26 CFR 1.263A–1: Uniform capitalization of costs. (Also § 162.)

Treatment of environmental remediation expenses under section 263A. This ruling holds that amounts incurred to clean up land that a taxpayer contaminated with hazardous waste by the operation of a manufacturing plant must be included in inventory costs under section 263A of the Code. Rev. Ruls. 94–38 and 98–25 clarified. Rev. Proc. 2002–9 modified and amplified.

Rev. Rul. 2004–18

ISSUE

Are costs incurred to clean up land that a taxpayer contaminated with hazardous waste by the operation of the taxpayer's manufacturing plant includible in inventory costs under § 263A of the Internal Revenue Code?

FACTS

X, a corporation using an accrual method of accounting, owns and operates a manufacturing plant that produces property that is inventory in *X*'s hands. *X*'s manufacturing operations discharge hazardous waste. In the past, *X* buried this waste on portions of *X*'s land. The land was not contaminated by hazardous waste when purchased by *X*.

In order to comply with applicable federal, state, and local environmental requirements, *X* incurs costs (within the meaning of § 461(h)) to remediate the soil and groundwater that had been contaminated by the hazardous waste, and to establish an appropriate system for the continued monitoring of the groundwater to ensure that the remediation removes all hazardous waste. The costs *X* incurs are not research and experimental expenditures within the meaning of § 174 or environmental management policy costs. The soil remediation and groundwater treatment restores *X*'s land to essentially the same physical condition that existed prior to the contamination. During and after the remediation and treatment, *X* continues to use the land and operate the plant in the same manner as *X* did prior to the cleanup except that *X* disposes of any hazardous waste in compliance with environmental requirements.

LAW

Section 263A(a) provides that the direct costs and indirect costs properly allocable to property that is inventory in the hands of the taxpayer shall be included in inventory costs.

Section 1.263A–1(a)(3)(ii) of the Income Tax Regulations provides, in part, that taxpayers that produce tangible personal property must capitalize (1) all direct costs of producing the property, and (2) the property's allocable share of indirect costs.

Section 1.263A–1(e)(3)(i) provides, in part, that indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production activities. Cost recovery, production facility repair and maintenance costs, and scrap and spoilage costs, such as waste removal costs, are examples of indirect costs that must be capitalized to the extent the costs are properly allocable to produced property. See § 1.263A–1(e)(3)(ii) (I), (O) and (Q).

Section 1.263A–1(e)(4)(iv)(I) provides that costs incurred for environmental management policy generally are not allocated to production or resale activities (except to the extent that the costs of any system or procedure benefit a particular production or resale activity).

Section 1.263A–1(c)(2)(ii) provides that the amount of any cost required to be capitalized under § 263A may not be included in inventory or charged to capital account or basis before the taxable year during which the amount is incurred within the meaning of § 1.446–1(c)(1)(ii). Pursuant to § 461(h), in determining whether an accrual method taxpayer has incurred an amount for any item during the taxable year, the all events test shall not be treated as met any earlier than when economic performance occurs.

Section 1.263A–2(a)(3)(i) provides that any cost required to be capitalized by § 263A must be capitalized regardless of whether the cost was incurred before, during, or after production.

Rev. Rul. 94–38, 1994–1 C.B. 35, analyzes whether costs incurred to clean up land and to treat groundwater that a taxpayer contaminated with hazardous waste from the taxpayer's manufacturing business are capital expenditures. The ruling holds that the costs to clean up land used in the taxpayer's manufacturing process and to treat groundwater are not capital expenditures because these costs do not prolong the useful life of the land or adapt the land to a new or different use. Therefore, costs incurred to clean up land and to treat groundwater that a taxpayer contaminated with hazardous waste from the taxpayer's business are deductible by the taxpayer as business expenses under § 162. Costs properly allocable to constructing groundwater treatment facilities, however, are capital expenditures under § 263.

Rev. Rul. 98–25, 1998–1 C.B. 998, holds that costs incurred to replace underground storage tanks containing waste by-products under the circumstances in the ruling are not capital expenditures under § 263, but are ordinary and necessary expenses under § 162.

ANALYSIS

The discussion in Rev. Rul. 94–38 of *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333 (1962), *nonacq.*, 1964–2 C.B. 8, demonstrates that the revenue ruling was intended to address whether the costs to clean up the land and to treat the groundwater are capital expenditures that must be capitalized into the basis of the land under § 263(a) or whether the costs are ordinary and necessary repair expenses under § 162. Rev. Rul. 94–38 does not address the treatment of these costs as inventory costs under § 263A. Similarly, Rev. Rul. 98–25 does not address whether amounts incurred to

replace underground storage tanks must be included in inventory costs under § 263A.

