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CONTENTS

TO SAVE OR NOT TO SAVE:
HISTORIC PRESERVATION IN NEW JERSEY -JUSTIFICATIONS, HINDRANCES, FUTURE 649
Brian Uzdavinis

NOTE: FEDERAL TAX CREDIT INCENTIVES AS A METHOD OF PROMOTING BROWNFIELD REMEDIATION.................695
Lauren Brantz

KELO V. NEW LONDON AND THE STATE LEGISLATIVE REACTION: EVALUATING THE EFFICACY AND NECESSITY OF RESTRICTING EMINENT DOMAIN FOR ECONOMIC REDEVELOPMENT AT THE STATE LEVEL.........................730
Ryan Frampton

WELFARE FRAUD, NECESSITY, AND MORAL JUDGEMENT...766
Eyal Kimel

PLACE THE DEATH PENALTY ON A TRIPOD, OR MAKE IT STAND ON ITS OWN TWO FEET? 788
Margo A. Rocklin

NOTE: FEDERAL TAX CREDIT INCENTIVES AS A METHOD OF PROMOTING BROWNFIELD REMEDIATION

Lauren Brantz

I. INTRODUCTION

The benefits of redevelopment are innumerable—a cleaner environment, more jobs, increased tax base, more stable communities, and a deterrence of urban sprawl.[1] The United States Environmental Protection Agency (EPA) defines the term "brownfields" as " 'abandoned, idled or underused industrial and commercial sites where expansion or redevelopment is complicated by real or perceived environmental contamination that can add cost, time or uncertainty to a redevelopment project.' "[2]

The United States Office of Technology Assessment (OTA) also includes in the definition sites whose "redevelopment may be hindered not only by potential contamination, but also by poor location, old or obsolete infrastructure, or other less tangible factors often linked to neighborhood decline."[3]

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[1] Nicholas T. Menas, *Tax Incentives for Brownfield Redevelopment: Are They Enough?, available at* http://library.findlaw.com/2003/May/16/132753.html (last visited Apr. 12, 2007).

[2] TODD S. DAVIS & KEVIN D. MARGOLIS, BROWNFIELDS: A COMPREHENSIVE GUIDE TO REDEVELOPING CONTAMINATED PROPERTY 5 (A.B.A. Sec. of Nat. Resources, Energy & Env't. L. 1997) (citing U.S. Envtl Prot. Agency 5, Off. of Pub. Aff., *Basic Brownfields Fact Sheet* (1996)).

[3] *Id.*

Brownfield sites do not include those facilities that are listed or proposed for listing on the National Priorities List (NPL),[4] or "a facility that is the subject of a planned or ongoing removal action under [the Comprehensive Environmental Response, Recovery, Compensation, and Liability Act (CERCLA)]."[5] According to the EPA, across the United States there are estimated to be at least half a million sites with uncertain or risky environmental conditions, in terms of known past uses and current status.[6]

The redevelopment of brownfields can and should be seen as a strategy and/or catalyst to revitalize and rejuvenate a declining or distressed neighborhood, as well as an optimal tool to combat urban sprawl[7]

In 2003 a "study conducted by the United States Conference of Mayors found that brownfield cleanups led to an increase of ninety million dollars in local tax revenues in forty-five cities.[8] Cleanups also were responsible for "helping to create over

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[4] The NPL is the list of national priorities among the known releases or threatened releases of hazardous substances, pollutants, or contaminants throughout the United States. *See* 42 U.S.C. § 9605(a)(8)(B) (2003). The NPL is intended as a guide for the EPA in determining which sites warrant further investigation. *Id.*

[5] *See* 42 U.S.C. § 9601(39)(B)(2003). CERCLA "authorizes two kinds of response actions: short-term removals, where actions may be taken to address releases or threatened releases requiring prompt response;" and "long-term remedial response actions, that permanently and significantly reduce the dangers associated with releases or threats of releases of hazardous substances that are serious, but not immediately life threatening." EPA, *Superfund*: *CERCLA Overview, available at* http://www.epa.gov/superfund/action/law/cercla.htm (last visited Apr. 12, 2007). Long-term response actions can be conducted only at sites listed on the NPL. *Id.*

[6] EPA, *Frequently Asked Questions: Brownfields*, http://www.epa.gov/compliance/resources/faqs/cleanup/brownfields (last updated Apr. 12, 2007)

[7] *See* Roberta F. Mann, Article, *Tax Incentives for Historic Preservation: An Antidote to Sprawl*?, 8 WIDENER L. SYMP. J. 207 (2002).

[8] UNITED STATES CONFERENCE OF MAYORS, RECYCLING AMERICA'S LAND: A NATIONAL REPORT ON BROWNFIELDS REDEVELOPMENT VOL. IV 12 (2003), *available at* http://www.deq.state.ok.us/pubs/lpd/RecycleAmerica2003.pdf.

