Internal Revenue Service

Number: **200108029**
Release Date: 2/23/2001
Index Numbers: 61.28-03;162.26-00;
263.03-00;

Department of the Treasury

Washington, DC 20224

Person to Contact:

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Refer Reply To:
CC:ITA:5-PLR-104652-00
Date:
November 24, 2000

Legend

Taxpayers	=
Owner 1	=
Owner 2	=
Seller	=
Lessee	=
Parcel 1	=
Parcel 2	=
Parcel 3	=
State	=
City 1	=
City 2	=
River	=
Contractor 1	=
Contractor 2	=
Contractor 3	=
Contractor 4	=
Contractor 5	=
Consultant 1	=
Consultant 2	=
Consultant 3	=
Terrain	=
Method	=
a	=
b	=
c	=
d	=
e	=
f	=
g	=
h	=

i =
j =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Year 6 =
Year 7 =
Year 8 =
Year 9 =
Year 10 =
Year 11 =
Year 12 =
Year 13 =
Year 14 =
Year 15 =
Year 16 =

Dear :

This letter ruling is in response to Taxpayers' ruling request dated January 12, 2000 under Rev. Proc. 98-17, 1998-1 C.B. 405. The facts are as follows:

FACTS

In Year 1, Owner 1 and Owner 2 purchased property from Seller know as parcels #2 and #3. A commercial building was built on parcel #2, in which the upper floor was used for laundry and shower facilities. In mid-decade, a dry cleaning machine was installed in the same upper floor area, which used a chemical known as perchloroethylene ("PCE") to clean clothes.

In Year 2, Owner 1 and Owner 2 acquired another parcel of property known as Parcel #1, which was adjacent to Parcels #2 and #3. Parcel #1 was not usable at the time of purchase, since the land was too low and consisted of Terrain. However, in mid-Year 3, fill material was spread along Parcel #1, making it usable for equipment parking and storage of oil used for dust control, and empty PCE tanks.

In the winter of Years 4-5, an employee of Owners 1 and 2 attempted to distill some quantity of PCE, which proved unsuccessful, because the chemical was scorched and therefore unusable. Also, while doing this process, the employee learned that when PCE was allowed to remain out of doors, water and contaminates would rise to the top and freeze. Upon learning this, the employee removed the frozen mass from

the top of the stored PCE and put it on the ground. The Taxpayers were unaware of the employee's attempt to distill the PCE prior to their purchase of the property.

Taxpayers purchased Parcel #1 in Year 6. At that time the property contained mobile home spaces, RV spaces with no utilities, a laundry and a drycleaners. Taxpayers purchased additional properties in Year 7, and opened a mobile home and RV sales operation.

In Year 8, the Taxpayers replaced the dry cleaning machine with a new machine that did not require changing the PCE, rather it only required adding more chemical when the level dropped according to use. In the same year, the Taxpayers contracted to dispose of the old machine, and all barrels in the storage area except those containing used motor oil. In Year 9, the drycleaning facility was closed and the existing machine was moved to an equipment storage shed that had been constructed by the Taxpayers behind the laundry and drycleaning building. The machine could not be drained, and the tank containing the chemical remained sealed.

In June, Year 10, the State Department of Environmental Conservation ("DEC") investigated a complaint concerning the barrel storage area. An investigation by personnel from the DEC revealed that one barrel had a small hole on its rim, but it appeared as though nothing had leaked since the barrel was full. All other barrels were found to be secure, and the Taxpayers contracted to remove the defective barrel.

Also in June, Year 10, a fire destroyed the equipment storage shed, and damaged the drycleaning machine wiring. No chemicals were released from the sealed chemical tank of the drycleaning machine. The DEC ordered the Taxpayers to dispose of the drycleaning machine and its contents. Taxpayers hired Contractor 1 to remove the PCE from the machine and to make the machine acceptable for disposal.

