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# THE IRS PLOWS NEW GROUND IN THE TAX TREATMENT OF LAND CLEANUP COSTS

ROY WHITEHEAD,\* PAM SPIKES,\*\* AND BRENDA YELVINGTON\*\*\*

## *I. Introduction*

Owners of real estate are often required to remove hazardous waste from their land because of environmental laws or because of a healthy desire to maintain a clean environment. Further, it is desirable that public policy, as reflected by the Internal Revenue Service's interpretation of the tax code, at least encourage, if not actively provide an incentive to clean up land. One of the issues that, until recently was unsettled, is whether the cleanup costs are currently deductible as ordinary and necessary repair expenses under section 162<sup>1</sup> of the Internal Revenue Code or whether the costs must be treated as a capital expenditure that must be capitalized under section 263<sup>2</sup> of the Code. There are currently few court decisions that provide specific judicial guidance concerning the tax treatment of cleanup costs. After procrastinating for several years the Internal Revenue Service has, however, finally issued a definitive Revenue Ruling concerning the treatment of cleanup costs associated with removal of hazardous wastes from land.<sup>3</sup>

## *II. Capital Expenditure or Ordinary and Necessary Expense*

The distinction between a capital expenditure and one that can be currently deducted is often difficult and must be based on the facts of each particular situation. Section 162(a) of the Internal Revenue Code allows deductions of: "All the ordinary and necessary expenses paid or incurred during the taxable year in carrying out any trade or business."<sup>4</sup>

Even though a particular taxpayer may incur an expense only once in the lifetime of its business, the expense may be justified as ordinary and necessary if it is appropriate in carrying on the business, is commonly incurred, and is not a capital expenditure.<sup>5</sup> Moreover, as the Supreme Court has specifically recognized,

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1. I.R.C. § 162 (1994).

2. *Id.* § 263.

3. Rev. Rul. 94-38, 1994-1 C.B. 35. (Jun. 2, 1994).

4. I.R.C. § 162(a) (1994).

5. *Commissioner v. Tellier*, 383 U.S. 687, 691 (1966). Even when, as in this case, the ordinary and necessary expenses was the cost of hiring a lawyer to represent the defendant against mail fraud charges. The court quoted language from the 1913 Senate debate on the first income tax bill that, "[T]he object

the "decisive distinctions between capital and ordinary expenditures are those of degree and not of kind,"<sup>6</sup> and a careful evaluation of the facts of each case is required.<sup>7</sup> In determining whether current deduction or capitalization is the appropriate tax treatment for any particular expenditure, it is important to consider the extent to which the expenditure will produce a significant future benefit.<sup>8</sup>

In contrast, section 263 of the Code allows no deduction for a capital expenditure — an "amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."<sup>9</sup>

The primary effect of characterizing a payment as either a business expense or a capital expenditure concerns the timing of the taxpayer's cost recovery. While business expenses are currently deductible, a capital expenditure usually is amortized and depreciated over the life of the relevant asset, or, where no specific asset or useful life can be ascertained, is deducted upon dissolution of the enterprise.

Section 1.162-4 of the Regulations dealing with the repairs, states:

The cost of incidental repairs which neither *materially* add to the value of property nor *appreciably* prolong its life but keep it in ordinary efficient operating condition, may be deducted as an expense . . . . Repairs in the nature of replacements, to the extent that they arrest deterioration or appreciably prolong the life of the property, shall be capitalized and depreciated . . . .<sup>10</sup>

Thus, it appears that the two key issues raised by the Regulations that must be examined in connection with any expenditures for cleanup costs are whether the property's life is appreciably prolonged, or whether the value of the property has materially increased as a result of the expenditure. If neither of these conditions is present, and if the expenditure merely restores the property or keeps it in an efficient operating condition, it is a maintenance or repair expense and is therefore deductible.<sup>11</sup>

On the issue of whether an expenditure adds to or increases the value of property, the tax court has ruled that the proper test is to compare the value after the repair has been completed with the value prior to the existence of the condition necessitating the repairs, and not with the value immediately prior to the making of the repair.<sup>12</sup>

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of this bill is to tax a man's net income; that is to say, what he has at the end of the year after deducting from his receipts his expenditures or losses." *Id.*

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

7. *Id.* The Court decided that payment of debts without legal obligation to heighten one's reputation is, rather than being ordinary, to a degree is extraordinary, and disallowed a deduction. *Id.*

8. *Indopco, Inc. v. Commissioner*, 503 U.S. 79, 87 (1992).