83,000 new jobs in seventy-four cities."[9] Furthermore, "a survey of 150 cities estimated that cleaning up their brownfield sites would produce as much as $1.9 billion in new tax revenues and nearly 600,000 jobs."[10]

In 2006, the Conference of Mayors followed up with a sixth edition of the survey to add to the previous editions.[11]

> In this years' survey, 172 (cities) estimated that they had more than 23,810 brownfields sites, with the average size of a brownfield site being approximately between 5 and 15 acres. There were 158 cities estimating that Brownfield properties comprised of 96,039 acres of land, representing potential new jobs and land tax revenue. More then 120 cities estimated that 2,579 sites have been "Mothballed," which is defined as sites that the current owner has no intention of redeveloping or selling due to environmental concerns. These are sites that owners would prefer to remain idle and unused rather than turn these sites over for development. This year's report again demonstrates that brownfields not only affect large urban areas, but also suburban and rural landscapes as well.[12]

Despite the obvious benefits, it is not unusual for a developer to shy away from a project that includes brownfield remediation.[13] Reasons for this may be the real or perceived increase in construction costs and contamination cleanup, as

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[9] *Id.*

[10] *Id.*

[11] UNITED STATES CONFERENCE OF MAYORS, RECYCLING AMERICA'S LAND: A NATIONAL REPORT ON BROWNFIELDS REDEVELOPMENT VOLUME VI (2006), *available at* http://www.usmayors.org/74thAnnualMeeting/brownfieldsreport_060506.pdf.

[12] *Id.* at 6.

[13] Melissa H. Weresh, *Environmental Law Symposium: The First Year of the Bush Administration: Brownfields Redevelopment and Superfund Reform Under the Bush Administration: A Refreshing Bipartisan Accomplishment*, 25 W. NEW ENG. L. REV. 193, 194 (2003).

well as the additional layers of bureaucracy in dealing with federal, state, and local agencies.[14] Despite these potential problems, because the location of these sites may offer exceptional private profits from redevelopment and also contribute to the public economic and community development goals, there is great interest in reusing these sites.[15]

There are a variety of tools which can help real estate companies and local communities offset the costs of a brownfield redevelopment project, including grants, tax incentives, and/or low-interest loans.[16] While all of these tools exist on the federal, state, and local levels, in this note I will only address the federal tax incentives currently in place to encourage brownfield revitalization. First, I will discuss the environmental laws that attempt to encourage capital investment.[17] Next, I will analyze the use of remedial incentives in the form of tax credits that have been implemented and appear to effectively encourage urban revitalization. For example, these incentives include: the Historic Preservation Tax Credit[18], the Low Income Housing Tax Credit[19] and the New

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[14] *See generally* Davis, *supra* note 2, at 9 (outlining some of the various barriers to redevelopment of brownfields).

[15] *Id.*

[16] *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788; Brownfields Tax Incentive, Pub. L. No. 106-554, 114 Stat. 2763 (2000); Working Families Tax Relief Act of 2004, Pub. L. 108-311, 118 Stat. 1166 (extending Brownfields Tax Incentive through December 31, 2005); *EPA Brownfields Tax Incentive Fact Sheet* (June 2003), http://www.epa.gov/brownfields/facts/taxincentive_03.pdf (last visited Apr. 12, 2007).

[17] The confusion surrounding the proper tax code treatment of brownfields is based on whether to deduct the cost immediately or to capitalize the expense later. While there are certain federal laws that encourage investment of capital through federal tax incentives, the current laws do not provide a clear enough understanding of the proper treatment, nor do the current laws provide a permanent solution to the confusion.

[18] Tax Reform Act of 1976, Pub. L. No. 94-455, § 2124, 90 Stat. 1520, 1916 (1976).

[19] Tax Reform Act of 1986, Pub. L. No. 99-514, § 252, 101 Stat. 2189 (1986).

Market Tax Credits.[20] Based on the amount of success in terms of investment capital that these credits have encouraged in such a short period of time, I will then argue that a similar tax credit incentive, which was recently proposed, should be implemented permanently to stimulate the investment of capital into important brownfields revitalization projects around the country.

II. EXISTING TAX INCENTIVES TO CLEAN UP BROWNFIELDS

A. CERCLA LIABILITY

Following a series of national stories highlighting dangerously polluted sites, Congress passed the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA or Superfund Act) "to reduce and eliminate threats to human health and the environment posed by hazardous waste."[21] CERCLA created a response program to identify, assess, and clean up hazardous waste sites[22] as well as a trust fund (Superfund) to enable the government to pay for costs incurred in the remedial actions.[23]

Liability is costly for potentially responsible parties (PRPs)[24] charged with the cleanup of a site under CERCLA.[25] Identified

[20] 26 U.S.C.A. § 45 (West 2006).

[21] Elliot Milhollin, Note, *Taxation of Superfund Cleanup Costs: How the IRS Continues to Frustrate CERCLA's Twin Policy Goals*, 5 WIS. ENVTL. L.J. 213, 213 (Summer 1998) (citing 42 U.S.C. § 9601 (1994)).

[22] *Id. See also* 42 U.S.C. § 9602 (2000). CERCLA defines hazardous substances with reference to an express list of substances in section 102 as well as substances provided for in other environmental statutes, including sections 307(a) and 311 of the Clean Water Act, section 3001 of Resource Conservation and Recovery Act, section 112 of the Clean Air Act, and section 7 of the Toxic Substance Control Act. 42 U.S.C. § 9601(14) (2003).

[23] 42 U.S.C. § 9601 (2003). *See also Id.* § 9611.