In Year 11, the DEC ordered the Taxpayers to test the soil on Parcel #1. The Taxpayers hired Tester 1, who tested soil samples from test holes on Parcel #1. On location tested 27 parts per million of PCE. The DEC then required Taxpayers to address remediation of soil contamination, which Taxpayers did by hiring Contractor 2. It was determined that Method was the most effective and cost efficient method to remediate the soil, and the Taxpayers purchased an air blower and remediation by the Method commenced in April, Year 12.

In May, Year 12, while installing water and sewer lines across Parcel #1, the DEC required the Taxpayers to test the soil from excavated ditches. High concentrations of PCE were detected, and the DEC declared the Taxpayers to be under EPA – RCRA laws and regulations. The Taxpayers subsequently contacted the EPA, and the EPA determined that the Taxpayers did not fall under RCRA because the Taxpayers were not generators of hazardous waste. This ruling allowed the Taxpayers to remediate the soil on site.

The Taxpayers began land farming the soil using Hydrosol and a rototiller, while some of the soils excavated in the water and sewer ditches were placed in lined storage cells approved by the DEC. Project Manager 1 was hired as the project manager to oversee the remediation. The DEC required the Taxpayers to do a site assessment, and the Taxpayers hired Consultant 1 to perform such assessment. The site assessment plan prepared by Consultant 1 was approved by DEC in December, Year 12.

In November, Year 12, the Taxpayers hired Project Manager 2 as the project manager. Consultant 1 informed Project Manager 2 that the site assessment plan written by Consultant 1 and approved by the DEC was only the start, and more assessment would be required by DEC.

The Taxpayers contracted with Contractor 3 and Contractor 4 to develop a comprehensive site assessment plan to satisfy the DEC. The Taxpayers hoped to avoid costly multiple plans and efforts in the field work of soil assessment.

While the comprehensive site assessment plan was being developed, the DEC informed the Taxpayers that the Taxpayers had to implement the Consultant 1 plan by December 20, Year 12, otherwise the DEC would take over the cleanup and all costs would be charged to the Taxpayers. In order to avoid the takeover, Project Manager 2 and a representative from Contractor 4 flew to City 1 on January 18, Year 12 to meet with DEC director of contaminated sites. The parties reached an agreement whereby the Taxpayers would submit for DEC approval a site assessment plan that would be at a minimum equal or more comprehensive than the previous Consultant 1 plan, and the Taxpayers would enter into a consent decree with the DEC specifying certain work and time lines.

A site assessment plan developed by Contractor 4 was finally approved on February 26, Year 13. Project Manager 2 had begun to implement such plan at the site on February 25. This site assessment was completed in March, Year 13. That same month, the DEC withdrew from their agreement made in City 1, on December 18, Year 12, refused to enter into a consent decree, and filed a lawsuit against the Taxpayers for being owners of a contaminated property and owing costs for oversight to the DEC. The DEC also made the Taxpayers perform a river bank sediment study to determine the contamination in the River and the possible effects on aquatic life.

In April, Year 13, the DEC insisted upon four ground monitoring wells. When the DEC used one of their own contractors to perform a river bank sediment assessment in May of the same year, the sample showed a very small trace amount of PCE.

Also in May, Year 13, Consultant 2 submitted a ground water assessment plan on behalf of the Taxpayers. The DEC informed the Taxpayers in June, Year 13 that this plan was not approved, and that the DEC would overtake this phase and charge

the costs to the Taxpayers. The Taxpayers, Attorney, Project Manager 2, and Contractor 4 met with the DEC that same month in City 2 to discuss the ground water conditions at the cleanup site. No agreement was reached. After two subsequent meetings, an agreement was reached in June, Year 13 whereby the DEC took control of all environmental assessment and cleanup work, with the costs being charged to the Taxpayers. The DEC took charge of the site in June, Year 13. The DEC and its contractor, Contractor 5, conducted a sampling of water in the storm sewer manholes on the opposite side of the highway bordering Parcel #1. A very small detectable trace of PCE was found in the last manhole nearest the river and also at the storm sewer outfall on the river bank. The Taxpayers and the DEC disagree as to the source of this PCE, since other sources nearby are known to exist.