9. I.R.S. § 263 (1994).

10. *Treas. Reg. § 1.162-4* (1994).

11. *Plainfield-Union Water Co., v. Commissioner*, 39 T.C. 333, 337 (1962).

12. *Id.*

Concerning the second issue or requirement for an expenditure to be capitalized is whether it appreciably or substantially prolongs the useful life of the property. The Tenth Circuit has indicated that there is no absolute rule requiring the automatic capitalization of every expenditure providing the taxpayer with a benefit enduring for a period in excess of one year.<sup>13</sup>

### III. The IRS and Cleanup Costs

As previously indicated, there appear to be few cases or rulings directly involving land cleanup costs. On February 26, 1992, however, the Supreme Court decided a case that the IRS adopted as analogous to a land cleanup case. In *Indopco, Inc. v. Commissioner*<sup>14</sup>, the Court held that a taxpayer has the burden of showing that costs for investment banking fees and expenses incurred during a friendly acquisition are not capital in nature and deductible as ordinary and necessary business expenses. Citing *Commissioner v. Lincoln Savs. and Loan Ass'n*<sup>15</sup>, the Court set out a five part test to qualify for a deduction under section 162(a) of the Code.<sup>16</sup> The Court stated "an item must (1) 'be paid or incurred during the taxable year,' (2) 'be for carrying on any trade or business,' (3) 'be an expense,' (4) 'be a necessary expense,' (5) 'be an ordinary expense.'"<sup>17</sup> The Court went on to state that the term "necessary" imposes "only the minimum requirement that the expense be appropriate and helpful for the development of the taxpayer's business."<sup>18</sup>

Prior to June, 1994, the IRS had issued two Technical Advice Memorandums (TAMs) on specific cleanup costs that were disappointing to most taxpayers.<sup>19</sup> While the TAMs did not address the broad issue of environmental cleanup costs, they did provide the rationale the IRS initially adopted in determining capitaliza-

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13. *United States v. Wehrl*, 400 F.2d 686, 689 (10th Cir. 1968), where the court stated, [T]his concept [the one-year rule] has received rather wide acceptance, and we are urged to make arbitrary application of it here. We think, however, that it was intended to serve as a *mere guidepost* for the resolution of the ultimate issue, not as an absolute rule requiring the automatic capitalization of every expenditure providing the taxpayer with a benefit enduring for a period in excess of one year.

*Id.* (emphasis added).

14. 503 U.S. 79 (1992). The IRS used the case for two propositions. First, that deductions are exceptions to the norm of capitalization, and secondly, for the proposition that the determination of whether an expenditure is capital requires an inquiry into the duration and extent of the benefits resulting from the expenditure.

15. 403 U.S. 345 (1971) (holding that the creation of a separate and distinct asset may be a sufficient condition for classification as a capital expenditure, not that it is an absolute prerequisite to such classification).

16. *Indopco*, 503 U.S. at 83.

17. *Id.* at 84.

18. *Id.* at 85. The Court went on to say that *Lincoln Savings* stands for the simple proposition that a taxpayer's expenditure that "serves to create or enhance a *separate and distinct* asset should be capitalized." *Id.*

19. Tech. Adv. Mem. 92-40004 (June 29, 1992); Tech. Adv. Mem. 93-15004 (Dec. 17, 1992).

tion versus current deductibility issues.<sup>20</sup> On June 2, 1994, the IRS issued Revenue Ruling 94-38 relating to the tax treatment of certain hazardous waste land cleanup costs.<sup>21</sup> The IRS's position outlined in the revenue ruling represents a complete reversal on some of the issues from the IRS's previous holdings in the TAMs.<sup>22</sup>

In order to fully understand the implications of Revenue Ruling 94-38 and the IRS's significant departure from its previous position on deductibility of cleanup costs, the specific facts of the TAMs and the basis for the IRS's holdings are discussed below. Some of the problems with the IRS's rationale in the TAMs are also presented. Finally, Revenue Ruling 94-38 is summarized.

