to generate $1,000,000 over its useful life. If the taxpayer were to deduct the entire expense in the year that he purchased the property, he would have $90,000 in income related to that expense. In the next nine years, he would have $100,000 in income per year. Thus, there is a mismatching of income to expense over the ten year period.

To appropriately match income with its related expense in this case, the taxpayer should deduct the $10,000 expenditure over a 10 year period (the useful life of the asset). By doing so, the taxpayer will have income of $99,000 ($100,000-[10,000/10]) per year relating to that expense, thereby matching income and the related expense. If an expenditure is likely to create benefits beyond the year in which the expense was incurred, the matching principle suggests that the expense must be capitalized and depreciated over the life of the asset. If not, the expense must be fully deductible in the year in which it is incurred.

Although it is clear that expenses should be matched with the related income, it is not as clear when an expense can be currently deductible and when it must be capitalized and depreciated over the useful life of the benefit provided. Arguably, any given expenditure will have some future benefit, and thus, should be capitalized. For example, if a taxpayer spends $1,000 to clean the machinery that he purchased, this expense arguably adds value to the machinery and prolongs its life by preventing the machinery from deteriorating.

36. I.R.C. § 162(a) (1994).

lished.[37] Other than the language of IRC § 162 and the presumption of capitalization, no specific authority exists regarding the treatment of environmental cleanup costs. Thus, the taxpayer must look to Treasury Regulations, Revenue Rulings, TAMs and case law for further guidance on this matter.

B. The Treasury Regulations

Through the Treasury Regulations, the Treasury Department has attempted to provide guidance for distinguishing between a currently deductible and a capital expense by distinguishing between a repair[38] and a replacement. Treasury Regulation § 1.162-4 sets forth several repair criteria, which specify that:

> [T]he cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense, provided the cost of acquisition or production or the gain or loss basis of the taxpayer's plant, equipment, or other property, as the case may be, is not increased by the amount of such expenditures.[39]

The repair criteria established in Treasury Regulation § 1.162-4 "were illuminated and contrasted with capital expenditures in *Illinois Merchants Trust Company*."[40] In *Illinois Merchants Trust Co.*, the taxpayer owned a seven-story brick building, which rested on a foundation of floating wooden piles.[41] Water levels lowered unexpectedly, causing

37. Indopco, Inc. v. Commissioner, 503 U.S. 79 (1992).

38. "A repair is not a permanent cure, but rather a means of dealing with intermediate consequences." American Bemberg Corp. v. Commissioner, 10 T.C. 361, 377 (1948), *aff'd*, 177 F.2d 200 (6th Cir. 1948), *cited in* Tech. Adv. Mem. 94-11-002 (Nov. 19, 1993).

39. Treas. Reg. § 1.162-4 (1994).

40. United States v. Wehrli, 400 F.2d 686, 689 (10th Cir. 1968). At the time of *Illinois Merchants Trust Co.*, Treasury Regulation § 1.162-4 was referred to as Article 103 of Regulation 45. *See* Illinois Merchant Trust Co., 4 B.T.A. 103, 105-06 (1926).

41. *Illinois Merchants Trust Co.*, 4 B.T.A. at 104.

wooden piles to be exposed to the effects of air and other elements.[42] As a result of the dry rot to the warehouse's river-side wall, the entire building threatened to collapse.[43] In order to prevent the total loss and further damage to the building, the rotted piles were replaced with concrete supports from the water level to the floor of the building.[44] This work not only required the removal of a vast portion of the ground floor but also required the partially-collapsed wall to be shored and raised up.[45]

Since the expense was incurred due to a sudden, unexpected condition and was necessary to keep the river-side wall in a serviceable condition, which did not add value or prolong the life of the property, the United States Board of Tax Appeals characterized the expenditure as a repair.[46] A repair merely keeps the property in an operating condition over its probable useful life for the uses for which it was acquired,[47] while "[r]epairs in the nature of replacements . . . shall either be capitalized and depreciated in accordance with section 167[48] or charged against the depreciation reserve if such an account is kept."[49] By prolonging the life of the asset, future income streams are added. Therefore, the matching principle dictates capitalization.[50]

The Internal Revenue Code sets forth abstract principles but, unlike Treasury Regulations,[51] Revenue Rulings and TAMs, the IRC does not illustrate their application to specific

42. *Id.*

43. *Id.*

44. *Id.*

45. *Illinois Merchants Trust Co.*, 4 B.T.A. at 104.

46. *Id.* at 107.

47. Treas. Reg. § 1.162-4 (1994).

48. IRC § 167 states that a taxpayer is entitled to a deduction for reasonable "wear and tear," exhaustion, and obsolescence of the property's use in the taxpayer's trade or business or the property's use to produce income. I.R.C. § 167 (1994).

49. Treas. Reg. § 1.162-4 (1994).

50. *See supra* note 35 and accompanying text.

51. Treasury Regulations occasionally have examples which illustrate their application. For example, Treasury Regulation § 1.162-5 (expenses for education) gives examples, while Treasury Regulation § 1.162-4 (repairs) does not give examples.

factual cases. A taxpayer may find it easier to understand whether the tax law applies to his set of facts when the tax law is expressed in the form of a factual analysis. Clearly, the IRS must issue either a Revenue Ruling or a TAM to accomplish this goal. However, since a TAM, unlike a Revenue Ruling, applies only to a specific set of facts and a specific taxpayer, a Revenue Ruling is more likely to clarify the law in any given area.

C. Revenue Ruling 88-57[52]

Prior to Revenue Ruling 94-38, Revenue Ruling 88-57 was the most significant Revenue Ruling that dealt with distinctions between current deductions and capital expenses. Although Revenue Ruling 88-57 did not directly involve environmental cleanup costs, its three-pronged test provides a basis for determining how environmental cleanup costs might be treated.[53]

Under the facts of Revenue Ruling 88-57, the taxpayer, who was involved in the railroad business, established a program for major cyclical rehabilitation of freight cars. Under this program, the taxpayer, a corporation, attempted to restore its freight-train cars to an efficient operating condition, usually after eight to ten years of continuous use.[54] The rehabilitation was accomplished by essentially stripping a freight car to its frame and then either reconditioning or replacing the structural components.[55] Without rehabilitation, the service life of a car would be only twelve to fourteen years,[56] while after rehabilitation, the freight car had an additional useful life of twelve to fourteen years.[57] With repeated rehabilitation, the cars can usually have a total operating life in excess of thirty years.[58]

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52. Revenue Ruling 88-57 overruled Revenue Ruling 69-116, but was modified by Revenue Ruling 94-38. *See* Rev. Rul. 94-38, 1994-1 C.B. 35.

53. Rev. Rul. 88-57, 1988-2 C.B. 36.

54. *Id.*

55. *Id.*

56. *Id.*

57. Rev. Rul. 88-57, 1988-2 C.B. 36.

58. *Id.*

After applying the relevant statutory and case law to the facts of Revenue Ruling 88-57, the IRS concluded that "cyclical expenditures for major rehabilitations . . . are capital expenditures under section 263(a) of the [Internal Revenue] Code."[59] The law on which the IRS relied to determine if property rehabilitation expenditures should be capitalized can be stated in the form of three tests.[60] If any of these three tests are satisfied, the expenditure must be capitalized rather than classified as currently deductible.[61] Therefore, capitalization is required if "(1) the expenditure appreciably prolongs the useful life of the property; [*or*] (2) the expenditure materially adds to the value of the property; *or* (3) the expenditure is part of a general plan of rehabilitation, modernization, and improvement of the property."[62]

Under the facts of Revenue Ruling 88-57, the useful life of the asset was increased, since after the rehabilitation expenditures, the freight-train cars had a service life of an additional twelve to fourteen years, and could have an aggregate service life of more than thirty years with repeated rehabilitations.[63] In addition, by applying the logic set forth in *United States v. Wehrli*,[64] the IRS concluded that the major rehabilitation program, which involved restoring the freight-train cars to an efficient operating condition, qualified as a plan requiring capitalization.[65] Furthermore, the IRS determined that the asset's prior value is the asset's value *immediately before the expenditure* rather than the asset's value

59. *Id.*

60. *Id.*

61. Rev. Rul. 88-57, 1988-2 C.B. 36.

62. *Id.* (emphasis added).

63. *Id.*

64. Rev. Rul. 88-57, 1988-2 C.B. 37 (citing United States v. Wehrli, 400 F.2d 686, 688 (10th Cir. 1968)). In *Wehrli*, the United States Court of Appeals held that expenditures made pursuant to "a 'general plan' of rehabilitation, modernization, and improvement of the property, must be capitalized, even though, standing alone, the item may appropriately be classified as one of repair." 400 F.2d at 689. In addition, the court found a general plan of improvement because the facts and circumstances of the case, "including, but not limited to, the purpose, nature, extent, and value of the work done," demonstrated that there was a plan. 400 F.2d at 690.

65. Rev. Rul. 88-57, 1988-2 C.B. 36, 37.

before the condition necessitating the expenditure occurred, except where there is a sudden decline in value.[66] Therefore, by applying the IRS's analysis from Revenue Ruling 88-57, environmental cleanup costs are likely to be capitalized and depreciated over the useful life of the benefit provided by the expenditure, rather than classified as currently deductible.

D. Technical Advice Memorandums

Although Revenue Ruling 88-57 provided some guidance as to the distinction between a currently deductible and a capital expense, it did not specifically address environmental cleanup costs. As a result, both IRS employees and taxpayers were left with many questions, predominately whether and to what extent Revenue Ruling 88-57 applied to environmental cleanup costs.

The IRS issued several TAMs[67] in responding to specific taxpayer situations. Although a taxpayer has access to these TAMs, he should not expect the IRS to dictate similar treatment in a similar situation.[68] However, these TAMs provide some indication as to how the IRS may treat a similar issue in the future. Therefore, by examining these TAMs in con-

66. *Id.* By applying the approach suggested by the IRS, the value of the property is likely to increase thereby resulting in capitalization. Consider, for example, a piece of property that a taxpayer initially purchased for $1,000,000. As a result of the taxpayer's pollution-emitting activities, the property is now worth only $600,000. If a taxpayer incurred an expenditure to restore the property to its prior condition, it would increase the property's value since there would be fewer health risks involved and a lower risk that the Environmental Protection Agency (EPA) would impose sanctions under environmental protection statutes, such as the Comprehensive Environmental Response, Compensation, and Liability Act. Thus, according to the definition of a capital expense under IRC § 263, an environmental cleanup expense must be capitalized and depreciated over the life of the benefit provided.

However, if the IRS applied the second approach, then it is unlikely that the property's value would increase. This is because it is assumed that the expenditure incurred will increase the property's value to its value prior to the pollution or condition necessitating the expense.