Also in June, Year 13, the DEC filed criminal charges against Lessee for releasing hazardous waste on Parcel #1 while he leased the property from the Taxpayers.

In July, Year 13, the DEC and Contractor 5 obtained a court order through a local magistrate to install monitoring wells for ground water on Parcel #1 and an area where the State Department of Transportation owned a right of way. A small trace of PCE was found in several of the wells. A dispute still exists between the DEC and the Taxpayers as to whether this small trace amount of PCE is in ground water (by regulatory definition) or surface water moving through fill material soil.

In August, Year 13, the EPA and the Taxpayers signed an Administrative Order of Consent, which allowed the Taxpayers to excavate and remediate RCRA class soil contamination on site. In September, Year 13, the EPA approved the Taxpayers' soil extraction plan, developed by Consultant 3. The plan provided that the contaminated soil would be removed and sorted through the winter in lined cells. Treatment of the soil would begin in spring of Year 14. The Taxpayers implemented this plan in September, Year 13, and all soil containing 1ppm or more of PCE was removed by October, Year 13.

The Taxpayers incurred costs for consultants, testing, supplies and equipment, labor, and legal fees. The Taxpayers originally expensed the costs on their tax returns for the Years 12 through and including 14. The environmental costs that were expensed on original income tax returns are as follows:

Year 12	$a
Year 13	$b
Year 14	$c

Costs incurred for year 15, but not yet expensed total $d, and costs incurred but not yet paid total $e. For Years 16 and subsequent, the Taxpayers estimate costs as being between $f and g.

At the start of Year 12, no insurance recovery was anticipated and the extent of the problem had not been anticipated. Consequently, Taxpayers elected to expense the costs as paid. The first insurance recovery, in the amount of $h, was not received until Year 14, with an additional negotiated insurance settlement in the amount of $i received in Year 15. The settlement was received in satisfaction of the Taxpayers' claims that they were entitled to insurance coverage under specified insurance policies for "defense, costs, expenses, supplemental payments ..., and damages incurred in connection with "Environmental Claims arising in connection with the Site."[1] See page 2 of the Settlement Agreement. Section 1.7 of the Settlement Agreement defines "Environmental Claims as

> [A]ny and all **CLAIMS** against the **TAXPAYERS**, whether based on the **TAXPAYERS'** alleged acts or omissions or status as a generator, user, disposer, owner/operator, or transporter, arising out of or as a consequence of actual, alleged, threatened or potential pollution, contamination or any other injurious environmental condition and/or the release ... discharge, dispersal, escape, leaching, or exposure to any actual or alleged injurious, toxic or noxious substance, including without limitation any hazardous substance as defined in State statutes and in 42 U.S.C. § 9601, smoke, vapors, soot, fumes, acids, alkalis, toxic chemicals, petroleum substances and derivates, liquids or gases, waste materials or other irritants, contaminants, or pollutants, of whatsoever nature, and shall include any such **CLAIMS** involving actual, alleged, threatened or potential **PROPERTY DAMAGE** (including alleged damage or injury to groundwater and other natural resources), **BODILY INJURY, PERSONAL INJURY, ADVERTISING LIABILITY**, and claims to recover cleanup or remediation costs, including costs incurred and sums expended for attorneys' fees and defense costs, investigation, removal, distribution, remediation, treatment or containment, whether incurred by the **TAXPAYERS** or others. This definition includes **CLAIMS** arising out of any materials sold by the **TAXPAYERS** for salvage, scrap, recycling, or disposal.

RULINGS REQUESTED

1) Whether the costs incurred by the Taxpayers to clean up land and treat contaminated groundwater are capitalizable under § 263?

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[1] The Settlement Agreement defines the "Site" as the property on which the Parcel 1 is located, including all structures on the property, all surface and subsurface soils on the property, and any all groundwaters and/or aquifers below and in the proximity of the property, and the adjacent River.

