Hidden Treasures & Hidden Traps:

A New Meaning to Due Diligence After January 2002 & How to Make the Most of the Bottom-Line Benefits of Brownfield Tax Treatment & Accounting

by Bruce A. Keyes

For Sale: 2000 gallons of paint - various colors.
Will throw in six acres of land for free...

The brownfield laws enacted during the last decade are not enough to make this an appealing offer to any but the most daring or determined. In fact, very few people ever find themselves choosing to be involved in a transaction involving a poster property for the brownfield cause. Nevertheless, the widespread impact from a number of brownfield laws may also benefit even the most mundane transactions.

This article discusses two issues of interest to anyone involved in acquiring or managing real estate:

1. Why does federal brownfields' legislation enacted on January 11, 2002, require more due diligence to discover and disclose environmental liabilities on property? Will it lead to greater corporate disclosure obligations in the wake of Enron and SEC Regulation FD?

2. When there is something to disclose, a few often overlooked brownfield tricks-of-the-trade can bring real value to the bottom line:

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- A benefit for the buyer—the rare instance when the IRS will let you treat environmental cleanup expenses on a newly acquired property as a deduction.

- Enjoying a one- to two-year reduction in the annual property tax assessment of a property.

- If share price is a concern, cost-effective remediation can remove an environmental liability and better the bottom line for shareholders to see.

PART 1: TELLING ALL - WHY Enron IS THE MIDDLE NAME OF ENviRONmental DISCLOSURE AND THE BROWNFIELDS REVITALIZATION ACT OF 2001

The meaning of due diligence in real estate transactions will change as a result of the Small Business Liability Relief and Brownfields Revitalization Act ("Brownfields Act") that went into effect on January 11, 2002

The Brownfields Act is part hype, part ripe. But when the dust settles, there are a few provisions that may significantly affect the way we do business.

For the most part, the Brownfields Act will have only subtle effects on the real estate world since much of the Brownfields Act embodies existing policy, with many of the provisions applying to only the most contaminated of properties. However, by amending the Superfund law (formally known as CERCLA, or the Comprehensive Environmental Response, Compensation and Liability Act) the Brownfields Act is likely to change the meaning of due diligence in every real estate transaction.

Section 223 of the Brownfields Act clarifies the standards and practices for conducting "all appropriate inquiry" in order to be protected by an innocent owner defense under federal CERCLA law (and likely under state laws, by extension). In general, the new law recognizes the common 1997 standard for Phase I site investigations, known as the American Society for Testing and Materials ("ASTM") Standard E1527 – 97 (1997). Parties to a due diligence review are likely to be using the more expansive ASTM Standard E1527 – 00 (2000), which contemplates an evaluation by the environmental professional of "business environmental risk" in the context of the commercial real estate transaction and requires greater detail as to potential risks that are not being evaluated within the scope of services.

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Both ASTM 1527 standards require the identification of "Recognized Environmental Conditions." Notably, however, the 2000 standard relies upon a greater degree of environmental professional judgment, and would allow some risks to be characterized solely as a "Historical Recognized Environmental Condition," which may or may not (in the professional's judgment) impact a property. Likewise, the 2000 standard would allow some conditions to be excluded from Recognized Environmental Conditions because they are only de minimis. Until the difference between the standards mandated by the Brownfields Act and the ASTM Standard E-1527-00 (2000) has been reconciled, parties conducting due diligence may wish to use the 2000 standard, but specifically require an identification and discussion of any historical and de minimis matters that would constitute Recognized Environmental Conditions under the 1997 standard.

The real changes to due diligence could come about, within two years, once the EPA satisfies its obligation to establish standards and practices for conducting "all appropriate inquiry" and as the changes work their way into the related state programs. "All appropriate inquiry" will include a review of matters such as chain of title, building department records, the relationship of the purchase price to the value of the property, specialized knowledge that the purchaser may have, and the results of an inquiry by an environmental professional.[1] Failure to conduct this level of due diligence may deprive an owner of an innocent purchaser defense. Purchasers should also be aware, however, of continuing obligations they will have after acquiring property in order to preserve the innocent owner protection. These obligations include complying with information requests, providing access to persons authorized to undertake cleanup, actions and complying with land use restrictions and institutional controls. In most cases, these obligations already exist where a cleanup has been undertaken.[2]

The Enron Connection

For publicly traded companies, SEC requirements have been increasingly strict about disclosing

environmental liabilities associated with real estate you own. In January 2000, the Securities and Exchange Commission proposed a new Item 302(c) to Regulation S-K regarding Supplementary Financial Information (Release Nos. 33-7793; 34-42354). The proposed rule would provide investors with more transparent and better-detailed disclosures concerning changes in valuation of long-lived assets, including real estate and applying, in particular, to environmental impairments. This rule has not moved into final form. Nevertheless, in October 2001, the U.S. EPA Office of Regulatory Enforcement issued an Enforcement Alert (EPA 300-N-01-008) highlighting environmental disclosure requirements under SEC Regulation S-K.

