LegalNews
Environmental Law Update

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BROWNFIELDS NEWS OF 2007

BROWNFIELDS TAX INCENTIVE: EXPENSING CLEANUP COSTS

There is a fundamental difference between traditional development and developing a Brownfield or even lesser contaminated property - Brownfield redevelopment starts with land that may actually have substantial negative value when taking into consideration the cost of environmental remediation and demolition of obsolete structures. That difference translates into real world cost accounting strategies that begin at the acquisition of a property and extend through the long term operation of the development.

Where Brownfields Meet The IRS.

The stage was set for accounting issues to hit the world of Brownfields when, through a series of IRS rulings, culminating in 1994, the government determined that:

- if you spend money to clean up land which you own and that became contaminated when you owned it, you are repairing the land and can deduct the expense.
- if you clean up land that you acquire after it was contaminated, and you know or should have known it was contaminated, you are making an improvement to the land and your costs must be capitalized, rather than deducted.

For more information on the matters discussed in this **Legal News: Environmental Law Update** please contact one of the following Foley & Lardner LLP professionals, or the member of the firm who normally handles your legal matters.

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It seemed almost perverse that if you wanted to acquire and clean up a Brownfield, you would be in a worse off position than if you had caused the contamination in the first place. So in 1997, Congress created the Brownfields Tax Incentive, Section 198 of the Tax Code. The incentive was expanded in 2000, but it sunset on December 31, 2005.

On December 20, 2006, President Bush signed the Tax Relief and Health Care Act of 2006, including an amendment to Section 198 of the Tax Code which:

- extends the Brownfields Tax Incentive until December 31, 2007.
- expands the types of sites eligible for expensing to include those contaminated with petroleum, as well as other hazardous substances.

- applies the extension and expansion retroactively to December 31, 2005, so cleanup costs incurred in 2006 are eligible.

Does the tax incentive work, and is there a real benefit?

In most circumstances, it goes without saying that a deduction is better than capitalizing an expense – if for no other reason than to capture the time value of money and to hedge against changes in rules or interpretations. Additionally, in a world where partners and investors may come and go out of a joint venture or ownership entity, there may be perceived value in being able to deduct costs at the front end. Of course, the difference between deducting and capitalizing is less stark if the objective is to develop and promptly sell.

In any development, accounting for extraordinary and potentially ongoing environmental costs as repairs, versus improvements, can have very real impacts. For instance, the environmental remedy may call for two feet of clean fill material. This cost, if eligible to be treated as a repair may be deductible, even if the fill feature can then be conveniently integrated into the site design. Likewise, concrete, asphalt and other forms of "hardscaping" can serve to encapsulate contamination and prevent groundwater infiltration, but also be integrated into the design for a housing component.

The tax treatment of ongoing cleanup costs, such as groundwater monitoring or maintenance of engineered barriers over contaminated materials, as either capital improvements or as repair costs, can influence the decision as to whether certain costs should be passed through to a lessee or a homeowners' association. It may also have an impact on the treatment of any offsetting income received as reimbursement through one of many Brownfields funding sources.

Section 198 of the Tax Code – the Brownfields Tax Incentive

Who qualifies? There must have been a release, or threat of release, of a hazardous substance (now, including petroleum products). You must also receive a certification statement from their state's environmental agency.

What expenses qualify? The category of allowable expenses is potentially very broad. Generally, expenditures for assessment and monitoring of a release (or threat of release), abatement, control or disposal of a hazardous substance, operation and maintenance of remediation systems (such as groundwater monitoring and maintenance of a concrete/asphalt "cap") and removal of demolition debris qualify for the Brownfields Tax Incentive. Expenditures for asbestos abatement which is part of or within a structure do not qualify unless there is a release or a threat of release into the environment outside of the structure.

Using the Brownfields Tax Incentive

In a simple case, a developer agrees to accept a property as-is, incurs costs for removing contaminated soil, installs groundwater monitoring wells and an impermeable barrier (such as a building or parking lot) over the area of contamination.

Subject to the terms of the tax incentive, these costs are deductible, arguably including the cost of installing the parking lot/impermeable barrier. Eligible environmental costs may also include ongoing groundwater monitoring and barrier maintenance and crack repair.

In a slightly more complicated case, a developer negotiates with a seller over cleanup issues. These issues may be made more complex because the buyer's planned residential or recreational use requires cleanup to a higher standard than the industrial use of the seller. In this case, we assume a buyer faces the choice of trying to force a seller to clean up the property to buyer's standards and paying the asking price, or offering to reduce the purchase price by the amount it will cost for the clean it up. So, which is the better deal?

From a liability standpoint, the two deals are very different. To minimize the liability of a buyer, a buyer often requires that the seller clean up a property to standards set before the buyer assumes title. However, in the case of property redevelopment it may be most efficient if the cleanup can be completed in conjunction with the final development, which demands a certain degree of cooperation or risk allocation. Liability issues themselves are very complex and may drive a deal.