2) Whether insurance proceeds received by the Taxpayers are treated as a reduction of basis and taxable only if their basis in the land is reduced below zero?

RULING ONE -- LAW AND ANALYSIS

Section 162 allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 1.162-4 of the Income Tax Regulations allows a deduction for the cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its useful life, but keep it in an ordinarily efficient operating condition.

Section 263(a) provides that no deduction is allowed for any amount paid out for permanent improvements or betterments made to increase the value of any property or for any amount expended in restoring property or for making good the exhaustion thereof for which an allowance is or has been made.

Section 1.263(a)-1(b) of the regulations provides that capital expenditures include amounts paid or incurred to (1) add value, or substantially prolong the useful life of property owned by the taxpayer, or (2) adapt the property to a new or different use.

Section 1.263(a)-2(a) of the regulations provides that capital expenditures include the costs of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

During the course of the cleanup, the Taxpayers incurred costs for consultants, testing, supplies and equipment, labor, and associated legal fees. Although the Taxpayers previously expensed some environmental costs on their federal tax returns for prior years, now the Taxpayers wish to capitalize all costs incurred for the cleanup, including those costs previously expensed.

Based on the facts provided to us, the Taxpayers must capitalize costs incurred with the cleanup, including those costs previously expensed. In this context, the appropriate test for determining whether expenditures increase the value of the 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. See Rev. Rul. 94-38, 1994-1 C.B. 35, citing Plainfield Union Water Co. v. Commissioner, 39 T.C. 333, 338 (1962), nonacq. on other grounds, 1964-2 C.B. 8.

In Rev. Rul. 94-38, the taxpayer had purchased uncontaminated property, upon which it built a manufacturing facility which discharged hazardous waste. This waste was buried on the taxpayer's property. After 23 years of manufacturing, the taxpayer undertook to clean up the property in order to comply with federal, state, and local

environmental requirements. The cleanup involved soil remediation and groundwater treatment, including the installation of groundwater treatment facilities. The effects of the cleanup were to restore the land essentially to the same physical condition that existed prior to the contamination.

The revenue ruling held that the costs to remediate the soil and groundwater contamination were deductible as ordinary and necessary business expenses, while the costs of constructing the groundwater treatment facilities were capitalizable. The groundwater treatment facilities were capitalizable because they had a value that extended substantially beyond the taxable year in which they were constructed. However, the other costs to remediate the soil and groundwater were deductible because the taxpayer did not increase the value of the land, but merely restored the land to the condition it was in before the taxpayer's operations contaminated it.

This situation is different from the situation in Rev. Rul. 94-38, where the Taxpayers were allowed a deduction for some of the cleanup expenditures. In the present case, the Taxpayers represent that they acquired the property in a contaminated state. Therefore, the expenditures for the remediation operations increased the value of the land, by improving the land from a contaminated state to a remediated state. Thus, Taxpayers must capitalize the costs incurred to clean up their land and treat contaminated groundwater.

RULING TWO – LAW AND ANALYSIS

The Taxpayers also request a ruling that the insurance proceeds they receive reduce their basis in the property and result in gross income only to the extent those proceeds exceed their basis in the property.[2]

Section 61 provides that, except as otherwise provided in subtitle A of the Code, a taxpayer must include in gross income "all income from whatever source derived."

In determining whether damages received in a settlement agreement are includible in gross income, the proper inquiry is "in lieu of what were the damages awarded." Raytheon Production Co. v. Commissioner, 144 F.2d 110 (1st Cir. 1944), aff'g 1 T.C. 952 (1943), cert. denied, 323 U.S. 779 (1944). All facts, including the allegations contained in the taxpayer's complaint, the evidence presented and the arguments made in the court proceeding, and the intent of the payor, must be considered in determining in lieu of what were the damages awarded.

