New Jersey Law Journal

VOL. CLXXVII – NO. 5 – INDEX 402 AUGUST 2, 2004 ESTABLISHED 1878

CORPORATE LAW

Mirage in the Contaminated Desert

Potential deficiencies of the Brownfields Tax Credit Act

By Peter R. Spirgel and Matthew Azoulay

On Jan. 15, 2004, Gov. McGreevey signed the Brownfields Tax Credit Act into law, establishing a corporation business tax credit for remediation costs of up to 100 percent, subject to certain restrictions, for companies that remediate and redevelop brownfields sites. L.2003, c.296, §1, eff. Jan. 14, 2004, codified at N.J.S.A. 54:10A-5.33, et seq.

Although the act seemed to provide another incentive for New Jersey businesses to clean up and reuse contaminated sites, potential developers should proceed cautiously (if at all), with a full understanding of the potential deficiencies of this program.

Brownfields Tax Credit Act Limitations

Pursuant to N.J.S.A. 54:10A-5.33 et seq., a taxpayer receives a credit against the corporate business tax (CBT) in an amount equal to 100 percent of the eligible costs of the remediation of a contaminated site as certified by the DEP and the Director of the Division of Taxation. The remediation costs must be incurred by the taxpayer during a three-year "privilege period," beginning on or after Jan. 1, 2004, and before Jan. 1, 2007. N.J.S.A. 54:10A-5.33.a. Notwithstanding that a corporation may be entitled to a credit in an amount equal to 100 percent of the eligible remediation costs, the total amount of the CBT credits for any given tax year may not exceed 50 percent of the CBT liability otherwise due, and may not reduce the tax liability to an amount less than the statutory minimum of $500.00.

An important provision of the act provides that the amount of tax year credit otherwise allowable, which cannot be applied for the tax year due to the annual credit limitation, may be carried forward to the next five privilege periods, or tax years. N.J.S.A. 54:10A-5.33.c. This carry-forward component may not be applied to a privilege period during which the taxpayer is merged into or acquired by another company. N.J.S.A. 54:10A-5.33.d. Accordingly, counsel should be mindful of the loss of the credit upon merger or acquisition, and should consider delaying, to the extent practicable (if at all), the remediation expenditures until after such merger or acquisition is complete in order to retain the full benefit of the credit.

In addition to the carry-forward component, under certain circumstances, a taxpayer may be permitted to transfer the CBT credits for use by other corporate taxpayers in the state not affiliated with the taxpayer. N.J.S.A. 54:10A-5.36. For purposes of the Brownfields Tax Credit Act, the test of affiliation is whether the same entity directly or indirectly owns or controls 5 percent or more of the voting rights or 5 percent or more of the value of all classes of stock of both the corporate taxpayer receiving the benefits and a corporate taxpayer that is surrendering the benefits. Id. As of the date of submission of this article, no regulations have been promulgated detailing the CBT credit transfer procedures, or general implementation of the Brownfields Tax Credit Act. Thus, it is extremely difficult to determine whether the transfer program will in practice afford developers and purchasers of remediated brownfields sites additional flexibility when structuring a transaction involving such a site.

Eligibility Requirements

The eligibility requirements set forth in N.J.S.A. 54:10A-5.34 provide broad discretion to the DEP in determining whether remediation costs are deemed eligible and whether the taxpayer is entitled to the CBT credit. For example, before incurring any remediation costs, the taxpayer must negotiate a satisfactory remediation plan with the DEP. This can be an arduous and time-consuming task. The taxpayer must also satisfy the DEP that it has clean hands under the New Jersey Spill Compensation and Control Act (Spill Act). See N.J.S.A. 58:10-23.11.

To be eligible for the CBT credit for remediation costs, the taxpayer must submit a written application to the DEP for review and certification of the eligible costs of the remediation. The DEP will certify the remediation costs provided that: (1) the taxpayer had entered into a memorandum of agreement with the DEP for the remediation of a contaminated site and the taxpayer is in compliance with the memorandum of agreement; (2) the taxpayer is not liable pursuant to the Spill

Spirgel is managing partner of Flaster/Greenberg of Cherry Hill and a member of the firm's Corporate Practice Group. Azoulay is an associate in the firm's Corporate and Real Estate Practice Groups.

Act for the contamination at the site; and (3) the costs of the remediation are actually and reasonably incurred by the taxpayer.

In addition, the taxpayer must establish a high probability that new business activity at the site will generate new and substantial tax revenue for the state. In order to receive the requisite certification from the Director of the Division of Taxation that there is such a probability, the following criteria must be met: (1) the remediated site is located within an area designated by the State Planning Act as a Planning Area 1 (Metropolitan) or Planning Area 2 (Suburban); (2) the subsequent business activity at the remediated site represents new corporation business tax, sales and use tax or gross income tax receipts; (3) there is a high probability that the estimated new tax receipts deriving from the business activity at the remediated site, within a three-year period from the inception of the business activity, will equal or exceed the value of CBT credits issued; and (4) if the business activity at the remediated site is the result of a relocation of an existing business from within the state, the tax credit authorized pursuant to the Brownfields Tax Credit Act will equal the difference in aggregate value of tax receipts from the CBT, the New Jersey Sales and Use Tax (N.J.S.A. 54:32B-1, et seq.), and the Gross Income Tax (N.J.S.A. 54A:1-1, et seq.) generated by the business activity in the privilege period immediately following the business relocation, less the aggregate value of tax receipts generated in the privilege period immediately prior to relocation, up to 100 percent of the eligible costs. If the difference in aggregate value is zero or less, no tax credit may be awarded.