[24] There are four categories of PRPs. (1) Past owners or operators of the facility (includes any person who owned or operated the facility at the time of hazardous substance disposal) 42 U.S.C. § 9607(a)(2) (2003); generators, (any person who arranged for the disposal, treatment, or transport of the

PRPs are required to pay "response costs," comprised of (A) "all costs of removal or remedial action incurred by the United States Government or a State . . .;" (B) "any other necessary costs of response incurred by any other person . . .;" (C) "damages for injury to, destruction of, or loss of natural resources, including the reasonable costs of assessing such injury, destruction or loss resulting from such a release;" and (D) "the costs of any heath assessment or heath effects study carried out under section 9604(i)."[26]

Identified PRPs are liable under CERCLA section 107(a)(4) for interest accrued on the response costs mentioned above.[27] With the use of a strict liability scheme that includes both retroactive[28] and joint and several liability[29], Superfund made every past and present property owner fully responsible for all costs associated with the clean up of environmental contamination.[30]

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hazardous substance at or to any facility owned or operated by another party if such facility contained hazardous substances) *Id.* § 9607(a)(3); (3) transporters (any person who accepted hazardous substances for transport to the treatment or disposal facility, or other site, if that person selected that facility or site) *Id.* § 9607(a)(4); and (4) current owners or operators of the facility. *Id. §* 9607(a)(1).

[25] *See* Milhollin, *supra* note 18, at 215.

[26] 42 U.S.C. § 9607(a)(4) (2003).

[27] *Id.*

[28] *See e.g.,* United States v. Shell Oil Co., 841 F. Supp. 962, 974 (C.D. Cal. 1993) (holding CERCLA's liability scheme is retroactive).

[29] *See e.g.,* United States v. Monsanto Co., 858 F.2d 160, 171 (4th Cir. 1988) (holding CERCLA's liability scheme is joint and several).

[30] *Id.* CERCLA imposes liability on any person for costs associated with the cleanup of a site where there has been an actual release or a threat of release of a hazardous substance from a facility. *See* 42 U.S.C. § 9607(a) (2003). "Person" is defined broadly to include "an individual, firm, corporation, association, partnership, consortium, joint venture, commercial entity, United States Government, State, municipality, commission, political subdivision of a State, or any interstate body." *Id.* § 9601(21). A "release" is "any spilling, leaking, pumping, pouring, emitting, emptying, discharging, injecting, escaping, leaching, dumping or disposing into the environment." *Id.* § 9601(22). A "facility" is

As a result, CERCLA has received criticism because these potential liabilities may encourage landowners to abandon their contaminated properties rather than redevelop them.[31] Some scholars take this even further to argue that the abandonment of contaminated properties results in urban sprawl, decreased tax revenues, and increased environmental justice issues.[32]

The breadth of liability under CERCLA illustrates that "the overriding environmental policy concern of CERCLA is the prompt cleanup of environmental contamination."[33] However, "neither CERCLA nor the EPA provides the resources necessary to remediate all of the sites on the national priority list, nor do they account for future sites."[34] Therefore, "from an environmental standpoint, the preferred federal tax treatment of environmental remediation expenses is one that provides an incentive for PRPs to voluntarily remediate the site."[35] Both federal and state governments have responded to these growing

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> any building, structure, installation, equipment, pipe or pipeline . . . well, pit, pond, lagoon, impoundment, ditch, landfill, storage container, motor vehicle, rolling stock, or aircraft, or . . . any site or area where a hazardous substance has been deposited, . . . or otherwise come to be located.

Id. § 9601(9).

[31] *See* 147 CONG. REC. H2348-49 (daily ed. May 21, 2001) (statements of Rep. Gillmore and Rep. Duncan).

[32] *See* Flannary P. Collins, Note, *The Small Business Liability Relief and Brownfields Revitalization Act: A Critique*, 13 DUKE ENVTL. L. & POL'Y F. 303, 304 (2003).

[33] Rachel E. Brown, Comment, *Explaining Environmental and Tax Policy Incongruity Twenty-Five Years Later: Treatment of Environmental Remediation Costs Imposed by CERCLA Under the Internal Revenue Code,* 18 TUL. ENVTL. L.J. 357, 363 (2005).

[34] *Id.* at 364. In 2004, nine long-term Brownfield sites accounted for 52% of the total Superfund obligations. EPA, *Superfund National Accomplishments Summary Fiscal Year 2004*, http://www.epa.gov/superfund/action/process/numbers04.htm (last modified Apr. 12, 2007). As a result, nineteen sites that were ready for construction were left un-funded. *Id.*

[35] *Id.*

concerns by enacting brownfields revitalization and tax legislation to encourage the redevelopment of brownfields and protect private developers from the strict and joint and several liability scheme under CERCLA.[36]

B. TAX CODE TREATMENT OF CLEANUP COSTS

1. Section 162 Deduction versus Section 263 Capitalization

"The greatest challenge in ascertaining the proper tax treatment of environmental cleanup costs is in distinguishing between deductible and capital expenditures. According to the Supreme Court, the differences between deductible expenses and capital expenditures 'are those of degree and not of kind.'"[37] "[T]he Internal Revenue Code's (Tax Code) treatment of remediation expenses imposed by CERCLA as deductible or subject to capitalization remains uncertain."[38]

"The various tests applied[39]... to determine whether deduction or capitalization is appropriate…have resulted in incongruent treatment of cleanup costs. The tests reflect the conflict between the environmental policy - to promote voluntary environmental cleanup, and the tax policies - to raise revenue and match income to related expenses."[40] "From a tax

[36] Collins, *supra* note 32, at 304.

[37] Brown, *supra* note 33, at 366 (citing Welch v. Helvering, 290 U.S. 111, 114 (1933)).

[38] Brown, *supra* note 33, at 358.

