IRS Clarifies Federal Tax Treatment of Environmental Remediation Costs

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The costs to remediate contaminated property can be substantial, and although over the years improved remediation technology and risk-based cleanup programs have resulted in more cost-effective cleanups, remediation costs can still approach millions of dollars. The Treasury Department and IRS recently issued two rulings clarifying the federal income tax treatment of environmental remediation costs. One ruling, Rev. Rul. 2004-18, 2004-8 I.R.B. (Feb. 6, 2004), reviewed whether remediation costs incurred in a current year may be deducted or capitalized. The other ruling, Rev. Rul. 2004-17, 2004-7 I.R.B. (Feb. 6, 2004), also examined how a taxpayer should treat remediation costs incurred in a current year to address past contamination.

Rev. Rul. 2004-18

In Rev. Rul. 2004-18 the IRS was asked whether environmental remediation costs associated with a taxpayer’s manufacturing facility were properly treated as an inventory cost. As an inventory cost, the taxpayer must capitalize the environmental remediation costs by including the costs among inventory costs rather than a deduction from gross income. The specific example used by the IRS in its revenue ruling analysis involved a manufacturing facility where property became contaminated in the ordinary course of business operations during the manufacture of inventory. Remedial activities were undertaken in response to the contamination and costs were incurred to cleanup contaminated soil and groundwater.

The IRS found that the costs to remediate the property used in the taxpayer’s manufacturing operations were incurred as a result of production activities. Accordingly, the IRS concluded that the remediation costs must be capitalized and included in inventory costs under IRC Section 263A. Prior to this ruling, a taxpayer may have expensed the environmental remediation costs and deducted such amounts from gross income.

The recent ruling of the IRS makes it clear that expensing such costs in the current year is improper under the tax code. However, taxpayers who may not have been capitalizing remediation costs should be mindful that, under the “transition rule,” the IRS will not challenge the prior treatment of remediation costs as deductible expenses in a tax year ending before February 7, 2004. Taxpayers should also be aware that changing their method of accounting to conform with this revenue ruling results in a change in accounting method. As a result, a taxpayer would be required to file Form 3115, Application For Change In Accounting Method, with the IRS National Office and attach a copy to a timely filed federal income tax return.

Rev. Rul. 2004-17

In a related revenue ruling the IRS looked at two situations to determine whether remediation costs incurred in a current taxable year could be properly deducted as related to restoration or repayment of an item previously included in gross income. The first situation involved a taxpayer who used the accrual method of
accounting and historically disposed of on-site hazardous wastes generated during production from 1950-1979. The taxpayer accounted for these waste disposal costs as a deductible business expense. With the advent of environmental statutes and regulations in the early 1980s, the taxpayer incurred remediation costs associated with the removal and proper disposal off-site of the hazardous wastes. The second situation was the same as the first with the exception that the taxpayer accounted for waste disposal costs as a production cost in calculating its inventory costs for all years.

The IRS concluded that the remediation costs the taxpayer incurred did not qualify as deductible expenses for the year in which the environmental contamination occurred. The IRS found that the payment of environmental remediation costs did not restore or repay to a later taxable year any portion of the proceeds received from the sale of products produced by the taxpayer’s manufacturing operations from 1950 through 1979. Therefore, the IRS determined that, under the two scenarios described in Revenue Ruling 2004-17, environmental remediation costs incurred in a current taxable year did not qualify as a deduction but should be capitalized as part of inventory costs for the current year.

**What This Means**

For manufacturing businesses involved in the remediation of soil and groundwater contamination resulting from prior or ongoing operations, these revenue rulings mean:

- Any costs incurred to clean up land that a manufacturer contaminated with hazardous waste must be capitalized and included in inventory costs under IRC Section 263A.

**Example:** Company X manufactures products that it sells to wholesalers and, in the process, creates hazardous waste. On February 8, 2004, Company X incurred a cost of $100,000 for remediation of the hazardous waste. Pursuant to the recently issued rulings, Company X is no longer entitled to deduct the $100,000 as a business expense. Instead, the $100,000 is included in its inventory costs (e.g., costs of goods sold). As a result, Company X will effectively be entitled to deduct the costs from its income only when the inventory is sold.

- Any costs incurred in the current year to remediate past environmental contamination must be capitalized in the taxpayer’s inventory costs in the current year.

**Example:** When Company X began its business in 1980, Company X buried the hazardous waste generated by the manufacturing activities in its own landfill in accordance with then applicable environmental laws. Since that time, the laws have changed and on February 10, 2004, Company X incurred $200,000 remediation costs which included removing the hazardous waste. Under the recently issued rulings, Company X may not deduct the $200,000 as a business expense from its 1980 gross income under the “claim-of-right” doctrine. Instead, since the expense was incurred in the 2004 tax year, Company X is required to capitalize the $200,000 in the cost of inventory for the 2004 tax year. (Note: Had the expense been incurred before February 7, 2004, Company X would qualify for transition relief and would be entitled to deduct the $200,000 from its 2004 tax year income.)