Relying on the *Indopco* case, the IRS first released a TAM concerning the costs to remove and replace asbestos insulation in manufacturing equipment.<sup>23</sup> While the TAM did not specifically address environmental land cleanup costs, it did state that the cost of removal and replacement of asbestos in equipment was in the nature of a capital expenditure because, by eliminating the human health risks, the expenditures increased the value of the taxpayer's equipment and made the property more marketable.<sup>24</sup>

In a second TAM, released in February 1993, the IRS revisited the capitalization of cleanup costs in the context of the cleanup of land.<sup>25</sup> Although the TAMs do not specifically address the broad issue of environmental cleanup costs for all situations, they certainly provide the taxpayer with the rationale the Service had adopted in determining capitalization versus current deductibility issues.

In the second TAM the taxpayer used a synthetic lubricant in some of its equipment before 1972 which contained PCBs. The taxpayer was notified of the PCB contamination in 1972 by the manufacturer and ceased to use the lubricant. The company, however, was faced with the task of disposing of the waste generated from the routine maintenance of the equipment. The waste was placed into numerous earthen pits and trenches on its property.

Subsequently, consistent with its regulatory authority, the EPA required the company to perform tests to determine the extent to which soil near the pits were contaminated with PCBs. During this process, it was revealed that the soil was contaminated. The EPA filed a complaint alleging that PCBs had been illegally disposed of by the taxpayer. The company and the EPA then reached an agreement that requires the company to initiate a cleanup program.

In the TAM, the costs anticipated being incurred by the company (relevant to this paper) include the following: (1) Soil and groundwater assessment to determine the level and location of PCB contaminated sites; and (2) Soil

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20. Tech. Adv. Mem. 92-40004 (June 29, 1992); Tech. Adv. Mem. 93-15004 (Dec. 17, 1992).

21. Rev. Rul. 94-38. 1994-1 C.B. 35 (June 2, 1994).

22. Tech. Adv. Mem. 92-40004 (June 29, 1992); Tech. Adv. Mem. 93-15004 (Dec. 17, 1992).

23. Tech. Adv. Mem. 92-40004 (June 29, 1992).

24. *Id.*

25. Tech. Adv. Mem. 93-15004 (Dec. 17, 1992).

remediation that includes the excavation and transportation of PCB-contaminated soil and backfilling.

The cleanup program is expected to take several years and cost millions of dollars. In addition, although the specific figure is not known, the total projected cleanup costs represented a significant percentage of the book cost of the taxpayer's system.

The taxpayer argued that all of the environmental cleanup costs are deductible as ordinary and necessary business expenses under section 162 and fall under the definition of "repairs."<sup>26</sup> The company also argued that the costs are not for the acquisition of an asset and only provide needed information about contaminated sites in order to undertake remedial actions. Finally, the taxpayer reasoned that because the costs were incurred to correct activities undertaken in the past, rather than provide a future benefit, the amounts should be deducted currently.

The IRS rejected the company's position that the cleanup costs were ordinary and necessary business expenses under section 162.<sup>27</sup> Specifically, the IRS outlined the four conditions that must be met under section 1.162-4 for a repair cost to be taken as a deduction.<sup>28</sup> The four conditions require that: 1) the repair is incidental;<sup>29</sup> 2) the repair does not materially add to the value of the property;<sup>30</sup> 3) the repair does not appreciably prolong the useful life of the property;<sup>31</sup> and 4) the purpose of the expenditure is to keep the property in ordinarily efficient operating condition.<sup>32</sup> The IRS concluded that the taxpayer failed to meet conditions one, two, and four.<sup>33</sup>

Relying on *Wolfsen Land & Cattle, Co. v. Commissioner*,<sup>34</sup> the IRS stated that the "costs of the cleanup project are more appropriately classified as capital expenditures than as maintenance or repair charges."<sup>35</sup> In *Wolfsen*, the taxpayer incurred the costs of draglining ditches in a farm irrigation system to clear them of sediment in order to keep the ditches functioning (i.e., to keep water flowing). The ditches were cleaned out every 10 years rather than every year. The court held that draglining the ditches constituted a systematic plan that had a significant impact on the value of the irrigation system and thus, should be capitalized.<sup>36</sup> In other words, the draglining materially increased the value of the property.