[39] Courts apply various tests and evaluate several factors to determine the proper treatment of environmental expenses. While some tests attempt to distinguish between incidental repairs and long-term improvements pursuant to the regulations, others involve analyzing whether the taxpayer incurred any "significant future benefits" or whether the expenses were part of a "general plan of rehabilitation."

Brown, *supra* note 31, at 366. *See also* INDOPCO, Inc. v. Comm'r, 503 U.S. 79 (1992); Plainfield-Union Water Co. v. Commr, 39 T.C. 333 (1962).

[40] Brown, *supra* note 31, at 358.

perspective, a current year deduction under section 162(a) is more desirable than capitalizing pursuant to section 263 or 263A because of the time value of money. A section 162(a) deduction permits the taxpayer to recover the full cost of the expense in the current year in tax savings (using before-tax dollars).[41] Capitalization means there is no deduction available for these expenses until the property is sold."[42] Since this could be several years, this increases the overall tax burden of the redevelopment project. This higher tax burden hinders redevelopment efforts — particularly in areas that need them most.[43] Depreciation results in cost recovery in smaller increments over a period of years (thirty-nine years for nonresidential real property).[44] Property not subject to depreciation, such as land, defers cost recovery until the sale or other disposition of the property (in after-tax dollars).[45]

The Supreme Court has declared that "an income tax deduction is a matter of legislative grace" and therefore "deductions are the exceptions to the norm of capitalization."[46] The burden of proof rests with the taxpayer to point with specific authority to a provision of the Tax Code allowing a deduction.[47] Thus, unless the taxpayer establishes that an expenditure qualifies for a section 162(a) deduction, the

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[41] "Taxpayers not entitled to an allowable deduction are faced with two alternatives: capitalize and depreciate, or, with property that cannot be depreciated, capitalize and add the cost of the expenditure to the basis of the property." Brown, *supra* note 31, at 364. *See also* I.R.C. §§167, 168 (2002), and *id*. §§ 263, 263A.

[42] Brown, *supra* note 33, at 364.

[43] *Id.*

[44] I.R.C. §§ 167(a)(1), 168(c) (2002).

[45] I.R.C. §§ 1016, 1001(a) (2002).

[46] INDOPCO, 503 U.S. at 84; *cf*. Treas. Reg. § 1.263(a)-4 (2004) (declaring deductibility as the norm and capitalization as the exception for intangibles). Treasury regulation section 1.263(a)-4 was adopted in 2004 and specifically lists the twelve intangibles that are subject to capitalization, all others are deductible. *Id*.

[47] *Id.*

taxpayer is required to capitalize the expense under section 263 or 263A.[48] Section 162(a) permits a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."[49]

While each of these requirements must be met, whether the cost constitutes a deductible expense, rather than a capital expenditure, is dispositive of its character.[50] The prevailing distinction in the regulations is between a repair (which is deductible) and a permanent improvement (which must be capitalized). Section 263 forbids a deduction for "any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate" and "any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made."[51]

The regulations characterize capital expenditures as those expenses that (1) add to the value of the property, (2) substantially prolong the useful life of the property, or (3) adapt the property to a new or different use.[52]

The regulations also establish a four-part test to determine the deductibility of repairs.[53] Ordinary and necessary business expenses are deductible as repairs if they: (1) are "incidental," (2) do not "materially add to the value of the property," (3) do not appreciably prolong the useful life of the property[54] and (4)

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[48] I.R.C. § 263 (2002).

[49] I.R.C. § 162(a) (2002).

[50] The taxpayer must prove the cost is (1) an expense, (2) that is reasonable, (3) necessary, (4) is paid or incurred during the taxable year, (5) in carrying on, and (6) any trade or business. I.R.C. § 162(a) (2002).

[51] Treas. Reg. § 1.263(a)(1)-(a)(2) (2004).

[52] *Id.* § 1.263(a)-1(b)(1)-(2). Specifically included is 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. *Id.* § 1.263(a)-2(a).

[53] Treas. Reg. § 1.162-4 (2004).

[54] Though the specific language of treasury regulation section 1.162-4 forbids deducting the costs of a repair that "appreciably prolongs" the property's life, because section 162 is defined with respect to section 263, the

keep the property in an "ordinarily efficient operating condition."[55]

In *Plainfield-Union Water Co. v. Commissioner*,[56] the Tax Court established an "added value" or "before-after" test for purposes of characterizing an expense.[57] The court held that "[t]he proper test is whether the expenditure materially enhances the value, use, life expectancy, strength, or capacity as compared with the status of the asset prior to the condition necessitating the expenditure."[58]

An expense that merely restores the property to its prior condition and does not add to the property's value, usefulness, or life expectancy qualifies for a deduction.[59] The Tax Code is silent as to what time period constitutes substantially prolonging the useful life of an asset. Some courts have adopted a twelve-month rule to provide a definite time period.[60]

Some courts are more willing to allow deductions of expenditures where the property has been continuously used for its original purpose. In *Midland Empire Packing Co. v. Commissioner*,[61] the Tax Court held that a meat-processing

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appropriate measure is to prolong its useful life appreciably as provided in section 1.263(a)-1(b)(1) (emphasis added).

[55] Treas. Reg. § 1.162-4 (2004)

[56] 39 T.C. 333 (1962).

[57] *Id.* at 388.

[58] *Id.*

[59] *Id.* at 337. The court reasoned that because properly performed repairs should increase the value of the property, limiting the analysis to the value of the property immediately before the expense (in the contaminated state) and the value immediately after (in an uncontaminated state) is not a meaningful distinction. *Id.* at 338.

