

Part I

Section 263A Capitalization and Inclusion in Inventory Costs of Certain Expenses

26 CFR 1.263A-1: Uniform capitalization of costs.

Rev. Rul. 2005-42

ISSUE

Are environmental remediation costs incurred to clean up land that a taxpayer contaminated with hazardous waste by the operation of the taxpayer's manufacturing activities properly allocable under § 263A of the Internal Revenue Code to the inventory produced during the taxable year the costs are incurred?

FACTS

Situation 1. *N*, a corporation using an accrual method of accounting, owns land and operates a manufacturing plant on Site *X* that *N* uses to produce stoves. Stoves are the only property produced by *N* and are inventory in *N*'s hands. *N*'s manufacturing activities discharge hazardous waste. In the past, *N* buried this waste on portions of Site *X* in accordance with then applicable law. Site *X* was not contaminated by hazardous waste when purchased by *N*.

In order to comply with federal, state, and local environmental requirements, *N* incurs costs in 2005 to remediate the contaminated soil and groundwater at Site *X*. The costs *N* incurs are not research and experimental expenditures within the meaning of

§ 174, qualified environmental remediation expenditures within the meaning of § 198(b), or environmental management policy costs. The soil remediation and groundwater treatment restores Site X to essentially the same physical condition that existed prior to the contamination. The soil remediation and groundwater treatment does not materially add to the value of Site X, appreciably prolong its life, or adapt it to a new or different use. During and after the remediation, N continues to manufacture stoves at Site X.

Situation 2. The facts are the same as in *Situation 1*, except that N manufactures clothes washers at Site X and no longer manufactures stoves. Clothes washers are the only property produced by N and are inventory in N's hands.

Situation 3. The facts are the same as in *Situation 1*, except that N temporarily ceases its manufacturing activities at Site X during a part of 2005 while it remediates the contaminated soil and groundwater.

Situation 4. The facts are the same as in *Situation 1*, except that N has permanently ceased its manufacturing activities at Site X and manufactures stoves at another site.

Situation 5. The facts are the same as in *Situation 1*, except that in the past N buried the waste on portions of Site Y, a remote dump site that N did not own or otherwise use in its manufacturing activities. N was not obligated to clean up the site when N buried the waste. In order to comply with federal, state, and local environmental requirements, N incurs costs in 2005 to remediate the contaminated soil and groundwater at Site Y. The soil remediation and groundwater treatment restores Site Y to essentially the same physical condition that existed prior to the contamination. The soil remediation and groundwater treatment does not materially add to the value of any of N's property, appreciably prolong its life, or adapt it to a new or different use.

During and after the remediation, *N* continues to manufacture stoves at Site X, but has permanently stopped using Site Y to bury waste.

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 are 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 properly allocable share of indirect costs.

Section 1.263A-1(c)(1) provides that to determine these capitalizable costs, taxpayers must allocate or apportion costs to various activities, including production activities. Section 1.263A-1(c)(1) further provides that after § 263A costs are allocated to the appropriate production activities, these costs generally are allocated to the items of property produced during the taxable year and capitalized to the items that remain on hand at the end of the taxable year. As a result, costs incurred during the taxable year are either included in the cost of goods sold during the taxable year or are capitalized to the items that remain on hand at the end of the taxable year using a method permitted under § 1.263A-1(f).

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 accounts or basis any earlier than the taxable year during which the amount is incurred within the meaning of § 1.446-1(c)(1)(ii).

Section 1.263A-1(c)(3) provides that capitalize means, in the case of property that is inventory in the hands of a taxpayer, to include in inventory costs.

Section 1.263A-1(c)(4) provides that costs that are capitalized under § 263A are recovered through depreciation, amortization, cost of goods sold, or by an adjustment to basis at the time the property is used, sold, placed in service, or otherwise disposed of by the taxpayer.

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. Generally, producers must capitalize direct and indirect costs properly allocable to property produced under § 263A, without regard to whether those costs are incurred before, during, or after production. See § 1.263A-2(a)(3)(i).

Section 1.263A-1(e)(3)(ii) provides examples of indirect costs that must be capitalized to the extent they are properly allocable to property produced. Indirect costs required to be capitalized include the costs of repairing and maintaining production equipment or facilities. See § 1.263A-1(e)(3)(ii)(O). In addition, costs related to temporarily idle production equipment or facilities, other than depreciation, amortization and cost recovery allowances, are indirect costs that are required to be capitalized. See § 1.263A-1(e)(3)(iii)(E).

Rev. Rul. 94-38, 1994-1 C.B. 35, holds that costs incurred to clean up land and to treat groundwater contaminated with hazardous waste from the taxpayer's business are not capital expenditures under § 263 because these costs do not materially add value to the land, prolong the useful life of the land or adapt the land to a new or different use and, therefore, such costs are deductible by the taxpayer as business expenses under § 162. Costs incurred for constructing groundwater treatment facilities, however, are

capital expenditures under § 263.

Rev. Rul. 2004-18, 2004-1 C.B. 509, considers whether costs incurred to clean up land that a taxpayer contaminated with hazardous waste by the operation of the taxpayer's manufacturing activities are includible in inventory costs under § 263A. Rev. Rul. 2004-18 states that 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 still must apply the rules of § 263A to determine whether the repair costs must be included in inventory. Rev. Rul. 2004-18 concludes, therefore, that environmental remediation costs similarly are subject to capitalization under § 263A and are required to be included in inventory costs under the facts of that ruling.