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26. Treas. Reg. § 1.162-4 (1994). Section 1.162-4 allows deductions of repair costs when the repair is incidental, the cost of the repair does not materially add to the value of the property, the repair does not appreciably prolong the life of the property, and the purpose of the expenditure is to keep the property in ordinary operating condition. *Id.*

27. I.R.C. § 162 (1994).

28. Treas. Reg. § 1.162-4 (1994).

29. *Id.*

30. *Id.*

31. *Id.*

32. *Id.*

33. Tech. Adv. Mem. 93-15004 (Dec. 17, 1992).

34. 72 T.C. 1 (1979).

35. Tech. Adv. Mem. 93-15004 (Dec. 17, 1992).

36. *Wolfsen Land & Cattle v. Commissioner*, 72 T.C. 1, 21, (1979).

In the TAM, the IRS found the taxpayer's situation to be similar to *Wolfsen*, in three ways.<sup>37</sup> First, the taxpayer chose to do an extensive cleanup project rather than annual waste identification and disposal.<sup>38</sup> The fact that the company was unaware that its method of disposal would require cleanup in the future was considered irrelevant to the proper characterization of the cleanup costs. Second, in both *Wolfsen* and the present TAM, the costs were undertaken as part of a systematic plan.<sup>39</sup> Third, based on *Wolfsen*, the taxpayer's property will be more valuable in its business after the cleanup of the PCB residues.<sup>40</sup>

As in the first TAM issued in 1992, the IRS rejected the test used by the Tax Court for determining whether an expenditure increased the value of the property.<sup>41</sup> In *Plainfield-Union Water Co. v. Commissioner*,<sup>42</sup> the tax court devised a test for determining whether an expenditure increases the value of the property thus triggering a requirement to capitalize cleanup costs. The court stated that the property's value after the expenditure must be compared to its value prior to the existence of the condition necessitating the expenditure in order to determine if its value was enhanced.<sup>43</sup>

The IRS distinguished the *Plainfield-Union* test by concluding that the cleanup operations were non-essential repairs; that the cleanup operations did materially add to the value of the property; and that the purpose of the expenditures was not to keep the property in ordinary efficient operating condition, but to effectuate a general restoration of the property which should be treated as an addition to the capital investment.<sup>44</sup>

#### *IV. Ingenious but Inappropriate*

The reliance on the *Indopco* and *Wolfsen* cases was ingenious but inappropriate for several reasons. First, recall that the tax court in *Plainfield-Union*, held that the proper test is to compare the value after the repair has been completed with the value prior to the existence of conditions necessitating the repairs, not with the value immediately prior to the making of the repair.<sup>45</sup> Cleanup costs for hazardous wastes, one should contend, restore the land to its condition and value prior to the existence of the condition necessitating the repairs and not to the value immediately prior to commencing the cleanup. In other words, the cleanup merely restores the land to its original value prior to its contamination. Unlike manufac-

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37. Tech. Adv. Mem. § 93-15004 (Dec. 17, 1992).

38. *Id.*

39. *Id.*

40. *Id.*

41. Tech. Adv. Mem. § 92-40004 (June 29, 1992).

42. 39 T.C. 333, 337 (1962). In *Plainfield-Union* the court decided that the expenditures to clean and restore a water main to its original water carrying capacity merely restored the asset to its original condition and did not create a new or separate asset. *Id.*

43. *Id.* at 340.

44. Tech. Adv. Mem. § 92-40004 (June 29, 1992).

45. *Plainfield-Union Water Co.*, 39 T.C. at 337.

turing equipment in the first TAM, the value of land prior to its contamination and its value after cleanup can be objectively determined by real estate appraisals.