[60] *See* United States Freightways Corp. v. Comm'r, 270 F.3d 1137, 1142-43 (7th Cir. 2001) (declaring that for administrative feasibility the taxpayer was entitled to a deduction when the benefit did not extend beyond one calendar year); *see also* Treas. Reg. § 1.263(a)-4(f) (2004) (creating a twelve-month rule for purposes of determining substantiality for deduction or capitalization of intangible assets); *cf.* United States v. Wehrli, 400 F.2d 686, 689 (10th Cir. 1968) (characterizing the one-year time period as merely a "guidepost").

[61] 14 T.C. 635 (1950).

plant was permitted to deduct expenses incurred in oil-proofing its basement because the basement was not put to a new or additional use; rather, the cost to oil-proof maintained the plant in an "ordinarily efficient operating condition" by continuing its use for meat processing.[62]

The Fourth and Sixth Circuits have recently applied the new use test to environmental cleanup costs. In *Dominion Resources, Inc. v. United States,*[63] the Fourth Circuit held that the taxpayer was required to capitalize its cleanup costs because the remediation enabled the property to become income producing.[64] Relying on the reasoning of *Dominion Resources*, the Sixth Circuit in *United Dairy Farmers, Inc. v. United States*[65] determined that remediation work done to property acquired in a contaminated state constituted a new use of the property and therefore the costs were not deductible.[66]

The Supreme Court created the "significant future benefit test" in *INDOPCO, Inc. v. Commissioner*.[67] The court reasoned, "[a]lthough the mere presence of an incidental future benefit – '*some* future aspect' - may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization."[68] In 2001, the Internal Revenue Service (the Service) issued a Revenue Ruling to clarify the distinction between deductibility and capitalization.[69] The Service concluded that the outcome depends on the context in which the

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[62] *Id.* at 642-43.

[63] 219 F.3d 359 (4th Cir. 2000).

[64] *Id.* at 372.

[65] 267 F.3d 510 (6th Cir. 2001).

[66] *Id.* at 518-519.

[67] 503 U.S. 79 (1992).

[68] *Id.* at 87.

[69] Rev. Rul. 2001-4, 2001-1 C.B. 295.

cost is incurred.[70] The Service observed that "where an expenditure is made as part of a general plan of rehabilitation, modernization, and improvement of the property, the expenditure must be capitalized, even though, standing alone, the item may be classified as one of repair or maintenance" and would therefore be deductible.[71] Application of the doctrine is fact-intensive and requires an analysis of, *inter alia*, the "purpose, nature, extent, and value of the work done."[72]

The Service's most recent pronouncement addressing cleanup costs imposed by CERCLA was issued in 2004.[73] The Service concluded "[e]nvironmental remediation costs are subject to capitalization under [section] 263A."[74] Further, "costs incurred ... to clean up land that a taxpayer contaminated with hazardous waste by the operation of the taxpayer's manufacturing plant must be included in inventory costs [and therefore capitalized] under [section] 263A."[75]

The practical effect of Revenue Ruling 2004-18 is that most expenses incurred in environmental remediation efforts after

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[70] *Id.*

[71] *Id.* at 298 (citing United States v. Wehrli, 400 F.2d 686, 689 (10th Cir. 1968)).

[72] *Wehrli*, 400 F.2d at 690.

[73] Rev. Rul. 2004-18, 2004-1 C.B. 509. In the revenue ruling case, the taxpayer was a corporation that purchased uncontaminated land and built a manufacturing plant that it owned and operated. The plant's operation resulted in the discharge of hazardous substances onto the land, which the taxpayer sought to clean up in accordance with environmental requirements. The taxpayer incurred soil remediation and groundwater treatment expenses as well as costs to construct a monitoring system to ensure hazardous substance removal. The operation of the manufacturing plant produced property that was inventory in the hands of the taxpayer. *Id.*

[74] *Id.* at 510.

[75] *Id.* The Service concluded that, because the remediation expenses were incurred as a result of the taxpayer's production activities, the costs were attributable to property that was produced by the taxpayer and was inventory in the taxpayer's hands. *Id.* (citing Treas. Reg. § 1.263A-1(e)(3)(i)) (2004)). It declared, "costs incurred to replace underground storage tanks and depreciation cost recoveries of the groundwater treatment facility must be included in inventory costs to the extent properly allocable to inventory." *Id.*

February 6, 2004 must be capitalized under section 263A of the Tax Code by a taxpayer that produces real or tangible personal property.[76]

2. Brownfield Tax Incentive

Congress enacted Section 198 of the Tax Code as part of the 1997 Taxpayer Relief Act[77] "[t]o encourage the cleanup of contaminated sites, as well as to eliminate uncertainty regarding the appropriate treatment of environmental remediation expenditures for Federal tax law purposes."[78] As an elective provision, section 198(a) authorizes a taxpayer to currently deduct qualified environmental remediation costs rather than capitalize them.[79] Such expenditure is allowed as a deduction for the taxable year in which it is paid or incurred.[80] This provision does not apply to costs incurred in the demolition of structures, and mining and solid waste reclamation costs.[81]