67. *See* Tech. Adv. Mem. 92-40-004 (June 29, 1992); Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992); and Tech. Adv. Mem. 94-11-002 (Nov. 19, 1993). In issuing these TAMs, the IRS applied the distinctions between currently deductible expenses and capital expenses that were developed in both statutory and case law.

68. FREELAND, *supra* note 3, at 26.

junction with Revenue Ruling 88-57 and other relevant tax law, a taxpayer could determine whether and to what extent environmental cleanup costs were currently deductible prior to Revenue Ruling 94-38.

1. The Asbestos TAMs

One major environmental cleanup cost that taxpayers incur relates to asbestos cleanup.[69] Generally, taxpayers incur two types of asbestos cleanup costs: (1) costs incurred in removing asbestos and replacing it with new insulation materials and (2) costs incurred in encapsulating asbestos. TAMs

69. "In a typical assessment of . . . [asbestos abatement] costs, Stephen L. Schweich, an environmental industry analyst with the Baltimore investment bank Alex. Brown & Sons, estimates that government and commercial property owners could spend a breathtaking $100 billion over the next 25 years to attack asbestos." Louis S. Richman, *Why Throw Money At Asbestos? Building Owners And Taxpayers Could Spend $100 Billion Over The Next 25 Years To Scrape The Stuff Out Of Buildings. But The Cleanup Might Cost More Lives Than It Saves*, FORTUNE, June 6, 1988, at 155. Mr. Richman points out that the costs of removing asbestos will be staggering.

> At an average of $25 a square foot, removing asbestos from a single floor of a Manhattan office tower can run [as much as] $1 million. If the removal contractors have to work near areas where building occupants are present, the price can jump to twice or three times as much.

Id. at 162. Purchasers of property containing asbestos will pay less money for purchasing the property and, in effect, take over the asbestos abatement responsibilities. *Id.* at 166. "Mitsui Real Estate, the Japanese developer that bought the Exxon building [in 1987], for example, knocked $90 million off the asking price. Brokers estimate that the bill for cleaning up the 53-story tower will run $50 million." *Id.*

Mr. Richman believes that current policies not only impose huge costs to deal with these risks of asbestos, but also increase the risks for others. Louis S. Richman, *Why Throw Money At Asbestos? Building Owners And Taxpayers Could Spend $100 Billion Over The Next 25 Years To Scrape The Stuff Out Of Buildings. But The Cleanup Might Cost More Lives Than It Saves*, FORTUNE, June 6, 1988, at 155, 170. Mr. Richman advocates that the EPA and local authorities set "standards for safe asbestos removal, and rigorously enforce [those] standards." *Id.* at 170. He concludes by stating that since:

> asbestos is omnipresent, holding building owners legally responsible for dubious health risks they had no part in creating makes little sense. [He believes that] [t]he EPA and Congress could reduce the confusion they have created by matching their regulatory zeal to a hard-nosed appraisal of the problem and the burden on [the] national treasure required to solve it.

Id.

92-40-004 and 94-11-002 considered whether costs incurred to remove and replace asbestos insulation could be currently deductible, under IRC § 162, or whether these costs had to be capitalized under IRC § 263.[70] However, only TAM 94-11-002 considered whether the costs to encapsulate asbestos-containing materials were currently deductible or whether these costs had to be capitalized and depreciated over the useful life of the property.[71]

a. TAM 92-40-004—The First Asbestos TAM

The facts of TAM 92-40-004 indicate that prior to 1980, certain equipment used in manufacturing a product was insulated with asbestos-containing materials.[72] However, as the health risks posed by asbestos became better known, the amount of airborne asbestos allowed in the workplace was reduced and the taxpayer was required to monitor the level of airborne asbestos.[73]

The taxpayer responded to these state and federal requirements and protected the health and safety of its employees by implementing an asbestos abatement program, under which it removed the asbestos insulation from the equipment entirely and replaced it with different insulating materials.[74] In the alternative, the taxpayer could have implemented a program that involved "continuous monitoring and encapsulation in the event that asbestos fibers became disturbed in the course of ordinary repair or improvement in the vicinity."[75] Although the method selected was initially more expensive, the taxpayer believed that such a method would ultimately be more cost-effective.[76] In addition, although the new insulation was less thermally-efficient than asbestos, the taxpayer recognized that health and safety concerns were at

70. *See* Tech. Adv. Mem. 94-11-002 (Nov. 19, 1993); Tech. Adv. Mem. 92-40-004 (June 29, 1992).
71. *See* Tech. Adv. Mem. 94-11-002 (Nov. 19, 1993).
72. Tech. Adv. Mem. 92-40-004 (June 29, 1992).
73. *Id.*
74. *Id.*
75. *Id.*
76. Tech. Adv. Mem. 92-40-004 (June 29, 1992).

least as important as heating expenses.[77] "The taxpayer also note[d] that the total cost of removal, although significant, [was] minor in relation to the facilities overall repair and maintenance costs and in relation to the assessed value of the equipment for property tax purposes."[78]

After applying the law to these facts, the IRS concluded that asbestos removal costs were to be treated as capital expenditures. The IRS provided two reasons for this conclusion. First, since deductions are the exception, rather than the rule, the taxpayer had the burden of proving that the expenses for removing and replacing asbestos were incidental repairs and would not prolong the useful life of the asset.[79] "Whether an expenditure increases [the] value or prolongs the [useful] life of [the] property generally turns on the taxpayer's particular facts and circumstances."[80]

Second, the IRS rejected the taxpayer's position that the *Plainfield-Union Water Co. v. Commissioner*[81] test was applicable for determining whether there was an increase in the property's value for purposes of deductibility, and concluded that this test was inapplicable under the facts of TAM 92-40-004. In *Plainfield-Union*, the Tax Court held that for purposes of determining whether there was an increase in property value, the taxpayer must compare the property's value after the expenditure with the property's value prior to the condition necessitating the expenditure.[82] "The taxpayer reason[ed] that, if the *Plainfield-Union* test [was] applied to an asset containing asbestos, then the value of the asset following abatement must be compared with its value before asbestos was known to be a health hazard."[83] The taxpayer claimed that there was no increase in property value because

77. *Id.*

78. *Id.*

79. *Id.*

80. Tech. Adv. Mem. 92-40-004 (June 29, 1992).

81. 39 T.C. 333 (1962).

82. Tech. Adv. Mem. 92-40-004 (June 29, 1992) (citing Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333, 338 (1962)).

83. Tech. Adv. Mem. 92-40-004 (June 29, 1992).

the appraised value of its equipment was decreased by precisely the cost required to abate the asbestos.[84]

The IRS found the *Plainfield-Union* test inapplicable and provided several reasons for this conclusion. First, the IRS held that *Plainfield-Union* only applied "where [the] repairs [were] necessary because the property ha[d] progressively deteriorated."[85] In *Plainfield-Union*, the taxpayer was forced to replace the lining in its pipes with cement, after the original lining had progressively deteriorated.[86] Under the facts of TAM 92-40-004, however, the taxpayer removed asbestos because it posed a health hazard and was the most cost-effective way to comply with regulatory guidelines.[87] Thus, the fact pattern in TAM 92-40-004 was unlike that in *Plainfield-Union*.

Another reason for the inapplicability of the *Plainfield-Union* test was due to the impossibility of either valuing "the asset prior to the existence of asbestos, or, using the *Plainfield-Union* standard, prior to the condition necessitating the expenditure."[88] Since there was no way of determining the prior value of the property with which to compare the current value, it could not be determined whether the property's value increased.

An additional reason that the *Plainfield-Union* test was inapplicable to the facts of TAM 92-40-004 is that the increase in the property's value following asbestos abatement is based on subjective factors[89] that are incompatible with the objective measurement articulated in *Plainfield-Union*.[90] The IRS held that "where asbestos levels are regulated by state and federal authorities, asbestos removal significantly reduces or eliminates the possibility that the taxpayer would be forced to suspend operations because of excessive concen-

84. *Id.*
85. *Id.*
86. *Id.*
87. Tech. Adv. Mem. 92-40-004 (June 29, 1992).
88. *Id.*
89. For example, improved marketability or safer working conditions. *Id.*
90. *Id.* "Generally, property without asbestos is more attractive to potential buyers, investors, and lenders. In fact, the lending policies of several financial institutions favor, and sometimes require, asbestos removal." *Id.*

trations[,] [and thus,] the taxpayer's property is more valuable because it can continuously operate within the regulatory guidelines."[91]

Lastly, the IRS considered the United States Supreme Court's decision in *Indopco v. Commissioner*,[92] where:

> the Supreme Court provided some guidance for distinguishing between deductions and capital expenditures. The Court noted that, in determining whether an expenditure is capital in nature, an important consideration is whether the taxpayer realizes benefits beyond the year in which the expenditure is incurred.[93]

Under the facts of TAM 92-40-004, the IRS found that the asbestos removal costs created long-term future benefits, such as a reduced liability risk for owners and investors and safer working conditions, "that accrue beyond the year that they were incurred."[94] Thus, after concluding that the *Plainfield-Union* test was inapplicable, that complying with regulatory provisions increased the property's value, and that asbestos removal costs create long-term benefits, the IRS treated asbestos removal costs as capital expenditures in TAM 92-40-004.

b. TAM 94-11-002—The Second Asbestos TAM

Nearly two years after the IRS issued technical advice on asbestos-related cleanups in TAM 92-40-004, the IRS issued further technical advice in another asbestos-related case. Under the facts of TAM 94-11-002, a taxpaying corporation sought to sell rental space and related services.[95] A few years after the purchase of a particular facility, which contained a warehouse and a boiler house, the taxpayer sought to expand the facility.[96] However, to secure a loan for this purpose, the

91. Tech. Adv. Mem. 92-40-004 (June 29, 1992).
92. Indopco v. Commissioner, 503 U.S. 79 (1992).
93. Tech. Adv. Mem. 92-40-004 (June 29, 1992) (citing Indopco, Inc. v. Commissioner, 503 U.S. at 84-85).
94. Tech. Adv. Mem. 92-40-004 (June 29, 1992).
95. Tech. Adv. Mem. 94-11-002 (Nov. 19, 1993).
96. *Id.*

bank required the taxpayer to remove any materials that contained asbestos from the facility and to "abate the problem of exposed and damaged asbestos-containing pipe insulation."[97] Not only did the bank require the taxpayer to remove all asbestos-containing materials from its boiler house, but, it also required the taxpayer to abate the problem of exposed and asbestos-containing pipe insulation within the warehouse. With respect to the warehouse, the asbestos was encapsulated, but with respect to the boiler house, the asbestos was removed. After complying with these conditions, the taxpayer deducted all of its costs of asbestos abatement under IRC § 162.[98]

The IRS, however, concluded that only the costs incurred to encapsulate the asbestos were currently deductible, while the costs incurred to remove the asbestos and replace it with other materials were capital expenditures. The IRS reasoned that with respect to the asbestos removal costs, the facts of TAM 94-11-002 were unlike the situation in *Plainfield-Union*,[99] where the Tax Court held that the "costs incurred . . . to clean and replace the tar lining in a portion of its pipeline with a cement lining" did not increase the value of the property when compared with the value of the property "prior to the condition necessitating the expenditure."[100] Under the facts of TAM 94-11-002, the IRS held that "the costs incurred to remove asbestos increased the value, use, and capacity of the taxpayer's property as compared to the status of its property in its original asbestos-containing condition."[101]

The IRS reasoned that these expenditures not only permanently removed "the health risks posed by the presence of asbestos in the boiler house,"[102] but also increased the property's attractiveness to investors, customers, etc. Furthermore, "the expenditures enhanced the usefulness and

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97. *Id.*

98. *Id.*

99. *Plainfield-Union*, 39 T.C. at 338, *cited in* Tech. Adv. Mem. 94-11-002 (Nov. 19, 1993).