Second, concerning the issue of whether the cleanup appreciably or substantially prolongs the useful life of the property, there is no absolute rule requiring the automatic capitalization of every expenditure providing the taxpayer with a benefit enduring for a period in excess of one year. Given that the cleanup only restores the property to its original condition, it follows that the taxpayer has not actually received a benefit enduring for a period in excess of one year because the property owner only has regained the asset he originally possessed. Finally, even if the cleanup is considered to be a benefit prolonging the life of the property, the *Wehrli* case indicates that there is no absolute rule requiring an automatic capitalization of every expenditure providing the taxpayer with a benefit enduring for a period in excess of one year and that the question is one of fact for the court.<sup>46</sup> The one year rule discussion in the case was merely a guidepost rather than an absolute rule.

Third, from a public policy perspective, the Internal Revenue Service's position creates a very practical disincentive that will result in the avoidance or delay of the cleanup of land. Given the position of the current national administration on environmental policy, landowners can expect greater opportunities to make contributions in the area of cleanup costs and should be encouraged to make those contributions voluntarily. Fourth, the IRS position that the property is somehow made more valuable because of the cleanup cannot be objectively supported. The more rational position is that the land is no more valuable than it would have been had not the hazardous waste condition occurred. The logical test, supported by the *Plainfield-Union* case, is to compare the value after the cleanup with the value prior to the existence of the condition necessitating the cleanup.<sup>47</sup>

Fifth, the costs associated with cleanup costs should be considered as "ordinary and necessary expenses," deductible under section 162(a) because they are necessitated by governmental and environmental policy.<sup>48</sup> The purpose of the cost is to properly utilize the land and protect the public rather than to create a more valuable asset.

Sixth, the cleanup costs should be capitalized only if they produce a new and distinct stream of income that could not have been generated by the real estate in its condition prior to the existence of the condition necessitating the cleanup.

Finally, there is a striking analogy between environmental cleanup costs and the tax treatment of land reclamation costs in the mining context. Costs incurred to reclaim mining land are clearly deductible under tax court decisions.<sup>49</sup> After all,

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46. *United States v. Wehrli*, 400 F.2d 686 (10th Cir. 1968).

47. *Plainfield-Union Water Co.*, 39 T.C. at 341.

48. For example, to comply with the requirements of the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), 42 U.S.C.A. §§ 9601-9675 (West. Supp. 1995).

49. *Ohio River Collieries Co. v. Commissioner*, 77 T.C. 1369 (1981), allowed a deduction for the costs of reclamation of land that had been strip-mined relying in part on the fact that government regulations required the expenditure.

the cleanup is a mere mending of the property rather than an addition to its value for its highest and best use.<sup>50</sup>

### V. The IRS Plows New Ground

There were numerous flaws in the IRS's arguments that supported its position concerning capitalization of cleanup costs. It appears that the IRS has, at least in part, corrected its approach to land cleanup costs in Revenue Ruling 94-38.<sup>51</sup>

The facts outlined in Revenue Ruling 94-38 are very similar to the facts present in the second TAM. The taxpayer was faced with the need to conduct a soil and groundwater assessment and conduct soil remediation including excavation and removal of contaminated soil.

In Revenue Ruling 94-38, the taxpayer was an accrual basis corporation that operated a manufacturing plant purchased in 1970. Due to manufacturing operations, hazardous waste was discharged, and the taxpayer buried the waste on portions of its land. In 1993, to comply with federal, state, and local environmental requirements, the taxpayer undertook soil and groundwater remediation procedures and established a system for the continued monitoring of the groundwater to ensure the remediation had removed all hazardous waste. The taxpayer also began constructing groundwater treatment facilities to extract, treat, and monitor contaminated groundwater.

An important fact stipulated in the revenue ruling is that "the effect of the soil remediation and groundwater treatment will be to restore (the taxpayer's) land to essentially the same physical condition that existed prior to the contamination."<sup>52</sup> This was the exact situation outlined in the second TAM where the IRS concluded that the costs should be capitalized.<sup>53</sup> The IRS's holding in the revenue ruling, however, is completely opposite, and appears to remove the economic disincentives of the previous position.