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[76] The Service indicated it would not "challenge the treatment of environmental remediation costs [of a type that are the subject of Revenue Ruling 2004-18] as deductible expenses rather than as costs properly capitalized to inventory under [section] 263A in any taxable year ending on or before February 6, 2004." *Id.* Further, the Service declared it would not pursue any such issue that had been raised before the Courts of Appeals or the Tax Court on or before February 6, 2004. *Id.* Finally, the Service would not impose penalties in instances where taxpayers or preparers characterized such expenses as deductible in a taxable year ending on or before February 6, 2004. *Id.* The section 263A auxiliary test operates like a recapture provision. Arguably, most real or tangible personal property produced by the taxpayer in a trade or business (or acquired by the taxpayer for resale) will likely constitute inventory in the hands of the taxpayer, thereby placing the taxpayer within the bounds of Revenue Ruling 2004-18 and requiring capitalization of the direct and indirect costs incurred in connection with such property. *Id.*

[77] Taxpayer Relief Act of 1997, Pub. L. No.105-34, 111 Stat. 788.

[78] Joint Comm. on Taxation, 105th Cong., General Explanation of Tax Legislation Enacted in 1997 135 (Comm. Print 1997).

[79] 26 I.R.C. § 198(a) (2002).

[80] I.R.C. § 198(a).

[81] *Id.* § 198(f).

Qualified environmental remediation costs are expenditures "otherwise chargeable to a capital account" and "paid or incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site.[82] Hazardous substances are defined with reference to CERCLA."[83] Section 198 specifically excludes remediation costs imposed by CERCLA, therefore the scope of 198 is limited to brownfields.[84] The express exclusion of CERCLA sites from section 198 makes it difficult to analogize section 198 to environmental remediation costs imposed by CERCLA.[85]

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[82] *Id.* § 198(b)(1).

[83] *Id.,* and *id.* § 198(d). Hazardous substance is defined as "any substance which is a hazardous substance as defined in section 101(14) [of CERCLA] and any substance which is designated as a hazardous substance under section 102 of [CERCLA]." *Id.* § 198(d)(1). Section 198(d)(2) of the Code specifically excepts from the definition "any substance with respect to which a removal or remedial action is not permitted under section 104 of [CERCLA] by reason of subsection (a)(3) thereof." *Id.* § 198(d)(2).

[84] Pursuant to section 198(c)(2), "any site which is on, or proposed for, the national priorities list under section 105(a)(8)(B)" of CERCLA cannot attain qualified contaminated site status. I.R.C. § 198(c)(2). Brownfields are certain to be located within a targeted area by a state environmental agency and actually or potentially contain a hazardous substance. *See* Small Business Liability Relief and Brownfields Restoration Act, Pub. L. No. 107-118, 115 Stat. 2356 (codified at 42 U.S.C. §§ 9601-9675 (2000)). Many of these substances are corrosive, ignitable, or toxic. A qualifying contaminated site is any property held for use in a trade or business, for production of income, or as inventory, and where a hazardous substance has been released (or threatened to be released) or disposed of on the site. This must be certified by the state's designated environmental agency. *Id.*

[85] According to the conference report concerning the Taxpayer Relief Act of 1997, "providing current deductions for certain environmental remediation expenditures . . . creates no inference as to the proper treatment of other remediation expenditures not described in the agreement." H.R. CONF. REP. No. 105-220, at 488 (1997). As the EPA explains, brownfields are not Superfund sites,

> Brownfields differ from Superfund sites in the degree of contamination. Superfund sites pose a real threat to human health and/or the environment. Brownfields, on the other hand, do not pose serious health or environmental threat. Instead they represent an economic or social threat, since they prevent development and therefore stifle local economies.

The Community Renewal and Reinvestment Act of 2000 removed the geographic targeting requirements of Internal Revenue Code Section 198.[86] Prior to this change, these clean-up costs had to be added to the purchase price of the land ("capitalized") unless the contaminated site was located in an empowerment zone or other designated low-income area.[87] This change allowed for a much broader application of the expensing election, opening it to developers of brownfields to expense the cleanup costs wherever brownfields are located. Now, clean-up costs may be deductible in the year they are incurred and do not have to be capitalized.[88] You can decide to expense part or all of any qualified environmental cleanup expenditure. The election is made by simply claiming the deduction on the tax return for the year in which the costs are paid or incurred.[89]

This provision was intended to clear up confusion about tax treatment of environmental contamination. However, despite this intention, the provision will remain a weak incentive unless it is made permanent. The reason it is a weak incentive is because Congress, for revenue reasons, scheduled for the expensing election to expire at the end of 2005.[90]

One impediment to being a worthwhile incentive stems from the fact that currently, any qualified environmental remediation expenditure expensed under section 198 is subject to recapture as ordinary income when the property that was contaminated is

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EPA, *What is a Brownfield*, *at* http://cfpub.epa.gov/superapps/index.cfm/fuseaction/faqs.viewAnswer/question_id/104/category_id/7/faqanswr.cfm. (last visited Apr. 12, 2007).

[86] *Transparency and Audit Capacity for the Research and Experimentation Tax Credit: Hearing Before the Senate Finance Committee on Expiring Tax Provisions*, 108th Cong. 1-8 (Testimony of Dr. David E. Martin, CEO, M·CAM), *http://www.senate.gov/~finance/hearings/testimony/2005test/dmtest031605.pdf* (last visited Apr. 12, 2007).

