DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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The Honorable Mary L. Landrieu
United States Senate
Washington, D.C. 20510-1804

Attention: Herman Gesser III

Dear Senator Landrieu:

I apologize for the delay in responding to your inquiry dated September 17, 2001, to Mr. Floyd Williams, National Director for Legislative Affairs for the IRS. You wrote about the tax treatment of an [redacted] company's costs of updating its underground storage tanks to conform with Environmental Protection Agency ("EPA") requirements. You asked whether the costs of updating underground storage tanks may be deducted and whether this position reconciles with Rev. Rul. 94-38, 1994-1 C.B. 35.

The IRS has permitted taxpayers to deduct the costs of replacing underground waste storage tanks where the new tanks were filled with waste once, sealed indefinitely, had no salvage value, and had no remaining useful life to the taxpayer. The IRS has required taxpayers to capitalize the costs of replacing underground gasoline storage tanks where such tanks constituted the acquisition of an asset that had useful life to the taxpayer substantially beyond the taxable year. In either situation, the conclusions are consistent with Rev. Rul. 94-38, which requires taxpayers to capitalize costs allocable to the construction of groundwater treatment facilities because they had a useful life substantially beyond the year in which they were constructed. I hope the following information helps explain our position.

The deductibility of costs incurred in connection with the updating of underground storage tanks is determined under §§ 162 and 263 of the Internal Revenue Code (the Code). In general, a taxpayer can deduct all the ordinary and necessary business expenses paid or incurred during the taxable year in carrying on a trade or business. (Section 162 of the Code). However, no deduction is allowed for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property. (Section 263 of the Code). Capital expenditures include amounts that add to the value or substantially prolong useful life of property owned by the taxpayer, or amounts that adapt property to a new or different use. Capital expenditures also include the cost 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.

In Rev. Rul. 94-38, 1994-1 C.B. 35 (copy enclosed), the IRS concluded that the costs of cleaning up land and treating groundwater that a taxpayer contaminated with hazardous wastes from its business can be deducted because they did not add value to the land, prolong the land's useful life, or adapt the land to a new or different use. The IRS also concluded that costs of constructing groundwater treatment facilities must be capitalized because these assets had a useful life substantially beyond the end of the taxable year in which they were constructed. This revenue ruling did not address the costs of updating underground storage tanks.

In Rev. Rul. 98-25, 1998-1 C.B. 998 (copy enclosed), the IRS specifically addressed the costs of updating underground waste storage tanks. Under the facts of this ruling, the taxpayer produced waste by-products in the course of its manufacturing operations, and placed these by-products in underground storage tanks, which it buried on its land. In a later year, the taxpayer incurred costs to remove the old tanks and replace them with new tanks made with materials that complied with current federal, state, and local environmental laws. The IRS held that the costs of acquiring and installing the updated storage tanks within one taxable year as well as the costs of removing, cleaning, and disposing of the old storage tanks were deductible as ordinary and necessary business expenses. In reaching this conclusion, the IRS noted that, unlike most storage tanks, which are used to hold a substance temporarily and are emptied and refilled repeatedly throughout their lives, the taxpayer's new tanks were filled with waste once, sealed indefinitely, and had no salvage value. Therefore, the IRS concluded that, upon being filled and sealed, the new underground storage tanks had no remaining useful life to the taxpayer. As a result, the cost of the tanks did not constitute capital expenditures. Moreover, the new storage tanks were distinguished from the groundwater treatment facilities required to be capitalized under Rev. Rul. 94-38 because those treatment facilities were useful to the taxpayer substantially beyond the taxable year.

The IRS also addressed the costs of updating underground storage tanks in its document, dated January 9, 1998, titled, "Coordinated Issue, Petroleum Industry, Replacement of Underground Storage Tanks at Retail Gasoline Stations" ("coordinated issue paper"). I have enclosed a copy of this coordinated issue paper. Under the facts of this coordinated issue paper, the taxpayer marketed gasoline at owned or leased retail locations, which contained gasoline pumps connected by pipes to underground gasoline storage tanks. The coordinated issue paper addressed the treatment of costs incurred to remove and dispose of leaking underground gasoline storage tanks, to replace them with tanks that comply with EPA requirements, and to clean up any contamination that may have occurred. The paper concluded that the costs to remove and replace the underground storage tanks must be capitalized. The paper reasoned that these costs were incurred for the acquisition of a new asset that had a useful life substantially beyond the taxable year. On the other hand, the paper held that the taxpayer could deduct the costs of disposing of the old tanks and the costs of cleaning up contamination that occurred during the course of the taxpayer's business operations.

The IRS's treatment of the costs allocable to the new underground gasoline storage tanks in the coordinated issue paper is consistent with conclusions in Rev. Rul. 98-25 and Rev. Rul. 94-38. Unlike Rev. Rul. 98-25, which involved waste storage tanks that were filled with waste once, sealed indefinitely, and had no remaining useful life to the taxpayer, the coordinated issue paper addressed new gasoline storage tanks, which will be emptied and refilled repeatedly throughout their useful lives. Thus, the taxpayer in the coordinated issue paper acquired property that it continued to use substantially beyond the end of the taxable year. Similarly, in Rev. Rul. 94-38, the taxpayer incurred costs to construct groundwater treatment facilities that had a useful life substantially beyond the end of the taxable year. In both situations, the IRS required the taxpayer to capitalize the costs allocable to the acquisition of the new property.

I hope this information will help you in responding to your constituent. If I can be of further assistance, please contact me at (202) 622-4800 or of my office at (202) 622-4950.

Sincerely,

Heather C. Maloy
Associate Chief Counsel
Income Tax and Accounting

Enclosures (3)