100. *Id.*

101. Tech. Adv. Mem. 94-11-002 (Nov. 19, 1993).

102. *Id.*

capacity of the . . . property by enabling the taxpayer to provide office space and a garage in the space made available by the elimination of the asbestos hazard."[103] Thus, unlike the costs in *Plainfield-Union*, the costs incurred for the removal of asbestos contained in the boiler house "did not return the property to the state that it was in before the condition necessitating the expenditures arose."[104]

The IRS reasoned that under the facts of TAM 94-11-002, the condition necessitating the expenditures arose when the property was acquired. The IRS concluded that the costs incurred to remove the materials that contained asbestos were capital expenditures because these expenditures added value to the property and adapted the property to a new and different use.[105] This is essentially the same holding as in TAM 92-40-004.

The encapsulation of the asbestos, however, did not add value to the property and did not adapt the property to a new use; it merely kept the property in its normal operating condition.[106] The IRS relied upon the Tax Court's decision in *Midland Empire Packing Co. v. Commissioner* where the Tax Court held that:

> [T]he addition of a concrete lining to walls in order to prevent seepage of oil into the petitioner's basement was a deductible repair expense. Specifically, the court concluded that the expenditure did not add to the value or prolong the useful life of the taxpayer's property over what it was before the oil began to seep into its basement. Moreover, the court found that the petitioner's plant did not operate on a changed or larger scale, nor was it suitable for additional uses. The expenditure merely served to keep the property in operating condition over its probable useful life for the purpose that it was intended.[107]

103. *Id.*

104. *Id.*

105. Tech. Adv. Mem. 94-11-002 (Nov. 19, 1993).

106. *Id.*

107. *Id. See* Midland Empire Packing Co. v. Commissioner, 14 T.C. 635, 641-42 (1950), *acq.*, 1950-2 C.B. 3.

Similarly, in TAM 94-11-002, the encapsulation costs "did not increase the value or prolong the useful life of the taxpayers [sic] property beyond what it was before the asbestos became damaged."[108] After also considering that the encapsulation was merely a temporary remedy, the IRS concluded that the costs of encapsulation satisfied the requirements of current deductibility. Thus, under the asbestos TAMs, the costs of encapsulation are currently deductible, while the costs of removing the asbestos and replacing it with new insulation material are capital expenses.

2. TAM 93-15-004—The Polychlorinated Biphenyl (PCB) TAM[109]

Another environmental problem taxpayers face is remediating PCB-contaminated soil and groundwater. In TAM 93-15-004, the IRS considered whether the costs to cleanup PCBs should be treated as currently deductible expenses or as capital expenditures.[110] Under the facts of this TAM, the Environmental Protection Agency (EPA) entered into an agreement with the taxpayer under which the taxpayer agreed to determine which sites were contaminated by PCBs in amounts that exceeded permissible levels. Environmental audits were also required to ensure compliance with this agreement. This TAM further states that:

> [U]nder the cleanup program, during these tax years and future years [the] taxpayer has incurred or anticipates incurring costs for the following: (1) soil contamination as-

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108. Tech. Adv. Mem. 94-11-002 (Nov. 19, 1993).

109. Polychlorinated biphenyls (PCB) belong to a group of synthetic organic compounds consisting of between one and ten chlorine atoms which are then attached to a biphenyl ring. PCBs are believed to be linked to skin disorders, liver dysfunction, reproductive disorders, and tumor formation. ENVIRONMENTAL ENCYCLOPEDIA, 645 (William P. Cunningham et al. eds. 1st ed. 1994).

110. TAM 93-15-004 also considered whether a taxpayer's legal fees with respect to claims made by the state and private third parties, and costs of litigation between a taxpayer and an insurance company, are currently deductible or capital expenses. Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992). This comment, however, only addresses the actual environmental cleanup costs, and not the legal fees associated with those costs.

> sessment, which involves testing to determine the level and location of PCB contamination at station sites and other sites; (2) groundwater contamination assessment; (3) remediation . . . ; (4) legal fees . . . ; (5) costs of oversight of the cleanup operations; (6) costs of environmental audits and [the] compliance manual required . . . ; and (7) research and development expenses for chemical remediation processes that might facilitate the remediation of PCBs.[111]

The IRS's analysis of the facts first involved determining whether the cleanup activities constitute incidental repairs within the meaning of Treasury Regulation § 1.162-4. In determining this, "courts look to the nature of the work in relation to the taxpayer's operations, and not solely to the cost of the work performed."[112] In addition, some courts have held that where the work performed on tangible assets in relation to the cost of the asset was costly, that work was a repair.[113] The IRS concluded that "although the cost of the cleanup program . . . [was] significant when compared to the taxpayer's overall capital investment, this factor alone [was] not dispositive of whether these amounts [were] deductible."[114]

The IRC requires "an inquiry into the duration and extent of the benefits realized by the taxpayer."[115] Courts have considered this reasoning in distinguishing between currently deductible and capital expenses.[116] The IRS concluded

111. Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992).

112. *Id.*

113. American Bemberg Corp. v. Commissioner, 10 T.C. 361 (1948), *aff'd*, 177 F.2d 200 (6th Cir. 1949), *cited in* Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992).

114. Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992).

115. *Id.*

116. *See, e.g.*, Mountain Fuel Supply Co. v. United States, 449 F.2d 816 (10th Cir. 1971); Wolfsen Land & Cattle Co. v. Commissioner, 72 T.C. 1 (1979). The court in *Mountain Fuel* required the taxpayer to capitalize "the cost of digging up, cutting, removing, hauling, straightening, cleaning, spotwelding corrosion pits, removal of defective sections, beveling, bending, reopening trenches, rewelding, relaying, testing and burying of all the old pipe returned to service." Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992) (citing Mountain Fuel Supply Co. v. United States, 449 F.2d 816 (10th Cir. 1971)). In *Wolfsen Land* the court held that "the costs of draglining ditches in an irrigation system on a farm to clear them of sediment and other materials that blocked the flow of water in the

that since the cleanup operations would benefit the rest of the asset's useful life, the expenditure should be capitalized.[117] However, the IRS recognized that:

> [T]here are some costs at issue that may not be attributable to the plan of rehabilitation, such as costs to assess [the] contamination of property that does not undergo rehabilitation as a result of the assessment. These costs may be deducted if it is determined that an assessed site will not undergo rehabilitation.[118]

Under TAM 93-15-004, the IRS determined that the *Plainfield-Union* increase in value test did not apply because the repair in *Plainfield-Union* was only a minor part of the taxpayer's business operations, while under the facts of TAM 93-15-004, the "cleanup program [was] a long-term systematic program that involve[d] systematically testing, assessing, remediating, removing and replacing extensive amounts of land."[119] The IRS recognized that although an expense may appear to be a repair, this expense will be considered a capital expense, if, when taken in conjunction with other expenses, the expense (cleanup costs) "will result in permanent betterments to [the] taxpayer's properties."[120]

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ditches" must be capitalized. Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992) (citing Wolfsen Land & Cattle Co. v. Commissioner, 72 T.C. 1 (1979)). In addition, the court held that characterizing environmental cleanup costs as a currently deductible expense or as a capital expenditure depends upon "an analysis of the work being performed, and not on whether [the] taxpayer was aware of the future consequences of its disposal practices." Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992).

117. Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992).

118. *Id.*

119. Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992) (citing Plainfield-Union Water Comp. v. Commissioner, 39 T.C. 333 (1962)).

120. Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992). TAM 93-15-004 states that:

> [Permanent] betterments include, but are not limited to, transforming sections of contaminated land into land that is no longer contaminated, avoiding further government penalties by bringing the properties into compliance with government regulations, providing a safe environment for workers and adjoining property owners, and increasing the marketability of the properties once the level of PCBs is brought within the safety range permitted under the environmental regulations.

Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992).

Therefore, TAM 93-15-004, similar to both TAMs 92-40-004 and 94-11-002, recognized that removing hazardous materials from a taxpayer's property will result in an overall increase in value. Although these expenditures may appear to be a repair, and thus, currently deductible, a taxpayer must consider whether these expenditures are actually part of an overall plan of improvement. If so, the costs must be capitalized. By following these guidelines[121] a taxpayer could determine how the IRS would likely treat environmental cleanup costs. However, the taxpaying public either did not agree with the IRS's treatment of environmental clean-up costs or found it to be ambiguous, as shown by the requests for guidance that led to the issuance of Revenue Ruling 94-38. Some of these concerns were addressed by Revenue Ruling 94-38.[122]

III. Revenue Ruling 94-38: What Does It Say and What Does It Accomplish?

The IRS, in Revenue Ruling 94-38, considered the treatment of soil and groundwater remediation costs previously addressed in TAM 93-15-004.[123] However, Revenue Ruling 94-38 did not address asbestos cleanup costs, cleanup costs related to pre-purchase pollution, or whether the Ruling was limited to nondepreciable property. Thus, even after Revenue Ruling 94-38, some concerns remain unaddressed.[124]

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121. These guidelines are the same as those set out in Revenue Ruling 88-57 and Treasury Regulation § 1.162-4. By applying these guidelines to most types of environmental cleanup costs, the IRS will likely treat these environmental cleanup costs as capital expenses. The TAMs, which followed Revenue Ruling 88-57, but preceded Revenue Ruling 94-38, confirmed this conclusion. *See* Rev. Rul. 88-57, 1988-2 C.B. 36. Although these TAMs do not have any binding effect, they do provide some indication as to how these environmental cleanup costs probably will be treated. *See generally* FREELAND, *supra* note 3.

122. *See infra* section III.

123. Rev. Rul. 94-38, 1994-1 C.B. 35.

124. *But see infra* note 197.