[87] *Id.*

[88] *Id.*

[89] *Id.*

[90] There have been proposals to extend the provision. *See supra* note 86.

sold or otherwise disposed of.[91] In effect, the amount expensed as a cleanup cost is treated as depreciation on IRC section 1245 property. Thus, when the property is sold, gain to the extent of the cleanup cost deduction is treated as ordinary income.[92]

As an example, in 2001, a hypothetical owner purchases an acre of land that was contaminated with a hazardous substance. The land cost $10,000 and the owner spent $5,000 in remediation expenses. Currently, he is allowed to claim a current deduction for the $5,000 instead of adding it to his basis in the land. If he sells the land for $16,000, he would be required to treat $5,000 of his $6,000 gain ($16,000 sale proceeds less $10,000 cost) as ordinary income taxable at 39.6%. The remaining $1,000 gain would be taxed at 20%.[93]

> If a developer were to acquire a brownfield, clean it up and restore it to a viable market use, but then immediately lose the benefit of the cleanup deduction at the time of sale, the developer is left with little, if any, incentive effect. If the recapture provision were repealed, section 198 would become a far better redevelopment incentive than it is now.[94]

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[91] *Tax Incentives For Land Use, Conservation, and Preservation: Hearing Before the Subcomm. on Select Revenue Measures of the Commitee on Ways and Means*, 107th Cong. 4-6 (2002) (statement of Timothy Brazell, Member, The Real Estate Roundtable), http://www.rer.org/media/newsreleases/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=1015

[92] *Id.*

[93] Id. at 6.

[94] *Lands of Lost Opportunity: What Can Be Done to Spur Redevelopment at America's Brownfield Sites?: Before the House Subcomm. on Federalism and the Census of the Comm. on Government Reform*, 109th Cong. 62-83 (2005) (Testimony of James E. Maurin), http://a257.g.akamaitech.net/7/257/2422/31oct20051400/www.access.gpo.gov/congress/house/pdf/109hrg/23259.pdf

III. TAX CREDITS SUCCESSFUL IN OTHER CONTEXTS

"One method that has been discussed for bolstering the existing federal grant and loan program for non-profits and state entities is to offer tax incentives to offset the costs of cleanup by private companies."[95] Transferable tax credits have been enormously successful in other contexts on the federal level.[96] The Historic Preservation Tax Credit[97], Low Income Housing Tax Credit[98], and New Markets Tax Credits[99] have all been used with great success to attract private equity into projects with substantial public benefits.[100]

A. HISTORIC PRESERVATION

Historic Preservation is defined by some as the "stewardship of the important places from our past, including buildings, structures, sites, districts and landscapes."[101] Preservation is not

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[95] *Id.*

[96] *Lands of Lost Opportunity: What Can Be Done to Spur Redevelopment at America's Brownfield Sites?: Before the House Subcomm. on Federalism and the Census of the Comm. on Government Reform*, 109th Cong. 85-110 (2005) (statement of Jonathan Philips, Senior Director, Cherokee Investment Partners, LLC), http://a257.g.akamaitech.net/7/257/2422/31oct20051400/www.access.gpo.gov/congress/house/pdf/109hrg/23259.pdf.

[97] Tax Reform Act of 1976, Pub. L. No. 94-455, § 2124, 90 Stat. 2520, 1916.

[98] Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

[99] New Markets Tax Credits Statute, 146 CONG. REC. H12393 (daily ed. Dec. *15, 2000).*

[100] *See supra* note 96.

[101] Office of Archaeology and Historic Preservation, Colorado Historic Society, *Colorado Preservation 2005: Summary of the Statewide Historic Preservation Plan. Denver, CO., available at* http://www.ci.greeley.co.us/cog/PageHome.asp?fkOrgID=87. The effects of historic preservation may range from esoteric and aesthetic, to land and resource conservation, to smart growth and neighborhood revitalization. *Id.* Through architecture and style, buildings and structures reflect our ethnic

only reusing an existing structure, it also represents places a value on history and architecture so that future generations may capture and experience a bit of an earlier generation's culture.[102] Older buildings and structures can be found in virtually every community and urban neighborhood. Often, these buildings and the lots on which they sit were once thriving, income-producing pieces of real estate.[103] Perhaps in prior days they were the site of a warehouse complex, manufacturing plant, or transportation facility.[104] However, today, they sit abandoned and derelict, casting blight on a once vibrant neighborhood and contributing little or nothing to the municipal funds.[105]

Valuing the past often has a positive economic impact on a community as well.[106] As a matter of broader economics, a rehabilitated structure may provide a higher investment return than tearing down and rebuilding.[107] Although it may cost more initially to restore an old building than to demolish and replace it with newer materials, the end result is the preservation of a certain quality of life and urban identity.[108] In 1976, Congress first passed a law for federal tax incentives for historic

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and cultural heritage and foster an appreciation of the distinctive architecture and even the open landscapes as magnificent art forms. *See* ROBERT E. STIPE, A RICHER HERITAGE: HISTORIC PRESERVATION IN THE TWENTY-FIRST CENTURY, 451–493 (The University of North Carolina Press, 2003).

[102] CAROL NORTON, UNIVERSITY OF LOUISVILLE, CENTER FOR ENVIRONMENTAL POLICY AND MANAGEMENT, BROWNFIELDS: HISTORIC PRESERVATION AS A REDEVELOPMENT OPTION (Spring 2005), *available at* http://cepm.louisville.edu/Pubs_WPapers/practiceguides/PG8.pdf (last visited Apr. 12, 2007).

[103] *See* Mann, *supra* note 7, at 217-18.