More recently, in the wake of the Enron collapse and the SEC's October 23, 2000, fair disclosure rule, (Regulation FD), investor's are demanding heightened transparency in corporate disclosures. The trend is clearly toward increasing disclosure of known liabilities and the Brownfields Act may set a new standard for knowledge—because it takes into account factors such as a below market price paid for real estate and legislates minimum requirements for "appropriate inquiry."

PART 2: GETTING BOTTOM-LINE BENEFITS FROM DISCLOSURE

In a recent transaction, due diligence disclosed that a property our client was to acquire had 2000 gallons of paint stored underground—in the soil and groundwater. Facing a cleanup costing around $1.2 Million, we were able to secure a combination of grants, tax credits, and TIF funding to cover the majority of the costs. However, these funds were available because we represented the innocent purchaser—very few programs are available to the current owner of property. Furthermore, grant funds often have difficult strings attached or may be otherwise unavailable for a particular project.

Whether you own or are purchasing real estate, one of the most overlooked sources for improving the bottom line of a project relates to tax treatment. If you have disclosed environmental liabilities associated with a property you own or if you think you may spend a few thousand dollars or more in the coming year on environmental issues related to a piece of real estate that you may purchase or currently own, you should consider the following strategies:

- When are you eligible to treat environmental cleanup expenses as a deduction?

- If a property is to be cleaned up in conjunction with a sale, who receives the tax benefit of the cleanup?

- Can you enjoy a one- to two-year reduction in the annual property tax assessment of a property?

- If share price is a concern, is it cost effective to clean up a property, and remove an environmental liability, thus bettering the bottom line for shareholders to see?

These strategies, discussed in detail below, are generally simple to implement. However, timing is often critical and the benefits will vary based on your particular circumstances. Evaluating the benefits and consequences of these strategies for your circumstances should be done in consultation with counsel.

When you are eligible to treat environmental cleanup expenses as a deduction.

A 1994 IRS ruling allows property owners who caused contamination on their property to deduct their environmental cleanup costs as a current expense, on the premise that these cleanup costs are considered to be repairs to the property. This deduction may also be allowed where contamination is discovered after taking ownership, when the cause of the contamination is unclear.

If you purchase a contaminated property, you will generally be required to capitalize the cleanup costs and depreciate them over the life of the property. That is, remediation expenditures generally must be added to the cost of the taxpayer's land acquisition (*i.e.*, basis) and often cannot be fully recovered for tax purposes until the land is sold.

The Brownfield Tax Incentive, Section 198 of the Internal Revenue Code, overrides capitalization requirements and allows a current deduction that can be used to offset other current income or result in a net operating loss.

Who Qualifies? The Brownfields Tax Incentive, created in 1997 and significantly expanded in December 2000, now applies to expenditures incurred between December 22, 2000, and December 31, 2003. In order to qualify under the expanded Brownfields Tax Incentive, there must have been a release, or threat of release, of a hazardous substance. Properties contaminated or threatened solely by a release of petroleum products (gasoline, diesel, heating oil, etc.) do not qualify. However, properties contaminated or

threatened by a mixture of petroleum products and other hazardous substances may still qualify for the Brownfields Tax Incentive. Also, the property must not be listed on, or be proposed for listing on, the Environmental Protection Agency's National Priorities List (NPL or Superfund site list).

In order to take advantage of the Brownfields Tax Incentive, taxpayers must receive a certification statement from their state's environmental agency. The state is likely to require at least minimal sampling results to determine eligibility. The 1997 version of the law included other geographical limitations relating to poverty levels that were difficult to implement and were dropped in the 2000 amendments.

What Expenses Qualify? The category of allowable expenses is potentially very broad. Taxpayers should consult with tax counsel to determine whether specific cost items are allowable expenses. Generally, expenditures for assessment and monitoring of a release (or threat of release), abatement, control, or disposal of a hazardous substance do 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.