A. The Facts Upon Which Revenue Ruling 94-38 Is Based

A taxpaying corporation built a manufacturing plant on land that it purchased in 1970.[125] Although the land was uncontaminated by hazardous waste at the time of purchase, the company's activities contaminated it.[126] In order to comply with local and federal environmental requirements, the corporation remediated the soil and groundwater that had been contaminated by hazardous waste, and decided to establish an appropriate system to safeguard the groundwater through continued monitoring.[127]

To implement these decisions, the corporation began to excavate the contaminated soil, transport it to waste disposal facilities, and use new soil to backfill the excavated areas.[128] In addition, the corporation also constructed groundwater treatment facilities to extract, treat, and monitor contaminated groundwater.[129] Although the construction of the groundwater treatment facilities would require at least twelve years to complete, the corporation would continue to monitor the groundwater to ensure that the hazardous waste had been removed in sufficient amounts to meet environmental requirements.[130] As a result of these activities, it was assumed that the land would return to its condition prior to the contamination, and the corporation would continue to use the land in the same manner as before, with the exception that it would "dispose of any hazardous waste in compliance with environmental requirements."[131]

B. The Analysis Used by the IRS in Issuing Revenue Ruling 94-38

In deciding whether the corporation's activities would be treated as current deductions or capital expenses, the IRS considered sections 162, 263, and 263A of the IRC and rele-

125. Rev. Rul. 94-38, 1994-1 C.B. 35.
126. *Id.*
127. *Id.*
128. Rev. Rul. 94-38, 1994-1 C.B. 35.
129. *Id.*
130. *Id.*
131. *Id.*

vant case law. Section 162 specifies that a taxpayer is allowed "a deduction [for] all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."[132] Revenue Ruling 94-38 indicates that even if a taxpayer incurs an expense only once in his lifetime, the expense may be "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."[133]

Revenue Ruling 94-38 points out that the Supreme Court in *Welch v. Helvering*[134] and *Deputy v. du Pont*[135] recognized that the " 'decisive distinctions [between capital and ordinary expenditures] are those of degree and not kind,' and a careful examination of the particular facts of each case is required."[136] For example, "it is important to consider the extent to which the expenditure will produce significant future benefits."[137]

The IRS concluded that the groundwater treatment facilities constructed by the corporation had a useful life beyond the year in which they were constructed.[138] In addition, since the construction constituted "production" within the meaning of IRC § 263A(g)(1), the corporation had to capitalize the direct costs and an allocable share of indirect costs under IRC § 263A. Thus, the construction costs are capital expenditures under IRC § 263 and Treasury Regulation § 1.263(a)-2(a).[139]

However, the "soil remediation expenditures and ongoing groundwater treatment expenditures (i.e., the groundwater treatment expenditures other than the expenditures to con-

132. I.R.C. § 162(a) (1994). *See also* Rev. Rul. 94-38, 1994-1 C.B. 35. IRC § 263 prohibits deductions for capital expenditures. *See* I.R.C. § 263 (1994).

133. Rev. Rul. 94-38, 1994-1 C.B. 35 (citing Welch v. Helvering, 290 U.S. 111, 114 (1933)).

134. 290 U.S. 111 (1933).

135. 308 U.S. 488 (1940).

136. Rev. Rul. 94-38, 1994-1 C.B. 35, 36 (quoting Welch v. Helvering, 290 U.S. at 114). *See also* Indopco, Inc. v. Commissioner, 503 U.S. 79, 86 (1992).

137. Rev. Rul. 94-38, 1994-1 C.B. 36; *see* Indopco, Inc. v. Commissioner, 503 U.S. 79, 85-86 (1992).

138. Rev. Rul. 94-38, 1994-1 C.B. 35, 36.

139. Treas. Reg. § 1.263(a)-2(a) (as amended in 1987).

struct the groundwater treatment facilities) do not produce permanent improvements to [the] land within the scope of [IRC] § 263(a)(1) or otherwise provide significant future benefits."[140] Revenue Ruling 94-38 states that "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 . . . hazardous waste)."[141]

The IRS reasoned "soil remediation and ongoing groundwater treatment expenditures do not result in improvements that increase the value of [the taxpayer's] property because [the taxpayer] has merely restored its soil and groundwater to their approximate condition before they were contaminated by [the taxpayer's] manufacturing operations."[142] In addition, "[t]hese expenditures do not prolong the useful life of the land, nor do they adapt the land to a new or different use."[143] Thus, the IRS did not require the company to capitalize the expenditures under IRC § 263. Also, since the soil remediation and groundwater treatment expenditures are "appropriate and helpful in carrying on [the taxpayer's business] and are commonly and frequently required in [the taxpayer's] type of business," the IRS allowed current deductibility of the expenditures.[144]

By analyzing the distinctions between currently deductible expenses and capital expenses, and by examining how the IRS has treated environmental cleanup costs and their reasons for doing so, a taxpayer could determine that environmental cleanup costs are likely to be treated as capital expenses. However, in some individual cases, there may be reason to allow current deductibility.[145] Unfortunately, Revenue Ruling 94-38 does not appear to provide clear guidance.

140. Rev. Rul. 94-38, 1994-1 C.B. 35, 36.

141. *Id.*

142. *Id.*

143. Rev. Rul. 94-38, 1994-1 C.B. 36. *See also* Indopco, Inc. v. Commissioner, 503 U.S. 79, 85-86 (1992).

144. Rev. Rul. 94-38, 1994-1 C.B. 36.

145. An examination of the relevant case law reveals that current deductibility of environmental cleanup costs was appropriate in cases such as: (1) Illinois

C. Effects of Revenue Ruling 94-38—What Did Revenue Ruling 94-38 Accomplish?

Revenue Ruling 94-38 merely modifies Revenue Ruling 88-57 "to the extent [that Revenue Ruling 88-57] implies that the value test applied by the court in *Plainfield-Union Water Co. v. Commissioner*[146] cannot be an appropriate test in any case other than the one in which there is sudden and unanticipated damage to an asset."[147] This has raised concerns about the intended effects of Revenue Ruling 94-38. It is clear that Revenue Ruling 94-38 addressed and virtually overruled TAM 93-15-004. However, Revenue Ruling 94-38 is ambiguous on several issues. It is unclear whether it applied to the asbestos TAMs. In addition, some uncertainty remains as to how to treat pre-purchase pollution costs,[148]

Merchants Trust v. Commissioner, 4 B.T.A. 103 (1926), where "the cost of inserting concrete supports beneath the wooden piles was allowed as an ordinary business deduction because the repairs were made to keep the property in efficient operating condition and did not add to the value of the property," Susan E. Anderson & Alison Dinkins, *Environmental Cleanup Costs: Ordinary or Capital Expenditure?*, Tax Notes Today, July 13, 1994, *available in* LEXIS, FEDTAX Library [hereinafter Anderson & Dinkins]; (2) *Plainfield-Union Water Co. v. Commissioner*, where

> a water company could receive a current deduction for changing the lining of water pipes from tar to cement. . . . The court held that any expenditure that returns property to the state it was in before the situation prompting the expenditure arose is classified as a repair if it does not make the property more valuable, useful, or longer-lived,

Anderson & Dinkins, *supra*, citing Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333 (1962); (3) Midland Empire Packing Co. v. Commissioner, 14 T.C. 635 (1950), where "the Tax Court determined that these costs were repairs since the expenditures neither enlarged the plant, nor increased the property's value or life," Anderson & Dinkins, *supra*, citing Midland Empire Packing Co. v. Commissioner, 14 T.C. 635 (1950); and (4) American Bemberg Corp. v. Commissioner, 10 T.C. 361 (1948), *aff'd*, 177 F.2d 200 (6th Cir. 1949), where the Tax Court considered the purpose, physical nature, and effect of the work in supporting a current deduction for the costs incurred. Anderson & Dinkins, *supra*, citing American Bemberg Corp. v. Commissioner, 10 T.C. 361 (1948). This examination of the case law reveals that a current deduction is allowed, if the expenditure does not extend the life of the property, or increase the value of the property, or adapt the property for a different use. Anderson & Dinkins, *supra*.

146. 39 T.C. 333 (1962).

147. Rev. Rul. 94-38, 1994-1 C.B. 36.

148. *See infra* note 197.

and whether Revenue Ruling 94-38 was limited to nondepreciable property.

IV. An Analysis of Existing IRS Policy

In analyzing Revenue Ruling 94-38, it is important to consider (1) whether the IRS's decision with respect to the treatment of soil and groundwater remediation is justified; (2) whether the decision is adequate to resolve concerns as to the treatment of environmental cleanup costs; and (3) the questions that Revenue Ruling 94-38 raises.

A. Is the IRS's Position on Soil and Groundwater Remediation Correct?

The first question that needs to be addressed is whether the position advocated by the IRS with respect to soil and groundwater remediation is sound. In Revenue Ruling 94-38, the IRS essentially adopted what the taxpayer advocated in TAM 93-15-004, thereby negating TAM 93-15-004. By doing so, the IRS adopted a more logical position than in TAM 93-15-004, where its position was inconsistent with its own reasoning and discouraged the immediate implementation of environmental remediation projects.[149]

In TAM 93-15-004, the IRS concluded that the PCB cleanup costs were capital expenses because (1) the cleanup involved "substantial modifications that constituted replacements and betterments" and thus, were more than "incidental repairs," and (2) "the costs incurred benefitted the taxpayer's entire operation over an extended period and increased the value of the property."[150] The IRS reasoned that the cleanup activities were not incidental repairs and that the property value was increased as a result of the cleanup

149. J. Virgil Waggoner, *Treasury's Position On Environmental Cleanup Costs Is Flawed, Chemical Company Contends*, Tax Notes Today, May 26, 1994, *available in* LEXIS, FEDTAX Library, 94 TNT 102-25, Doc. 94-5032. Mr. Waggoner also suggested that the case law, the Treasury Regulations, and tax accounting principles clearly establish that environmental cleanup costs, especially cleanup of PCB contamination, should be currently deductible. *Id.*

150. Waggoner, *supra* note 149 (citing Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992)).

activities. It relied upon *Wolfsen Land and Cattle Company v. Commissioner*,[151] where the taxpayer was required to capitalize the costs of clearing sediment from irrigation ditches to allow water to flow through the system.[152] The IRS found several similarities between the facts of *Wolfsen* and TAM 93-15-004.[153] First, in both cases, a program of waste identification and disposal was only implemented after years of ongoing operations. Second, in both TAM 93-15-004 and *Wolfsen*, the IRS held that it was irrelevant when the repair was made, concluding that whether a cleanup expense is classified as a repair depends on the work that is performed and not the taxpayer's awareness "of the future consequences of [its] disposal practices."[154] Third, the expenditures were made as part of a systematic plan. Finally, the property would be more valuable after the expenditure than before. Since the facts in TAM 93-15-004 were similar to those in *Wolfsen*, the IRS concluded that the expenditures would similarly be capitalized.