Clearly, the most difficult hurdle with respect to obtaining the requisite certification from the Director of the Division of Taxation is the taxpayer's ability to establish to the satisfaction of the Director of the Division of Taxation that subsequent business activity at the remediated site represents new taxes to the state, and that the amount of the new taxes generated will equal the value of the CBT credit awarded within three years. Based on requirements to obtain the necessary certifications from the DEP and the Division of Taxation, a taxpayer must involve the DEP and the Division of Taxation in all planning aspects of the proposed remediation, including the post-remediation development plans for the site. The failure of the act to provide specific and objective guidelines about the certification process should result, at a minimum, in hesitation before proceeding to remediate and redevelop a brownfields site under the act.

While needing to proceed cautiously to be certain that remediation costs incurred will be reimbursable, a taxpayer considering application of the Brownfields Tax Credit Act is forced to begin the process relatively quickly, as the total amount of the CBT credits issued are capped at $12 million per state fiscal year for the years 2005, 2006 and 2007. N.J.S.A. 54:10A-5.36.b. All applications must be received on or before February 1 of each year.

(Un)Realization of Program Benefits

After analyzing the (limited) details of the Brownfields Tax Credit Act, it is questionable whether the act's benefits will motivate developers facing decisions regarding remediation and redevelopment of brownfields sites. Since the act imposes significant hurdles before it confers any benefits, and because the DEP and the Division of Taxation appear to have broad discretion in granting or denying certification of compliance with the act, it is doubtful that the act will have the desired effect of stimulating companies to undertake meaningful remediation programs. Objective guidelines to help prospective remediators determine if the tax credits will benefit them are not set out in the act.

Federal Tax Treatment

While site remediation based upon New Jersey's tax incentives requires cautious consideration in light of questionable benefits and the need to proceed quickly in order to qualify for CBT credits, federal tax treatment must be examined under a different set of rules and circumstances. Although the number of facilities requiring remediation is projected to dramatically increase, the federal tax treatment of these costs has been the subject of much uncertainty. Specifically, a taxpayer must determine whether remediation expenses are capital expenses or ordinary expenses. Further complicating the tax treatment of remediation expenses is the Internal Revenue Code (IRC) Section 162(f)'s prohibition on the deduction of any fine or similar penalty paid to a government for the violation of any nature. While the availability of state tax credits for remediation costs under the newly enacted Brownfields Tax Credit Act are in large part illusory, structuring remediation efforts to maximize tax benefits to your client can yield tangible benefits.

Capital vs. Ordinary Expense

Section 263 of the IRC provides that a current deduction is not permitted for amounts paid for permanent improvements to increase the value of any property, or amounts incurred to restore property subject to an allowance for depreciation.

Conversely, IRC Section 162(a) allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business…." The regulations promulgated under section 162 permit the cost of "incidental repairs" to be deducted. Incidental repairs are defined as repairs that neither add materially to the value of the property nor appreciably prolong its useful life; but rather keep it in its ordinary efficient operating condition. Treas. Reg. §1.162-4.

The IRS and the courts have identified four factors, which determine whether remediation costs should be deducted or capitalized:

Increase in value. If the remediation activities materially add to the property's value prior to the condition that triggered the expenditures, the expenditures are capital expenditures. See *Oberman Mfg. Co. v. Comm'r*, 47 T.C. 471 (1967). If the remediation costs do not substantially prolong the useful life of the property, the taxpayer can argue that they are currently deductible ordinary expenses. See *Illinois Merchant Trust Co. v. Comm'r*, 4 B.T.A. 103 (1926).

New and different use. If the remediation activities qualify the property for a new or different use, then the expenses have been held to be capital in nature.

Prolong the property's useful life. To be currently deductible, the expenditures must not substantially prolong the useful life of the property.

Materiality. If the costs are incidental

as opposed to substantial remediation activities such as the replacement of a large volume of contaminated soil, the expenses are ordinary expenses. Treas. Reg. §1.162-4.

Recently, the IRS issued two Revenue Rulings on the deductibility of remediation costs. The first Revenue Ruling, 2004-18, involved the deduction of costs incurred to remediate ground water contamination. The IRS held that the taxpayer must capitalize the remediation costs by including them in inventory costs. The IRS reasoned that the contamination caused by manufacturing activities of the taxpayer were indirect costs allocable to the inventory, since they were incurred in conjunction with the manufacture of such inventory.

This result is not as disadvantageous as if the costs had to be capitalized as part the taxpayer's basis in its real property. By treating the remediation costs as allocable to inventory, the taxpayer will recover such remediation expenses as the inventory is sold; however, taxpayers using the FIFO method of inventory accounting should be careful to avoid such costs getting allocated to a layer of inventory that does not turn over frequently. In situations where the contamination is caused by activities unrelated to the manufacture of inventory (i.e., oil contamination at a truck depot), it may still be possible to argue that such expenses are currently deductible.

The second Ruling, 2004-17, examined the application of the "claim of right" doctrine to amounts paid to remediate environmental contamination that occurred in prior taxable years. IRC §1341. Under the claim of right doctrine, the taxpayer argued that the remediation expenses should be allocated to prior years when presumably this taxpayer was in a higher tax bracket. The taxpayer argued that it should be allowed to amend its prior returns rather than deducting the expenses on its current return. The IRS concluded that the claim of right doctrine does not apply where contamination from prior manufacturing activities is remediated in the current taxable year. The IRS reasoned that the remediation costs were not "income" items that were overstated in the earlier year and that such costs were not closely enough related to the prior year's manufacturing activity to satisfy the requirements of IRC Section 1341.

The tax treatment of remediation costs remains unclear and dependent on the facts and circumstances of each case. Taxpayers faced with the need to remediate existing contamination on their property or considering the acquisition of contaminated property should consult with tax counsel to determine the tax consequences of each potential course of action. Analyzing available options before remediating or acquiring the property could result in substantial tax savings. ■