From a cost standpoint, a seller cleanup may present a very different financial deal compared to a buyer cleanup with price adjustment. In a grossly oversimplified example, assume a $740,000 property requiring $240,000 in environmental investigation and cleanup costs and no depreciable improvements.

- If the seller spends $240,000 to clean up contamination, the seller will be able to deduct the cleanup cost. In effect, the seller will be taxed on net income of $500,000. Assuming the Seller is in the 33% tax bracket, the seller's cost of cleanup is effectively reduced $80,000 as a result of the deduction.
- If the buyer negotiates a purchase price reduction to $500,000 and then spends $240,000 on cleanup, the seller is still taxed on a net income of $500,000 and the seller's tax liability is still $80,000 less than if the sale had been at the higher price. On the other hand, assuming the Brownfields Tax Incentive is not in place, the buyer will be forced to capitalize its costs and the basis of the property will be $740,000 for purposes of depreciation.
- Using the Brownfields Tax Incentive, the buyer negotiates a purchase price reduction to $500,000 and then spends $240,000 on cleanup. The seller is still taxed on a net income of $500,000. However, the buyer can make use of the $240,000 deduction to offset against other current income or carry forward as net operating losses. The buyer will likely also be able to control the quality and timing of the cleanup. This scenario may also be the most favorable for both minimizing real estate transfer taxes and keeping the assessed value low.

The typical deal is inevitably made more complex. For instance, the parties may agree to an escrow, rather than a pure price reduction. If the buyer intends to implement the work, there may be advantages to a combination of purchase price reduction to reflect the cost of certain work, and an escrow to reflect the uncertain costs.

Making Matters Complex - The Unusual Usual World Of Brownfields

A true Brownfield is characterized by extraordinary costs to prepare land for redevelopment as a result of past uses, where the costs far exceed the intrinsic value of the property. Unless there is a solvent responsible party that will pay for these costs, true Brownfields will not be redeveloped without some form of public subsidy or deal enhancement.

Another significant trait of Brownfields is that even simple environmental cleanups often involve two or more years of groundwater monitoring and paved surfaces or caps that require periodic maintenance. These future costs are sometimes difficult to quantify.

This hypothetical effectively illustrates the accounting issues. A buyer is evaluating a beautiful, but tax delinquent, lakefront property. Due diligence discloses a pit containing arsenic, tars and other wastes – permeating the soil and groundwater. The buyer faces a potential cleanup cost of $2.0 million. In order to make the transaction economically viable, the buyer secures a combination of grants, tax incentives, lien waivers and Tax Increment Financing to cover the majority of the costs. The eventual development includes a combination of nondepreciable improvements and depreciable buildings and features. Based upon the initial investigation and extent of contamination, the buyer secures a temporary reduction in the assessed value which lowers carrying costs and creates more increment for Tax Increment Financing.

Brownfield specific funding is available because the buyer did not cause the contamination. Some programs are geographically or economically targeted and some, such as new market tax incentives, are not available to specific uses. Only a very few state or federal brownfield grant or tax credit programs are available to a party that caused contamination.

It is also relevant to note that costs are often expected to extend out over a period of several years – long after facility operations may be taken over by a manager/operator or a new owner. Also state and federal funding programs often operate on a reimbursement basis (where the income may be realized in a different year than the costs), so on its face, the transactions look like a combination of costs attributable to the redevelopment of the property and income to offset these costs.

Two approaches to accounting for costs. Two scenarios are presented for purposes of considering tax consequences. From the onset of the transaction, it is important to clarify that the buyer is not obligated to complete the transaction without the funding and that, in turn, funding was conditioned upon completion of the project. Thus, the government subsidies become part and parcel of the purchase.

The first approach is the "part and parcel" scenario. Under this approach, costs associated with the cleanup are added to the basis in the property, which are then reduced to the extent of corresponding government reimbursements. Upon the sale of the asset, the land is taxed at the lower capital gain rate, while the gain would be treated as recapture income or as capital gain depending upon the extent of depreciation, including buildings and other depreciable assets. There appears to be a basic fairness to this approach since the final basis in the property reflects what a developer would pay for the property and the developer is not penalized for the subsidies required to overcome the upside-down economics of a Brownfield transaction.

The second approach regards the government subsidies as income, but assumes an election under Section 198 of the Code to deduct the qualified environmental costs. One consideration in this scenario is that few state tax laws recognize or parallel Section 198 treatment. Under this scenario, neither the expenses nor the reimbursements affect the basis in the property. When the property is sold, the gain not in excess of the deductible expenses would be treated as ordinary income; any gain in excess of that amount would be taxed at the lower capital gain rate. Again gain on depreciable assets would be treated as recapture income or as capital gain, depending upon the extent of depreciation.

The relative merit of each approach depends in large part upon the extent of costs eligible for Section 198 treatment and the extent of costs reimbursed through grants and subsidies. Also, some of the issues addressed represent untested waters with respect to IRS interpretations and rulings. Under any circumstance, these tax and accounting considerations are best considered at the onset of a transaction, in order to create the most defensible position and maintain consistency in approach. And of course, every Brownfield deal poses its own unique set of issues.