Based on the circumstances presented in the revenue ruling, the IRS concluded that the costs incurred to cleanup land and to treat groundwater, that a taxpayer contaminated with hazardous waste from its business, are deductible by the taxpayer as ordinary and necessary business expenses under Internal Revenue Code

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50. *Wehrli*, 400 F.2d at 689, characterizes a "repair" as an expenditure to restore to a sound state or mend one which keeps the property in an ordinary efficient operating condition and does not add to the value of the property nor appreciably prolong its life. The court also states that whether the life of the asset is prolonged is a question of fact. *Id.*

51. Rev. Rul. 94-38, 1994-1 C.B. 35 (June 2, 1994). The ruling specifically stated that the expenditures incurred by the taxpayer represented necessary and ordinary expenses within the scope of § 162 of the code. I.R.C. § 162 (1994). The cleanup of the land did not produce permanent benefits to the taxpayer within the scope of §263 of the code. *Id.* § 263. The ruling cites, and appears to adopt, the holding of *Plainfield-Union* at least to the extent that the cleanup did not increase the value of the land when compared to its value in its original condition. *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333, 340 (1962).

52. Rev. Rul. 94-38, 1994-1 C.B. 35 (June 2, 1994).

53. Tech. Adv. Mem. 93-15004 (Dec. 17, 1992).

(IRC) section 162.<sup>54</sup> The costs attributable to the construction of groundwater treatment facilities are capital expenditures under section 263(a) of the Code.<sup>55</sup>

In the revenue ruling, the IRS first stated that the IRC "generally endeavors to match expenses with the revenues of the taxable period to which the expenses are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes."<sup>56</sup> In addition, relying on *Indopco*, the IRS acknowledged that in determining whether expenditures may be currently deductible or capitalized, it is important to consider the extent to which the expenditure will produce significant future benefits.<sup>57</sup>

Applying the above points to the taxpayer's situation, the IRS held that the soil remediation expenditures and ongoing groundwater treatment expenditures "do not produce permanent improvements to [the taxpayer's] land within the scope of IRC Sec. 263(a)(1) or otherwise provide significant future benefits."<sup>58</sup> Furthermore, the ruling concluded that the appropriate test for determining whether the expenditures increase the value of property is the test outlined in *Plainfield-Union*.<sup>59</sup> In evaluating the potential increase in value to the taxpayer's land due to the soil remediation costs, the IRS concluded that the taxpayer "merely restored its soil and groundwater to their approximate condition before they were contaminated by [its] manufacturing operations."<sup>60</sup>

In the ruling, the IRS also supports the current deduction for the soil remediation expenditures and ongoing groundwater treatment expenditures by indicating that the costs are not subject to capitalization under IRC section 263(a)(2) because the contamination was not present when the property was acquired. Deductions were also justified because the land was not subject to an allowance for depreciation, amortization, or depletion.<sup>61</sup> Finally, the IRS concluded that the expenditures (other than the costs attributable to the construction of facilities) are "appropriate and helpful in carrying on [the taxpayer's] business and are commonly and frequently required in [the taxpayer's] type of business."<sup>62</sup>

As expected, the IRS concluded that the groundwater treatment facilities constructed by the taxpayer have a useful life beyond the taxable year in which they are constructed.<sup>63</sup> Consequently, these costs are capital expenditures under IRC section 263(a).<sup>64</sup> In addition, the taxpayer is required to capitalize the direct

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54. I.R.C. § 162 (1994).

55. *Id.* § 263(a).

56. Rev. Rul. 94-38, 1994-1 C.B. 35. (Jun. 2, 1994).

57. *Id.*

58. *Id.*

59. *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333, 341 (1962).

60. Rev. Rul. 94-38, 1994-1 C.B. 35. (Jun. 2, 1994).

61. *Id.*

62. *Id.*

63. *Id.*

64. I.R.C. § 263(a) (1994).

costs and a proper share of allocable indirect costs of constructing these facilities under IRC section 263A.<sup>65</sup>

### *Conclusion*

The change in position of the IRS on cleanup costs has corrected the economic disincentive present in its former position. Taxpayers (at least taxpayers in similar circumstances discussed in this article) who voluntarily comply with environmental laws may now currently deduct their expenses. The IRS' decision to correct the economic disincentives created by its position in the previous TAMS is good public policy for both the taxpayers involved and the general public.

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65. *Id.*