ANALYSIS

Environmental remediation costs incurred to clean up land and to treat groundwater that a taxpayer contaminated with hazardous waste from its production activities do not materially add to the value of the land, appreciably prolong its life, or adapt it to a new or different use. Rev. Rul. 94-38. Thus, these costs are more in the nature of repairs than capital improvements and, under § 263A, are indirect costs that must be included in inventory costs to the extent allocable to inventory. Rev. Rul. 2004-18. Generally, repair costs incurred to keep equipment or facilities used in production activities in an ordinarily efficient operating condition directly benefit or are incurred by reason of the

performance of the production activities and, therefore, are properly allocable to inventory, without regard to whether those costs are incurred before, during, or after production. See §§ 1.263A-1(e)(3)(i), 1.263A-1(e)(3)(ii)(O) and 1.263A-2(a)(3)(i). Under §§ 1.263A-1(c)(1) and 1.263A-1(c)(2), these repair costs are allocable to the property produced during the taxable year in which the costs are incurred, even though the repairs may have been necessitated by the use of the equipment or facilities in the production of property in prior taxable periods.

Like repair costs, environmental remediation costs incurred by a taxpayer to clean up land and to treat groundwater that the taxpayer contaminated with hazardous waste from its production activities are costs that directly benefit or are incurred by reason of the performance of the production activities even if the condition that necessitated the remediation arose during prior taxable periods. See § 1.263A-2(a)(3)(i). As with repair costs, environmental remediation costs are properly allocable to inventory without regard to whether those costs are incurred before, during, or after production. See § 1.263A-1(c)(2). Likewise, remediation costs are allocable under § 1.263A-1(c)(1) to the property produced during the taxable year in which the costs are incurred.

In *Situation 1*, during 2005, *N* manufactures stoves at Site *X*. The costs *N* incurs in 2005 to clean up Site *X* are incurred by reason of *N*'s production activities, within the meaning of § 1.263A-1(e)(3)(i). Because the environmental remediation costs to clean up Site *X* are incurred in 2005, they are properly allocable to the inventory produced by *N* in 2005, in accordance with §§ 1.263A-1(c)(1) and 1.263A-1(c)(2). Therefore, the environmental remediation costs are allocable to the stoves produced by *N* during 2005, using an allocation method permitted under § 1.263A-1(f).

In *Situation 2*, during 2005, *N* manufactures clothes washers at Site *X*. The costs *N* incurs in 2005 to clean up Site *X* are incurred by reason of *N*'s production activities, within the meaning of § 1.263A-1(e)(3)(i). Because the environmental remediation costs to clean up Site *X* are incurred in 2005, they are properly allocable to the inventory produced by *N* in 2005, in accordance with §§ 1.263A-1(c)(1) and 1.263A-1(c)(2). Therefore, the environmental remediation costs are allocable to the clothes washers produced by *N* during 2005, using an allocation method permitted under § 1.263A-1(f).

In *Situation 3*, during a part of 2005, Site *X* is temporarily idle. Nevertheless, the costs *N* incurs in 2005 to clean up Site *X* are incurred by reason of *N*'s production activities, within the meaning of § 1.263A-1(e)(3)(i). See § 1.263A-2(a)(3)(i). Because the environmental remediation costs to clean up Site *X* are incurred in 2005, they are properly allocable to the inventory produced by *N* in 2005, in accordance with §§ 1.263A-1(c)(1) and 1.263A-1(c)(2). Therefore, the environmental remediation costs are allocable to the stoves produced by *N* during 2005, using an allocation method permitted under § 1.263A-1(f).

In *Situation 4*, *N* has permanently ceased its manufacturing activities at Site *X*. Nevertheless, the costs *N* incurs in 2005 to clean up Site *X* are incurred by reason of *N*'s production activities, within the meaning of § 1.263A-1(e)(3)(i). See § 1.263A-2(a)(3)(i). Because the environmental remediation costs to clean up Site *X* are incurred in 2005, they are properly allocable to the inventory produced by *N* in 2005, in accordance with §§ 1.263A-1(c)(1) and 1.263A-1(c)(2). Therefore, the environmental remediation costs are allocable to the stoves produced by *N* during 2005, using an

allocation method permitted under § 1.263A-1(f).

In *Situation 5*, *N* has permanently ceased burying waste from its manufacturing activities on Site *Y*. Nevertheless, the costs *N* incurs in 2005 to clean up Site *Y* are incurred by reason of *N*'s production activities, within the meaning of § 1.263A-1(e)(3)(i). See § 1.263A-2(a)(3)(i). Because the environmental remediation costs to clean up Site *Y* are incurred in 2005, they are properly allocable to the inventory produced by *N* in 2005, in accordance with §§ 1.263A-1(c)(1) and 1.263A-1(c)(2). Therefore, the environmental remediation costs are allocable to the stoves produced by *N* during 2005, using an allocation method permitted under § 1.263A-1(f).

HOLDING

Environmental remediation costs that are incurred to clean up land that a taxpayer contaminated with hazardous waste by the operation of the taxpayer's manufacturing activities are incurred by reason of the taxpayer's production activities and are properly allocable under § 263A to the inventory produced during the taxable year the costs are incurred.

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 modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified, clarified, and modified by Rev. Proc. 2002-54, 2002-2 C.B. 432, except that the scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply to a taxpayer that makes the change for its first or second taxable year ending after February 6, 2004. A taxpayer that files Form 3115 to comply with Rev. Rul. 2004-18 and this revenue ruling 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. See Rev. Rul. 2004-18. Additionally, a taxpayer that (1) files a Form 3115 on or before July 20, 2005, to comply with Rev. Rul. 2004-18 for its first taxable year ending after February 6, 2004, or was not required to change its method of accounting to comply with Rev. Rul. 2004-18, and (2) files Form 3115 to comply with this revenue ruling for its first taxable year ending after June 20, 2005, may effect the change using either a § 481(a) adjustment 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 "92." 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. 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 Roman Faron of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue ruling, contact Mr. Faron at 202-622-4930 (not a toll-free call).