The approach taken in TAM 93-15-004 is flawed for several reasons. First, the IRS disregarded the results of the *Plainfield-Union* test,[155] which determined there was no increase in the property's value or useful life. As previously stated, unless the expenditure creates an increase in value or useful life, it cannot be classified as a capital expense. Nevertheless, the IRS concluded that since the *Plainfield-Union* test was not the sole factor to be considered, they were not obligated to base their decision entirely upon it.[156]

Second, the IRS improperly classified the cleanup activity as part of a general plan of improvement. In concluding that there was a plan, the IRS relied on *Jones v. Commis-*

151. 72 T.C. 1 (1979).

152. Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992).

153. *Id.*

154. *Id.*

155. This test compared the value of the property immediately after the expenditure to the value of the property before the condition that necessitated the expenditure. Tech. Adv. Mem. 92-40-004 (June 29, 1992) (citing Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333, 338 (1962)).

156. Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992).

sioner,[157] where the taxpayer was required to make repairs to his building, which consisted of repairing cracks, waterproofing, replastering, plumbing, electrical work, etc. The district court's position in *Jones* was that even though an activity, such as painting, would ordinarily be classified as a repair, if the activity is part of an overall plan of rehabilitation and improvement of the property, then this activity must be capitalized. Perhaps the court's reasoning was based upon the concept of judicial economy. It may be impractical to determine what constitutes a repair or improvement, when all are part of an overall plan of rehabilitation and improvement. The activity involved in *Jones* went beyond the mere soil and groundwater remediation involved in TAM 93-15-004. Thus, the soil and groundwater remediation was not part of a general plan of improvement and should not have been classified as a capital expense.

The IRS's position in Revenue Ruling 94-38 provided an incentive which encouraged immediate implementation of similar remediation projects. It accomplished this by providing for the current deductibility of the groundwater treatment facility monitoring costs, as well as the cost of soil and groundwater remediation.[158] The costs of building the facility, however, would have to be capitalized.

Unlike TAM 93-15-004, the position in Revenue Ruling 94-38 was sound, because it primarily relied on the *Plainfield-Union* test. The IRS's position in Revenue Ruling 94-38 rejected the notion that the soil and groundwater remediation, while similar in nature to that in TAM 93-15-004, was part of an overall plan of rehabilitation and improvement.[159]

However, the IRS's reasoning is susceptable to attack. Throughout the Revenue Ruling, the IRS states conclusions without providing adequate reasoning. For example, the IRS concluded, without any discussion, that the expense in Revenue Ruling 94-38 did not adapt the property to a new or different use. This position contradicted TAM 93-15-004, where

157. 242 F.2d 616 (5th Cir. 1957).

158. *See* Waggoner, *supra* note 149 and accompanying text.

159. Rev. Rul. 94-38, 1994-1 C.B. 35.

the IRS concluded that a similar expense did adapt the property to a new and different use. In TAM 93-15-004, unlike Revenue Ruling 94-38, the IRS reasoned that removing contaminated soil and replacing it with uncontaminated soil resulted in the creation of a new capital asset (land). Thus, it is apparent that in Revenue Ruling 94-38 the IRS flatly rejects its position in TAM 93-15-004.

B. Is Revenue Ruling 94-38 Sufficient to Resolve Concerns as to the Treatment of Environmental Cleanup Costs?

The IRS's decision in Revenue Ruling 94-38 provides inadequate guidance to taxpayers, thereby raising concerns regarding the extent of its applicability. Although, arguably, Revenue Ruling 94-38 is limited to its facts and should not be applied beyond that scope, the questions it raises regarding the treatment of environmental cleanup costs cannot be resolved by merely concluding that it is inapplicable.

Conceivably, the rationale of Revenue Ruling 94-38 could apply to these questions, especially the treatment of asbestos abatement costs.[160] Although the IRS may conclude that Revenue Ruling 94-38 is "fact-specific,"[161] the IRS must still

160. *See infra* section IV(C)(2). One commentator has argued that the IRS extend Revenue Ruling 94-38 to other environmental remediation costs, such as asbestos abatement, "as quickly as is administratively feasible." Steven A. Wechsler, *National Realty Committee Urges Expansion of Revenue Ruling 94-38*, Tax Notes Today, Sept. 29, 1994, *available in* LEXIS, FEDTAX Library, 94 TNT 192-49; *see also* Evan Slavitt, *Tax Implications Of Environmental Expenses*, Tax Notes Today, July 18, 1994, *available in* LEXIS, FEDTAX Library, 94 TNT 141-62. Mr. Slavitt argues that the term "asbestos removal" can be substituted for the term "soil remediation" "without doing any violence either to the factual premise or the logic of the revenue ruling. Accordingly, the Revenue Ruling must be interpreted as overruling the two prior TAMs. While this outcome may not have been intended, it will be hard for the IRS to justify any distinction." *See* Slavitt, *supra*.

161. Merrill Feldstein, the author of Revenue Ruling 94-38, has indicated that Revenue Ruling 94-38 "is limited to its facts and applies only to costs associated with land remediation when the taxpayer caused the damage. The ruling does not apply to asbestos abatement, removal of storage tanks, cleanup of preacquisition contamination, or costs incurred in cleaning up property prior to selling it." Marlis L. Carson, *Environmental Cleanup Ruling has Narrow Impact, Says IRS's Feldstein*, Tax Notes Today, Aug. 9, 1994, *available in* LEXIS,

set forth their position in a Revenue Ruling that addresses questions left unanswered by Revenue Ruling 94-38. For example, with respect to asbestos abatement costs, one possible course of action would be to suspend TAMs 92-40-004 and 94-11-002 and conduct an administrative review to find a replacement for these TAMs.[162] Another possible option would be to extend Revenue Ruling 94-38 to other environmental remediation costs, such as asbestos abatement "as quickly as is administratively feasible."[163]

Although both approaches may lead to the same result, the first approach advocates an administrative review prior to issuing any further guidance. Under this approach, there is no guarantee that Revenue Ruling 94-38 would apply to asbestos cases, while the second approach advocates the extension of Revenue Ruling 94-38 to such areas. Until some action is taken by the IRS, questions raised by Revenue Ruling 94-38 will continue to pose uncertainty.

C. What Questions Does Revenue Ruling 94-38 Raise?

The IRS's decision in Revenue Ruling 94-38 focused on whether costs attributable to soil and groundwater remedia-

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FEDTAX Library, 94 TNT 155-6. Ms. Feldstein also pointed out that the IRS "is taking a 'wait and see' approach to issuing more guidance, choosing to 'see what Rev. Rul. 94-38 prompts.'" *Id.* Ms. Feldstein "stressed that the application of the revenue ruling is dependent on a facts and circumstances approach, and she would not speculate as to how it would apply to situations differing from the facts in the ruling." *Id.* Finally, Ms. Feldstein stated that although she was unsure whether Revenue Ruling 94-38 "would apply to the cleanup of a combination of preacquisition and post-acquisition contamination," she felt that the answer "depends upon the breadth of the application of *Plainfield Union.*" *Id.* However, since this statement was made during the annual meeting of the American Bar Association's Environmental Taxes Committee, in New Orleans on August 6, 1994, it provides no binding authority which can be relied upon.

162. *See* Wechsler, *supra* note 160 and accompanying text.

163. Wechsler, *supra* note 160. Steven A. Wechsler is President of the National Realty Committee. Jody J. Brewster, IRS Assistant Chief Counsel (income tax and accounting) recently stated at a Real Estate Taxes Subcommittee meeting of the American Bar Association (ABA) Tax Section that the IRS is considering issuing a Revenue Ruling that would extend the treatment of Revenue Ruling 94-38 to asbestos abatement costs. Amy S. Cohen, *IRS May Issue Ruling On Treatment Of Asbestos Removal Costs, Says Brewster*, Tax Notes Today, Feb. 3, 1995, *available in* LEXIS, FEDTAX Library, 95 TNT 23-8.

tion of nondepreciable property after its purchase were currently deductible. However, it is unclear whether the Revenue Ruling can be applied to (1) depreciable property, (2) asbestos abatement costs, and (3) pre-purchase pollution cleanup costs.[164] By failing to specifically address these issues, the IRS has created uncertainty for taxpayers.

1. Depreciable Property

Revenue Ruling 94-38 specifically points out that the property involved was nondepreciable.[165] However, since the IRS does not specifically state whether the Revenue Ruling is limited to nondepreciable property, it raises the question as to whether the result would be different in the case of depreciable property. If the situation were to arise, the IRS would most likely argue that Revenue Ruling 94-38 was limited to cases involving nondepreciable property. Furthermore, the IRS might argue that IRC § 263(a)(2) specifies that property subject to an allowance for depreciation, amortization, or depletion must be capitalized.[166]

However, this argument fails because there is no indication that Congress or the IRS intended for a distinction between a repair and a capital expense to be inapplicable to IRC § 263(a)(2). This distinction between a repair and a capital expense is addressed in Treasury Regulation § 1.162-4 which indicates that a repair is that:

> which neither materially add[s] to the value of the property nor appreciably prolongs its life, but keep[s] it in an ordinarily efficient operating condition . . . . [However,] repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall either be capitalized and depreciated in accordance with section 167 or charged against the depreciation reserve, if such an account is kept.[167]

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164. *But see infra* note 197.
165. Rev. Rul. 94-38, 1994-1 C.B. 35.
166. I.R.C. § 263(a)(2) (1994). The IRS relies on this provision in Revenue Ruling 94-38.
167. Treas. Reg. § 1.162-4 (1994).

There is no indication that this test is not applicable to cases of depreciable property. Congress could have set forth this distinction in the statute, or the distinction could have been presented in the regulations. However, no such distinction was made in the IRC or in the language of Treasury Regulations § 1.162-4 and § 1.263(a)-2(b). Therefore, the IRS would have no logical basis for such a distinction.

The language of Treasury Regulation § 1.162-4 clearly indicates that a repair in the nature of a replacement can be charged against the depreciation reserve. To have a depreciation reserve, the asset must be depreciable. Therefore, the test in Treasury Regulation § 1.162-4 must be considered in determining the deductibility of any given expense.

IRC § 263(a)(2) specifies that a deduction is not allowed for amounts expended to restore property for which an allowance, such as depreciation has already been made.[168] It may be inferred that IRC § 263(a)(2)'s language contemplates the test adopted in Treasury Regulation § 1.162-4. Further support for this position is found in Treasury Regulation § 1.263(a)-1(b). This Treasury Regulation indicates that the amounts referred to in IRC § 263(a)(1) and (a)(2) "include amounts paid or incurred to add to the value, or substantially prolong the useful life, of the property owned by the taxpayer . . . or to adapt the property to a new or different use."[169] The language of Treasury Regulation § 1.263(a)-1(b) clearly indicates that the test to determine whether an expense is a repair or replacement must still be applied. The test for capitalization set forth in Treasury Regulation § 1.162-4 must be satisfied, because IRC § 263(a)(2) is insufficient, by itself, to deny current deductibility to a repair for restoring a depreciable asset.