Working the tax benefits of a cleanup into a property transaction

In the example of our paint-contaminated property, we were faced with the choice of trying to force the seller to clean up the property and pay the seller's asking price, or offering to reduce the purchase price by the amount it would cost to clean it up. So, which is a better deal?

From a liability standpoint, the two deals are very different. To minimize the liability of a buyer, we often require that the seller clean up a property to standards that we set before the buyer assumes title. Liability issues themselves are very complex and may drive a deal.

From a cost standpoint, these may also be very different deals. The grossly oversimplified example illustrated below assumes purchase of a $740,000 property, requiring $240,000 in environmental investigation and cleanup costs:

- If the seller spends $240,000 to clean up contamination, seller will be able to expense the cleanup cost. In effect, the seller will be taxed on net income of $500,000 and in the world of a one-third tax bracket, the seller's pain of cleanup is 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 seller's tax liability is still $80,000 less than if the sale had been at the higher price. The buyer capitalizes its costs and the basis of the property is $740,000 for purposes of depreciation.

- Using the Brownfield Tax Benefit, 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 deduction to offset against other current income or carry forward as net operating losses. The buyer has also succeeded in controlling the quality of the cleanup.

Through a coordinated effort, environmental, real estate, and tax counsel may be able to improve the terms of a transaction, create an unexpected windfall for a client, or generally improve the bottom line for shareholders through special tax treatment available as a result of federal brownfield initiatives.

Can you enjoy a one- to two-year reduction in the annual property tax assessment of a property?

Under generally accepted property appraisal guidelines, detrimental conditions such as environmental liability will result in a reduction of the fair market value of the property based upon the cost of repair, including ongoing operation and maintenance costs, as well as the perceived risk.

Often, a temporary reduction in the assessed value of real estate is available, but:

- Timing is critical, since many jurisdictions limit challenges to assessed values to specific times of the year;

- You will need reliable information to demonstrate the cleanup costs. This typically requires a

Phase II site investigation and an estimate from an environmental consultant;

- The reduction in price may be limited to reflect costs that will be reimbursed, such as from petroleum tank funds;

- You may create an undesirable, albeit temporary, stigma associated with the property.

In the context of our client's paint-contaminated property discussed above, the site investigation report and a cleanup cost estimate from an environmental consultant was enough to satisfy the property assessor to grant a temporary reduction in the assessment. The timing is critical and a sophisticated assessor is likely to consider any known reduction in the purchase price as reflecting the diminished value of the property.

A reduction in assessed value of the paint-contaminated property resulted in more than $40,000 in savings to our client. In that case, the assessed value dropped from around $500,000 to $300 during the period that it took to piece together a viable transaction and we were able to stop the clock on the accumulation of property tax debt.

If share price is a concern, is it cost-effective to clean up a property, remove an environmental liability and better the bottom line for shareholders to see?

Environmental liabilities that you may now be carrying on your books are, in all likelihood, based upon estimated cleanup costs. In light of the recent brownfield reforms and the move toward risk-based remediation, you may be carrying these costs far in excess of the actual cleanup cost. By addressing your environmental problems you may benefit by removing a liability (perhaps overestimated) from your books while being able to deduct the related cleanup expenses.

For conditions that may yet need to be disclosed or evaluated, it is important to accurately quantify the scope of the issue in light of the more rational cleanup standards in current use. Finally, any time an environmental liability is disclosed is a good time to think about negotiating for a reduction in the assessed value of the property.

CONCLUSIONS

The term "brownfield" may apply to any property that has issues—real or perceived—relating to environmental contamination. The recent brownfield initiatives may offer benefits available to the traditional owner of real estate and not just the high-risk brownfield sites.

Through a coordinated effort, environmental, real estate, and tax counsel may be able to improve the terms of a transaction, create an unexpected windfall for a client, or generally improve the bottom line for shareholders through special tax treatment available as a result of federal brownfield initiatives.

Strategies to help the bottom line will be increasingly important as companies more fully evaluate their disclosure obligations in light of the legislated standards for due diligence found in the Brownfields Act of 2001 and in the aftermath of Enron and the SEC's fair disclosure regulations. REI

NOTES

1. Brownfields Act at Section 223; CERCLA, Section 101(35)(B).
2. The Brownfield Act also includes increased federal funding, liability reform for those unlucky enough to be involved in a National Priorities List site and better integration with state programs.

ABOUT THE AUTHOR

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finance; development and enterprise zones; local, state, and federal grants; and innovative remediation and financing structures employing the use of Business Improvement Districts. [redacted]