The holding of Rev. Rul. 94–38 that the costs to construct a groundwater treatment facility must be capitalized under §§ 263(a) and 263A rather than deducted under § 162 demonstrates the distinction between capital expenditures and costs that are more in the nature of repairs than capital improvements. As with other types of deductible business costs, such as labor costs, taxes, rent, and supplies, once repair costs are determined to be deductible under § 162, a taxpayer with inventories must still apply the rules of § 263A to determine whether the repair costs must be included in inventory. Section 1.263A–1(e)(3). In addition, if repair costs must be capitalized under §§ 263(a) and 263A to a depreciable asset, a taxpayer with inventories must still apply the rules of §§ 263A to determine whether the depreciation expense must be included in inventory. Section 1.263A–1(e)(3)(ii)(I).

In this situation, *X* incurs environmental remediation costs to clean up land that was contaminated as part of the ordinary business operations of *X*'s manufacturing of inventory. *X*'s environmental remediation costs are incurred by reason of *X*'s production activities within the meaning of § 1.263A–1(e)(3)(i). The costs are properly allocable to property produced by *X* that is inventory in *X*'s hands under § 1.263A–1(e)(3)(i). Accordingly, *X* must capitalize the otherwise deductible environmental remediation costs by including the costs in inventory costs in accordance with § 1.263A–1(c)(3). Similarly, costs incurred to replace underground storage tanks and depreciation cost recoveries of the groundwater treatment facility must be included in inventory costs to the extent properly allocable to inventory.

HOLDING

Environmental remediation costs are subject to capitalization under § 263A. Therefore, costs incurred (within the meaning of § 461(h) and § 1.263A–1(c)(2)(ii)) to clean up land that a taxpayer contaminated with hazardous waste by the operation of the taxpayer's manufacturing plant must be included in inventory costs under § 263A.

TRANSITION RULE

This paragraph applies to costs that would have been properly deducted in the taxable year but for the requirement to capitalize the costs to inventory under § 263A, and for which the taxpayer's method of accounting was to deduct the costs. The Internal Revenue Service will not challenge the treatment of environmental remediation costs to which this paragraph applies as deductible expenses rather than as costs properly capitalized to inventory under § 263A in any taxable year ending on or before February 6, 2004. Therefore, the treatment of environmental remediation costs to which this paragraph applies as amounts properly capitalized to inventory under § 263A will not be raised as an issue in any taxable year ending on or before February 6, 2004, and, if the treatment of such environmental remediation costs as deductible expenses rather than as amounts properly capitalized to inventory under § 263A has already been raised as an issue in examination or before Appeals or the Tax Court in a taxable year ending on or before February 6, 2004, the issue will not be further pursued. The Service will not impose penalties on taxpayers or preparers for treating environmental remediation costs to which this paragraph applies as deductible expenses rather than as costs properly capitalized to inventory under § 263A in taxable years ending on or before February 6, 2004.

CHANGE IN METHOD OF ACCOUNTING

A taxpayer using a method of accounting that does not comply with this revenue ruling is using an impermissible method of accounting. Any change in a taxpayer's treatment of environmental remediation costs to conform with this revenue ruling is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply. A taxpayer changing its method of accounting to comply with this revenue ruling must file a Form 3115 in accordance with the automatic change in method of accounting provisions of Rev. Proc. 2002–9, 2002–1 C.B. 327, as amplified, clarified and modified by Rev. Proc. 2002–54, 2002–2 C.B. 432, and Rev. Proc. 2002–19, 2002–1 C.B. 696, with the following modifications: (1) the scope limitations in section 4.02 of Rev. Proc. 2002–9 do not apply to a taxpayer that wants to make the change for its first taxable year ending after February 6, 2004; and (2) a taxpayer that files a Form 3115 in accordance with this revenue ruling to make the change in method of accounting for its first taxable year ending after February 6, 2004, may effect the change using either a § 481(a) adjustment as provided in sections 5.03 and 5.04 of Rev. Proc. 2002–9 or a cut-off method. For purposes of Line 1a of Form 3115 (revised December 2003), the designated number for the automatic accounting method change authorized by this revenue ruling is "77." A taxpayer making the automatic change in method of accounting authorized by this revenue ruling and another automatic change in method of accounting under § 263A for the same taxable year may file one Form 3115 to make both changes, but must comply with the ordering rules of § 1.263A–7(b)(2) and must enter the automatic accounting method change numbers for both changes on Line 1a of Form 3115 (revised December 2003).

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 98–25 and Rev. Rul. 94–38 are clarified by providing that the otherwise deductible amounts at issue in Rev. Rul. 98–25 and Rev. Rul. 94–38 are subject to capitalization to inventory under § 263A.

Rev. Proc. 2002–9 is modified and amplified to include in the APPENDIX the automatic change provided in this revenue ruling.

DRAFTING INFORMATION

The principal author of this revenue ruling is John Moriarty of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue ruling, contact Mr. Moriarty at 202–622–4930 (not a toll-free call).