The case law supports this position. In *Midland Empire Packing v. Commissioner*,[170] the Tax Court allowed a current deduction for depreciable property. The taxpayer in *Midland Empire* built a concrete wall to protect its property from fur-

168. I.R.C. § 263(a)(2) (1994).
169. Treas. Reg. § 1.263(a)-1(b) (1994).
170. 14 T.C. 635 (1950).

ther damage caused by oil. The Tax Court reasoned that since this expenditure did not prolong the expected life of the property over what it would have been before the event that necessitated the repair, and since this repair did not add value to the property, this expense was currently deductible.[171] This indicates that the repair or replacement test set forth in Treasury Regulation § 1.162-4 was applied.

The IRS's reasoning in Revenue Ruling 94-38 could conceivably be applied to asbestos remediation costs.[172] Since asbestos is a depreciable asset, it can be concluded that Revenue Ruling 94-38 also applies to depreciable property. Thus, it is sufficient to consider the nature of the expense (that is, does it add value to the property, increase its useful life, etc.) to determine whether Revenue Ruling 94-38 applies.

Since the IRS has not specifically stated whether Revenue Ruling 94-38 applies to depreciable property, this question remains unanswered and their response is uncertain. However, there is no indication that the distinction between a repair and a capital expense is inapplicable to depreciable assets. Courts and the IRS[173] have allowed current deductions in the case of depreciable property. Therefore, the fact that property is depreciable should not limit the applicability of Revenue Ruling 94-38.

2. Asbestos Abatement Costs

The IRS's current position with respect to the tax treatment of asbestos abatement costs is unclear. Revenue Ruling 94-38 does not specifically address this issue. However, the IRS has addressed this issue in TAMs 92-40-004 and 94-11-002.[174] These TAMs, however, are inconsistent with the reasoning in Revenue Ruling 94-38.[175]

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171. Midland Empire Packing v. Commissioner, 14 T.C. 642.

172. Wechsler, *supra* note 160.

173. *See* Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992) (encapsulation of asbestos is currently deductible).

174. *See supra* notes 72-108 and accompanying text for discussion of the treatment of asbestos abatement costs under TAMs 92-40-004 and 94-11-002.

175. *See supra* notes 132-45 and accompanying text for the IRS's reasoning in Revenue Ruling 94-38.

First, TAM 92-40-004 held that the costs incurred to remove asbestos and to replace it with other insulation increased the value of the property because it removed the health and safety risks that existed.[176] This TAM applied the *Plainfield-Union* test to determine whether there was an increase in the value of the asset.[177] The IRS concluded that the *Plainfield-Union* test was inapplicable to determine whether asbestos removal costs increase property value.[178] Thus, this TAM requires capitalization of these asbestos abatement costs.

TAM 94-11-002, however, represents the IRS's most recent position on the tax treatment of asbestos abatement costs. In TAM 94-11-002, the IRS held that the costs of removing and replacing asbestos with other insulating materials were capital expenditures, while costs for encapsulating the asbestos and the continual monitoring of this encapsulation were currently deductible.[179]

The issue, therefore, is whether asbestos removal costs are currently deductible. Although the IRS agrees with the taxpayer that encapsulation is currently deductible, this position must still be justified. The IRS should address the issues of asbestos removal and abatement costs in a Revenue Ruling allowing a current deduction for both the costs of asbestos encapsulation and asbestos removal.

The costs of asbestos encapsulation should be currently deductible. This is because these costs "neither appreciably increase the value of the taxpayer's property nor substantially prolong its useful life,"[180] thereby indicating that the effects of the encapsulation are merely temporary. In other words, encapsulation deals with intermediate consequences. Thus, the requirements for capitalization have not been satisfied with respect to encapsulation.

176. Tech. Adv. Mem. 92-40-004 (June 29, 1992).

177. Tech. Adv. Mem. 92-40-004 (June 29, 1992) (citing Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333 (1962)).

178. *Id.*

179. Tech. Adv. Mem. 94-11-002 (Nov. 19, 1993).

180. *Id.*

These requirements have also not been satisfied with respect to asbestos removal. Nevertheless, the IRS has taken a different position which requires capitalization of asbestos removal costs. This view cannot be justified in light of the IRS's reasoning in TAM 94-11-002 and Revenue Ruling 94-38 and thus should not be reflected in the Revenue Ruling that addresses asbestos abatement costs.

There are several reasons justifying why the IRS should allow current deductibility of asbestos removal costs.[181] First, the soil and groundwater remediation process is similar to the process of asbestos removal and replacement. In Revenue Ruling 94-38, the taxpayer had to excavate the contaminated soil, transport this soil to waste disposal facilities, and replace it with uncontaminated soil.[182] This process, for which current deductibility is allowed, is similar to removing asbestos and replacing it with new insulating materials, because both processes involve removal of contaminated material and replacement with new material.

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181. However, there is a possible argument against this position. This argument is based on the Tax Court's holding in Boddie v. Commissioner, 72 T.C.M. (CCH) 350 (1961). In *Boddie*, the Tax Court held that the costs incurred to repair a heating system by replacing it with a new heating system were capital expenses. *Id.* at 352. The taxpayer contended that since the heating system was part of the house and since the house was depreciated as a whole, the replacement of the heating system was a repair of the house. *Id.* However, the Tax Court rejected the taxpayer's argument, relying upon IRC § 263(a)(2) in reaching their decision. *Id.*

If one accepts the Tax Court's position, it is apparent that removal and replacement of asbestos could not be deducted. This is because *Boddie* suggests that removal and replacement of a depreciable asset is not deductible because the repair of the furnace involved installing a new furnace. The replacement of the furnace was not considered a repair of the house. Essentially, the furnace was viewed as a separate depreciable asset by the court, rather than part of a larger asset. 72 T.C.M. (CCH) at 352.

This situation, however, is unlike that in the case of asbestos. Although asbestos is a depreciable asset, it is normally considered to be part of the overall asset. Thus, unless the asset, such as machinery, has a greater value, a greater useful life, or is adapted to a new use, the removal of asbestos and replacement with new insulation materials is currently deductible. Therefore, it is clear that an argument against the current deductibility of asbestos removal based on the *Boddie* case is without merit.

182. Rev. Rul. 94-38, 1994-1 C.B. 35.

Second, the distinction between asbestos removal and asbestos encapsulation and monitoring is unclear.[183] The IRS bases its distinctions on three grounds: (1) the elimination of health risks; (2) attractiveness of property to potential purchasers; and (3) whether the effect of the expense was more than temporary. As discussed below, consideration of these three grounds reveals that the distinction between asbestos removal and encapsulation is tenuous, at best. Therefore, both asbestos removal and encapsulation merit current deductibility.

The IRS's first ground for distinction was its reliance upon the fact that asbestos "removal costs added value [to the taxpayer's property] by eliminating the health risks associated with asbestos."[184] However, the encapsulation costs, which also reduced the health risks, were currently deductible.[185] Thus, "the elimination or reduction of health risks is not a very cogent indicator for when a cost must be capitalized."[186]

The IRS also relied upon the fact that asbestos removal makes property more attractive to prospective buyers, thereby adding value to the property.[187] However, this will not only apply to asbestos removal, but also to encapsulation and any other type of repair, since all repairs make the property more attractive to potential purchasers.[188] Thus, the fact that an expense results in a more attractive-looking property, does not necessarily make the expense capital in nature.[189]

Furthermore, the IRS relied upon the fact that asbestos removal resulted in more than a temporary effect. That is, it "cured more than the 'intermediate consequences' of the as-

183. *See* Lester Droller, *IRS Continues Flawed Analysis of Treatment of Environmental Cleanup Costs: TAM 94-11-002*, Tax Notes Today, May 6, 1994, *available in* LEXIS, FEDTAX Library, 94 TNT 88-41.

184. *Id.*

185. *Id.*

186. *Id.*

187. Tech. Adv. Mem. 92-40-004 (June 29, 1992).

188. Droller, *supra* note 183.

189. *Id.*

bestos problem."[190] However, the effects of the encapsulation costs were temporary. These expenses did not completely eliminate the asbestos from the site, but rather served only as a remedial measure.[191] "The taxpayer will have to continuously monitor asbestos levels and re-encapsulate or remove insulation if the materials become worn or damaged."[192] Thus, TAM 94-11-002 essentially holds that an asbestos abatement expense can be currently deductible, if it has a temporary effect. "[T]his position, [however] ignores the case law,[193] as well as the common understanding of the term 'repair.' "[194]

Asbestos removal did not create a new asset, but merely kept the original asset in a pollution-free condition. However, even if the asbestos removal did adapt the property to a new use, the case law relied upon by the IRS did not support its decision.[195] Nonetheless, given its position in Revenue Ruling 94-38, the IRS has opened the door to allowing similar types of deductions for removal of contaminated material and replacement with uncontaminated material. Although this may not have been the intention of the IRS, the IRS has placed itself in the position of having to allow such deductions if it wishes to remain consistent with its position in Revenue Ruling 94-38.

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190. *Id.*

191. *Id.*

192. Droller, *supra* note 183.

193. *See* Illinois Merchants Trust, 4 B.T.A. 103 (1926), *cited in* Droller, *supra* note 183. Mr. Droller argues that:

> There is not the slightest inference in *Illinois Merchants Trust* that the offending condition (the rotted piles) was only temporarily cured. Rather, unlike in *American Bemberg*, it is clear that the taxpayer in *Illinois Merchants Trust* did cure the very source of its problem (the rotted piles underlying its property). Thus, based on *Illinois Merchants Trust* alone, the TAM's assertion that a repair 'is not a permanent cure' is demonstrably wrong. A repair may be temporary (as in *Plainfield Union*) or it may be permanent.

Id. (citations omitted).

194. Droller, *supra* note 183.

195. *See* Droller, *supra* note 183 and accompanying text.

3. Pre-Purchase Pollution Cleanup Costs

The IRS's position with respect to whether Revenue Ruling 94-38 applies to pre-purchase pollution costs is also unclear.[196] In Revenue Ruling 94-38, the IRS points out that it was dealing with a taxpayer that sought to remediate its property, which contained no pollution at the time of purchase. This, of course, raises the question of whether Revenue Ruling 94-38 is limited to cases where there is no pre-purchase pollution. The IRS, however, does not answer that question, thereby creating more uncertainty for the taxpayer.[197]

To alleviate this uncertainty, the IRS must issue a Revenue Ruling that addresses this issue. Upon analysis of this issue, the IRS's position in this Revenue Ruling must be that in cases where the taxpayer was aware of the pre-purchase pollution, the remediation expense must be capitalized. However, if the taxpayer was not aware of the pre-purchase pollu-

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196. *See infra* note 197.