[2] The Taxpayers do not request a ruling concerning, and we do not address, the tax consequences to them, if any, of the State's expenditure of up to $j for environmental cleanup costs of the property.

As in other types of tort damage suits, recoveries that represent a reimbursement for lost profits are income. The reasoning is that because the profits would be taxable income, the proceeds of litigation which are their substitute are taxable in like manner. Raytheon at 113. See also Estate of Longino v. Commissioner, 32 T.C. 904 (1959) (amount received in settlement of a claim for damages to a cotton crop caused by the use of an insecticide is taxable); Rev. Rul. 73-161, 1973-1 C.B. 366 (lump sum compensation for damages of every kind caused by construction of a pipeline easement across taxpayer's farmland is includible in income because the payment was for expected loss of future rental income.)

In contrast, if the suit is not to recover lost profits but is for injury to good will or other assets, the recovery represents a return of capital. Raytheon at 113. Generally, an amount received for injury to good will is included in gross income only to the extent that it exceeds the taxpayer's basis in the good will. See Collins v. Commissioner, T.C.M. 1959-174 (amounts received by a partnership for anticipated damage to leases on oyster beds from the laying of pipelines across such beds were allocated between anticipated damage to oyster beds and anticipated destruction of oysters. Payments for the former represented a recovery of capital and payments for the latter represented a recovery of lost profits.)

In Rev. Rul. 81-277, 1981-2 C.B. 14, M agreed to construct a nuclear power plant for P at a set price of 250x dollars. M agreed to provide, at no additional cost to P, any items later determined to be necessary to deliver a plant that met all safety requirements. Stricter environmental requirements were imposed during the construction period, and a dispute arose as to M's obligations. M paid P 40x dollars, the estimated cost to complete the plant, and was released from its construction obligations. The revenue ruling holds that the 40x dollar payment to P was a return of capital, reducing P's basis in the plant.

In this case, the insurance proceeds (including those received under the Settlement Agreement) that the Taxpayers received are a return of capital as in Rev. Rul. 81-277. The amount of proceeds the Taxpayers received in excess of their basis in Parcel 1, if any, is in includible in their gross income under the analysis provided in Raytheon.

In Raytheon the court found that the taxpayer received damages in an antitrust suit that represented compensation for the destruction of good will. In holding that compensation for the loss of good will in excess of Raytheon's basis is gross income the court explained:

> But to say that the recovery represents a return of capital in that it takes the place of the business good will is not to conclude that it may not contain a taxable benefit. Although the injured party may not be deriving a profit as a result of the damage suit itself, any conversion thereby of his

> property into cash is a realization of any gain made over the cost or other basis of the good will prior to the illegal interference. Thus A buys Blackacre for $5,000. It appreciates in value to $50,000. B tortiously destroys it by fire. A sues and recovers $50,000 tort damages from B. Although no gain was derived by A from the suit, his prior gain due to the appreciation in value in Blackacre is realized when it is turned into cash by the money damages.

Raytheon at 114.

Therefore, the Taxpayers should reduce their basis in the Parcel 1 by $h in Year 14 and $i in Year 15, reflecting the amount of insurance proceeds they received in those years. If the amount of the insurance proceeds they received in Year 14 or Year 15 exceeded their basis in the Parcel 1 in those years, they must include such excess amounts in gross income in the years such amounts were received. The Taxpayers' have represented that "that by the end of the year Year 15 the costs will have exceeded the insurance recovery." If the insurance proceeds the Taxpayers received in Year 15 exceeds their basis in the Parcel 1, they would still be required to include such amounts in income in Year 15, even if those proceeds are used in Year 16 to pay for additional cleanup costs.

* * * * *

Accordingly, we rule as follows:

1) The costs incurred by the Taxpayers to clean up land and treat contaminated groundwater are capitalizable under § 263.

2) Insurance proceeds received by the Taxpayers are treated as a reduction of basis and taxable only if their basis in the land is reduced below zero.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,
Associate Chief Counsel
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Senior Technician Reviewer, CC:ITA:5