197. However, in TAM 95-41-005, the IRS set forth a position with respect to the treatment of pre-purchase pollution cleanup costs. *See* Tech. Adv. Mem. 95-41-005 (September 27, 1995). Although a TAM is not necessarily binding on the IRS with respect to all taxpayers, this TAM demonstrates where the IRS's position is heading. Under the facts of TAM 95-41-005, the taxpayer obtained property in an uncontaminated condition and used the property as farmland, until the property became contaminated, due to its disposal of agricultural chemical waste products. The taxpayer then transferred this property to the County. The County intended to use this property for a recreational center. However, due to the hazardous waste contamination, the County transferred the property back to the taxpayer for $1. The taxpayer conducted testing to determine the extent of the environmental damage. The taxpayer sought to deduct these expenses as well as expenses incurred for consulting and engineering services as an ordinary and necessary business expense under IRC § 162. The taxpayer sought to rely on Revenue Ruling 94-38, which provided that costs incurred for soil and groundwater remediation are currently deductible. *Id.*

The IRS, however, reasoned in TAM 95-41-005 that Revenue Ruling 94-38 was inapplicable to a situation involving pre-purchase pollution cleanup costs. The IRS based this decision on the test in *Plainfield-Union*, claiming that this test only sought to restore property to its uncontaminated condition at the time it was acquired by the taxpayer. Thus, based on the IRS's reasoning, the pre-purchase pollution cleanup costs (those relating to the determination of the extent of environmental damage) must be capitalized and Revenue Ruling 94-38 does not apply. Although the facts of this TAM do not explicitly deal with actual remediation expenses, there is an indication that the IRS will also apply this decision to that factual situation. *Id. But see* note 207.

tion, then the remediation expense must be currently deductible. Thus, the applicability of Revenue Ruling 94-38 will depend on the taxpayer's awareness of the existence of pre-purchase pollution at the time of purchase. This makes it difficult, if not impossible, to apply the *Plainfield-Union* test as it was applied in Revenue Ruling 94-38 because the value of the property immediately before the contamination cannot be determined.

In Revenue Ruling 94-38, the IRS concluded that since the groundwater treatment facility constructed by the corporation had a useful life beyond the year in which it was constructed, the costs incurred to construct this groundwater treatment facility had to be capitalized.[198] However, the IRS recognized that ongoing groundwater treatment expenses could be currently deducted.[199] Thus, the IRS appropriately considered the matching principle in reaching its decision in Revenue Ruling 94-38.[200]

The fact pattern analyzed in Revenue Ruling 94-38 only considered a situation in which there was no pollution on the property prior to purchase. It did not consider a situation in which the taxpayer sought to remediate a condition existing on the property at the time of purchase.[201] By alluding to this issue, but failing to respond to it, the IRS has created an uncertainty which must be resolved with an additional Revenue Ruling. This Revenue Ruling must provide that in determining whether pre-purchase pollution cleanup costs are currently deductible, the IRS must consider whether the taxpayer had knowledge of the existing pollution at the time he purchased the property. If the taxpayer had such knowledge, the costs of cleaning up the pollution must be capitalized. However, if the taxpayer did not have such knowledge, then these cleanup costs can be currently deductible.

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198. Rev. Rul. 94-38, 1994-1 C.B. 35.

199. *Id.*

200. However, the matching principle was not the only factor that was considered by the IRS in reaching its decision. *See* Rev. Rul. 94-38, 1994-1 C.B. 35.

201. Rev. Rul. 94-38, 1994-1 C.B. 35.

This position is supported by both the Tax Court's decision in *De Cou v. Commissioner*[202] and Treasury Regulation § 1.165-3.[203] This case demonstrates that in determining whether or not a loss caused by a latent defect is currently deductible, the taxpayer must not have been aware of the defect at the time of purchase.[204] The Treasury Regulations demonstrate that, in determining whether expenses incurred in demolition of a building (thereby resulting in a loss) are deductible under IRC § 165, depends on the taxpayer's intent at the time that he purchased the property. If the taxpayer intended to demolish the building, then he is not entitled to a current deduction. On the contrary, if the need to demolish the building results from some sudden and unexpected change in events, the taxpayer is entitled to a current deduction. Thus, the Tax Court focuses on the taxpayer's knowl-

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202. 103 T.C. 80 (1994). In *De Cou*, the taxpayer purchased, developed, and leased residential and commercial property. *Id.* at 80-81. After consulting an architect the taxpayer decided to renovate some of his properties and subsequently leased them to several businesses. *Id.* at 81. The taxpayer also negotiated the purchase of additional properties that adjoined the already purchased properties. Prior to the purchase of this property, the taxpayer inspected the property to determine the possibilities for potential renovation and incorporation into the other properties. *Id.*

An initial inspection revealed nothing that would prevent this incorporation. De Cou v. Commissioner, 103 T.C. at 81. In addition, the inspection did not reveal any structural defects in the property. However, hidden structural defects were found at the time of renovation. These hidden defects were so substantial that one of the buildings had to be demolished and removed. *Id.*

In reaching their decision to allow a current deduction for the loss sustained, the Tax Court focused on the unexpectedness of discovering the defects. *Id.* at 87-88. The Tax Court's rationale in *De Cou* essentially supports the position that discovering a defect in property, independent of actual deterioration, can result in a decrease in the property's value sufficient enough to justify current deductibility. LAURIE L. MALMAN, ET AL., PROBLEMS, CASES, AND MATERIALS ON FEDERAL INCOME TAXATION 12 (Teacher's Update 1995) (on file with Pace Environmental Law Review).

203. If "in the course of a trade or business . . . real property is purchased *with* the *intention* of demolishing either immediately or subsequently the buildings situated thereon: No deduction shall be allowed under section 165(a)." Treas. Reg. § 1.165-3(a)(1) (1994) (emphasis added). However, a loss "arising from a demolition of old buildings shall be allowed as a deduction under section 165(a) if the demolition occurs as a result of a plan formed *subsequent* to the acquisition of the buildings." Treas. Reg. § 1.165-3(b)(1) (1994) (emphasis added).

204. 103 T.C. 80 (1994).

edge at the time of purchase and the IRC uses the intent of the taxpayer at the time of purchase to determine whether costs of demolition resulting in a loss are currently deductible.

This reasoning, as well as the reasoning in *De Cou*, can also be used to determine whether pre-purchase pollution cleanup costs are currently deductible. If the taxpayer purchases property and is aware that the property contains pollution, which requires cleanup, he should not be entitled to a current deduction. This is because he purchased the property knowing that he would have to incur costs of cleanup (that is, with the intent to cleanup the property). Under such circumstances, it is likely that the taxpayer paid less for the property than he would have paid if he was unaware of the pollution.[205] A current deduction in such a case would result in an unfair advantage over a purchaser who paid full value for the property, and then had to incur the costs of cleanup.

Consider, for example, that there are two purchasers, A and B. Each purchases an identical piece of property worth $1,000,000. Consider also, that both pieces of property contain pollution that will cost $100,000 to remediate. Since A was aware of the pollution on the property, he demanded a lower purchase price and paid only $900,000 for the property. However, B was unaware of this pollution and paid $1,000,000 for the property. Now, consider that both A and B incurred a cost of $100,000 to remove the pollution from the property. By doing so, A's total cost of the property would be $1,000,000 (the $900,000 purchase price plus the $100,000 cleanup cost) while B's total cost would be $1,100,000 (the $1,000,000 purchase price plus the $100,000 cleanup cost). To allow a current deduction under these circumstances would result in only $800,000 ($900,000 less $100,000) that would have to be capitalized, while allowing B a current deduction would result in $1,000,000 ($1,100,000 less $100,000)

205. This assumes that sellers will seek the actual fair market value of their property and not consider reducing its value for the required remediation unless the taxpayer brings it to their attention. However, if the seller does consider the needed remediation in setting the price, it is assumed that he will inform the purchaser of this.

that would have to be capitalized. Clearly, these results are unjust, providing favorable treatment to one who was aware of the pollution at the time of purchase and did not pay full value.

To achieve an equitable result, only a taxpayer who purchases property while he is unaware of the existing pollution should be entitled to a current deduction. Under these facts, requiring A to capitalize the $100,000 cleanup expense will result in the capitalization of $1,000,000 ($900,000 purchase price plus $100,000 cleanup expense). Furthermore, allowing B a current deduction will result in the capitalization of $1,000,000 ($1,000,000 purchase price plus $100,000 cleanup costs less $100,000 deduction). Thus, both A and B would capitalize $1,000,000 if the taxpayer's knowledge of existing pollution at the time of purchase is used as the determining factor for whether pre-purchase pollution cleanup costs are currently deductible.

Not only does this approach create an equitable result, but it is also consistent with the matching principle and the *Plainfield-Union* test. This approach is consistent with the matching principle because it considers whether the expense incurred will benefit future income periods.[206] The approach is also consistent with the *Plainfield-Union* test because it provides a basis for comparing the value of the property after the cleanup expenses are incurred.

206. In a letter from McGee Grigsby of Latham & Watkins to Stuart L. Brown, the Associate Chief Counsel for the IRS, Mr. Grigsby advocates that the "matching principle" be used to avoid a distortion of actual income. McGee Grigsby, *Commentator Analyzes Tax Treatment Environmental Cleanup Costs*, Tax Notes Today, Oct. 6, 1993, *available in* LEXIS, FEDTAX Library, 93 TNT 206-50, Doc. 93-10258.

Mr. Grigsby's view was supported by Bob Kilinskis of the Treasury's Office of Tax Legislative Counsel. This was evident at a panel discussion sponsored by the Federal Bar Association Tax Section, where Mr. Kilinskis stated that "[Mr. Grigsby] believes that the matching concept should be the basis for further guidance or legislation on environmental cleanup because it is the underpinning of the code sections involved." Barbara Kirchheimer, *'Matching Concept' Should Provide Framework For Tax Treatment of Environmental Cleanup, Says Treasury Official*, Tax Notes Today, Jan. 12, 1994, *available in* LEXIS, FEDTAX Library, 94 TNT 8-3.

To apply the matching principle, it must first be determined whether the expense incurred impacts past,[207] current, or future income periods. If the expense affects either past or current income periods, the expense is currently deductible. If the expense affects future income periods then the expense must be capitalized.

The matching principle works well when the expense relates to the taxpayer's income-producing activities. However, in the case of pre-purchase pollution cleanup costs, the cleanup expense relates to the prior owner's (the seller's) income-producing activities. Therefore, the ordinary use of the matching principle is inapplicable in the case of pre-purchase pollution cleanup costs.

Nevertheless, the theory underlying the matching principle can be used to resolve concerns surrounding the treatment of pre-purchase pollution costs. By using the approach demonstrated above, it is clear that the matching principle applies. This is because the approach allows for distinctions between expenses that impact current or past income-producing periods and future income-producing periods.

The following example illustrates that the approach advocated above is consistent with the matching principle. Consider, once again, the fact pattern discussed above. In this

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207. There are many examples of income that precede the expenditure. Grigsby, *supra* note 206. A common example is compensation. *Id.* Current compensation is usually based on past performance. *Id.*

> Often, several years of past performance are awarded on a single occasion. Although the IRS once argued that allowing a current deduction for compensation related to several years of past performance would not clearly reflect income in the year of the deduction, the Supreme Court put that issue to rest long ago in *Lucas v. Ox Fibre Brush Co.*, 281 U.S. 115 (1930).

Grigsby, *supra* note 206.

Other examples include legal expenses and litigation settlement payments. Grigsby, *supra* note 205. "The current deductibility of such expenditures is well-established." *Id. Commissioner v. Tellier*, 383 U.S. 687 (1966), allowed a taxpayer to currently deduct "expenses incurred in defending charges of past criminal conduct." Grigsby, *supra* note 205. These examples demonstrate that "when the expenditure relates to previously earned income, the expenditure is currently deductible . . . . To conclude otherwise would distort and not clearly reflect income by further separating the income from the associated expenditures." Grigsby, *supra* note 205.

example, the $100,000 cleanup costs are currently deductible when the taxpayer was unaware of the existence of pollution. These costs are currently deductible under the matching principle because the costs relate back to past income-producing activities. That is, they relate back to the date of purchase. In addition, the costs were incurred to restore the property to what its value should have been had the taxpayer paid the actual value of the property (which considered the pollution). Under the facts of this example, the value of the property with pollution was $900,000. The taxpayer paid $1,000,000 for the property and $100,000 to cleanup the property. As a result of the cleanup, the property is worth $1,000,000. Thus, since the expense incurred merely restored the property to its current value without impacting future income periods, the cleanup costs must be currently deductible.

However, if the taxpayer was aware of the pollution at the time of purchase, then it is assumed that he paid a lower price for the property (the property's value without the pollution LESS the cost to cleanup the pollution). In this case, the purchase price would have been $900,000 ($1,000,000 less $100,000). If costs are incurred to remove the pollution, these costs no longer relate to prior or current income-producing activities because the taxpayer actually paid what the property was worth at the time he purchased it. He did not pay more for the property in the way that the purchaser in the prior example did. Thus, his cleanup expense of $100,000 would increase the value of the property and provide him with future benefit. Therefore, under the matching principle, the expense must be capitalized.

It is apparent through the two examples illustrating the use of the matching principle that the approach advocated above is consistent with the underlying theory of the matching principle. This is because the effect of the expense on past, current, and future income-producing periods is considered.

The approach discussed above is also consistent with the *Plainfield-Union* test. To apply the *Plainfield-Union* test, the value of the property after the cleanup expense is incurred

must be compared with the value of the property prior to the condition necessitating the expenditure. This poses difficulty in cases where the condition causing the need for the cleanup expense was not caused by the taxpayer but by a prior owner (the seller) of the property. Thus, there was no basis for comparison because it was difficult, if not impossible to determine the value of the property when it was in the seller's hands.

However, by using the date of purchase as a date for comparison, it can be determined whether there was actually an increase in property value caused by the purchase. The basis for using the date of purchase as the date of comparison in the case of pre-purchase pollution cleanup costs is that on the date of purchase the pollution is factored into the purchase price.

Consider, once again, that the taxpayer was aware of the existence of pollution on the date of purchase. As a result, he paid $900,000 for the property rather than $1,000,000. Once the $100,000 is expended to remove the pollution, the property is worth $1,000,000 (the value it would have been, if there was no pollution). Under these facts, *Plainfield-Union* would dictate a capitalization, because the expense incurred increased the value of the property prior to pollution from $900,000 to $1,000,000.

However, also consider that if the taxpayer was unaware of the pollution at the time of purchase, he would have likely paid $1,000,000 for the property (the value of the property, if there was no pollution). In such a case, if the taxpayer expends $100,000 to remove the pollution, it must be currently deductible because there was no increase in the property's value as a result of the cleanup expense. That is, the value of the property immediately after the expenditure ($1,000,000) was equal to what it was before the condition necessitating the expenditure ($1,000,000). Thus, current deductibility is authorized.

The use of the purchase price, rather than the value of the property prior to the contamination, as a means for determining whether there was an increase in property value, is a proper substitute in applying the *Plainfield-Union* test. This is because the taxpayer's awareness of the existence of pollu-

tion is the condition that necessitated the expenditure. If the taxpayer knew of the existence of pollution, he would have paid a lower price for the property, thereby eliminating the need for a current deduction. However, if the taxpayer was unaware of the existence of pollution, he would not have paid less for the property. Thus, any expenditure to cleanup the property would only restore the property's value to what it would have been if no pollution actually existed, thereby creating the need for a current deduction. Therefore, it is apparent that the approach advocated above is consistent with the *Plainfield-Union* test.

Based on the above analysis, it is apparent that the treatment of pre-pollution cleanup costs depends upon the taxpayer's awareness of the existence of the pollution at the time of purchase.[208] Such an approach is appropriate in view of the Tax Court's decision in *De Cou*.[209] It is also apparent

208. The approach advocated in TAM 95-41-005 is consistent with that advocated above because there is a clear indication that the taxpayer (buyer) knew of the existing contamination at the time that the County transferred the property back to it. This is because the purchase price is relatively low ($1) and the taxpayer was the one who actually contaminated the property to begin with. Thus, since under the approach mentioned above, knowledge of the existence of contamination will determine whether the cleanup expense is currently deductible, the fact that such knowledge existed here will mean that it is non-deductible and must be capitalized, according to the approach set forth above.

Although the IRS did not refer to the actual costs of remediation in this TAM, the IRS's reasoning would lead one to believe that this decision is generally applicable to all pre-purchase pollution cleanup costs. Based on the reasoning above, such an approach would be wrong. That is, it would be inconsistent with what the *De Cou* case and the Treasury Regulation appear to advocate as a rule. Thus, although the actual conclusion in this TAM is consistent with such an approach, the fact that the IRS apparently adopts a "hard and fast rule" demonstrates the IRS's approach in the case where the subsequent purchaser had no knowledge of the contamination at the time of purchase.

However, it is also possible to conclude that the taxpayer was always the owner of the property. That is, he acquired it in an uncontaminated condition and polluted the property. The property was then transferred to another and then back to the taxpayer. Ignoring the intermediate transfer, it could be held that the taxpayer was always the owner of property. Prior to publication of this article, the IRS has taken this position in a currently unnumbered TAM, thereby reversing their position in TAM 95-41-005. Therefore, the applicability of Revenue Ruling 94-38 to pre-pollution cleanup costs still remains unaddressed. *See supra* note 197.

209. 103 T.C. 80 (1994).

that asbestos removal costs are currently deductible according to the IRS's reasoning in Revenue Ruling 94-38. Furthermore, it is apparent that Revenue Ruling 94-38 is not limited to nondepreciable property in light of the courts' and the IRS's allowance of current deductions in the case of depreciable property and in light of the fact that there is no indication that Congress or the IRS intended to limit the distinction between repairs and capital expenses to IRC § 263(a)(1). The IRS must consider these issues and state the positions advocated above in a Revenue Ruling. Unless the IRS takes some action, uncertainty will continue to linger.

V. Conclusion

Revenue Ruling 94-38 may be a step towards resolving the controversy regarding the tax treatment of environmental cleanup costs. However, it has yet to be determined to what extent this Revenue Ruling applies. An examination of the facts and reasoning inherent in Revenue Ruling 94-38 reveals that its factual circumstances are limited in nature. Given the need for guidance in the area of environmental remediation, either Revenue Ruling 94-38 must be expanded or further guidance must be given with respect to other types of environmental remediation costs, including asbestos abatement.

Revenue Ruling 94-38 appears to resolve the concerns that existed prior to its issuance by addressing the proper tax treatment of certain environmental cleanup costs. The fact that this Revenue Ruling specifically involved post-purchase soil and groundwater remediation may cause a taxpayer to question whether it is limited to those types of environmental cleanup costs. Merrill D. Feldstein, author of Revenue Ruling 94-38, issued a statement at the August 6, 1994 meeting of the Environmental Tax Committee of the American Bar Association, indicating that Revenue Ruling 94-38 is restricted to its facts.[210] This leaves the taxpayer in the same position that he was in prior to Revenue Ruling 94-38 with respect to asbestos cleanup costs and cleanup costs relating

210. *See supra* note 161.

to pre-purchase pollution. In addition, since Revenue Ruling 94-38 specifically dealt with soil (a nondepreciable asset), the taxpayer is left wondering whether the IRS would apply its reasoning in Revenue Ruling 94-38 to depreciable assets.

The IRS must issue another Revenue Ruling that addresses these concerns. Based upon the existing law, it is clear that this Revenue Ruling must state that: (1) the reasoning of Revenue Ruling 94-38 also applies to depreciable assets; (2) asbestos removal costs and asbestos encapsulation costs are currently deductible; and (3) the treatment of pre-purchase pollution cleanup costs depends upon the taxpayer's knowledge of the existence of the pollution at the time of purchase.

The circumstances that led to the issuance of Revenue Ruling 94-38 have yet to be fully resolved. In considering the three TAMs that preceded Revenue Ruling 94-38, only the facts of TAM 93-15-004 appear to be addressed. It is uncertain whether Revenue Ruling 94-38 would also apply to the facts of TAMs 92-40-004 and 94-11-002. Although some ambiguity was resolved, other uncertainty remains and will continue to linger until the IRS takes definitive steps to clarify these situations. The IRS must establish and express its views on the tax treatment of environmental remediation costs.

In Revenue Ruling 94-38, the IRS was trying to clarify its position in an area of law filled with ambiguity. However, the IRS has added to this confusion by raising new questions. The IRS may have intentionally left these questions unanswered by trying to take a cautious step-by-step approach to provide guidance. In addition, the IRS has left itself some leeway to deal with a potential situation that it wished to distinguish in the future. However, by issuing the limited guidance that it did, the IRS has created the need for the expansion of Revenue Ruling 94-38 to other types of environmental cleanup costs, such as asbestos.

Now, the IRS is in the position of having to extend Revenue Ruling 94-38 further and sooner than it anticipated. The position taken in Revenue Ruling 94-38 is sound. Any future Revenue Ruling must remain consistent with Revenue Rul-

ing 94-38, and its reasoning must extend to depreciative assets, asbestos remediation and encapsulation, and the treatment of pre-purchase pollution cleanup costs when there is no knowledge of the existing pollution at the time of purchase. Failure to take any action will most likely result in taxpayers taking it upon themselves to decide whether they are entitled to a deduction. Since most taxpayers are likely to decide the issue in their own favor, it will be up to the IRS to discover the noncompliance. This will increase audit work and litigation expenses, as taxpayers seek to defend their position in the midst of the IRS's uncertainty. In order to avoid this, the IRS must provide further guidance and attempt once again to clarify its position in a muddled area of the law.