[104] *Id.*

[105] *Id.*

[106] *Id.* at 218.

[107] *Id.*

[108] John Berendt, *Foreword* to COLIN AMERY WITH BRIAN CURRAN, VANISHING HISTORIES: 100 ENDANGERED SITES FROM THE WORLD MONUMENTS WATCH, 89. (Harry N. Abrams, Inc., 2001); NATHAN WEINBERG, PRESERVATION IN AMERICAN TOWNS AND CITIES (Westview Press, Inc., 2003)).

rehabilitation.[109] One of the most widely used historic preservation funding tools is the Federal Rehabilitation Tax Credit (RTC) program.[110] The RTC is a funding tool created to encourage more developers to consider the social and economic benefits of historic buildings by providing a means to reduce the amount of federal taxes owed on a completed redevelopment project.[111]

The credit provides a dollar for dollar income tax offset for up to 20% of qualified rehabilitation expenditures.[112] The credit has a two-pronged structure: certified historic structures are eligible for the 20% credit and other qualified rehabilitation buildings are eligible for a 10% credit.[113] A certified historic structure must either be listed in the National Register for Historic Places[114] or be located on a registered historic district and certified by the Secretary of Interior as being of historic significance to the district.[115] The credit is also structured to

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[109] Tax Reform Act of 1976, Pub. L. No. 94-455, § 2124, 90 Stat. 1520, 1916 (codified as amended at 42 U.S.C. § 405(c)(2)(C)(i) (1999).

[110] I.R.C. § 47 (2000).

[111] *Id.*

[112] *Id.*

[113] *Id.* § 47(a)(1)-(2). Designated or certified properties are eligible for the full 20% tax credit. Buildings that were built prior to 1936 and do not qualify for listing on the National Register may receive tax credits that are 10% of the rehabilitation costs. *Id.* § 47(a)(1)-(2).

[114] I.R.C. § 47(c)(3)(A)(i)-(ii) (2000).

[115] *Id.* On the federal level, there are two designation distinctions: National Register of Historic Places and National Historic Landmarks. The National Register of Historic Places lists properties that bear special significance to the country's past. This includes not only buildings and structures, but also districts or neighborhoods, places, and even certain objects are eligible for listing. *See* National Register of Historic Places, *available at* http://www.cr.nps.gov/hps/TPS/standards_guidelines .html. (last visited Apr. 12, 2007). Each nomination is measured on its own particular merits and must meet a uniform set of standards set forth by the U.S. Department of Interior and the National Park Service. A nomination process for a listing might include documentation on past use and ownership of a property and its contribution to the local, state or national history. I.R.C. § 47. However, there are no restrictions on the use and renovation of the

limit its benefits to significant rehabilitative efforts-the "qualified rehabilitation expenditures" must exceed the greater of the adjusted basis of the building or $ 5,000 within a two year measuring period.[116] Not only must the building be "substantially rehabilitated," but most of the original historic structure must remain.[117]

Currently there are approximately 78,000 listings in the National Register, which includes all National Park System's historic areas.[118] The National Park Service defines national Historic Landmarks as properties that "possess exceptional value or quality in illustrating and interpreting the heritage of the United States."[119] Landmarks must be first listed on the

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building unless the building owner is using historic tax credits as a means to offset preservation costs. The purpose of the Register is to encourage and support both public and private parties in identifying and protecting the nation's historic and archeological resources. *See* National Park Service, U.S. Dep't of Interior, *Federal Historic Preservation Tax Incentives* (2004), *available at* http://www.cr.nps.gov/hps/TPS/tax/index.htm.

[116] I.R.C. § 47(c)(1)(C) (2000). Thus, if a historic property is purchased for $200,000 with $50,000 being allocated to the land and $150,000 to the structure, the qualified rehabilitation expenditures must exceed $150,000 within the appropriate measuring period. *Id.*

[117] *Id.* § 47(c)(1)(A)(iii)(I)-(III). For a building that is not a certified historic structure, 50% or more of the existing external walls must be retained in place as external walls, 75% or more of the existing external walls must remain in place as external or internal walls, and 75% or more of the existing internal structural framework must remain in place. *Id.* § 47(c)(1)(A)(iii).

[118] *See* National Park Service, *supra* note 115.

[119] *Id.* The National Park Service promotes the use of the tax credits, stating:

> Rehabilitation of historic buildings attracts new private investment to the historic core of cities and towns and is crucial to the long-term economic health of many communities. Enhanced property values generated by the Historic Preservation Tax Incentives program result in augmented revenues for local and state government through increased property, business, and income taxes. Historic Preservation Tax Incentives also create moderate and low-income housing in historic buildings.

National Register, meet the eligibility standards, and go through a nomination process before determining designation.[120] Once a building is determined to be either a National Historic Landmark, on the National Register, and/or a contributing factor in a historic district, it becomes eligible for federal and state tax credits, as well as other funding sources.[121]

The National Park Service and the Internal Revenue Service set the guidelines and criteria for receiving the tax credits. The historic preservation and rehabilitation project must adhere to the standards set forth by the Secretary of the Interior, and the credits are not issued until the project is complete and certified.[122] As an added incentive, tax credits can be "sold" to a third party who in turn can use them to lower their federal income tax liability. This funding tool provides a way to raise capital to help defray rehabilitation construction costs. [123]

According to the National Park Service, since 1976 this tax credit and a related 10% historic rehabilitation tax credit have produced impressive results, including: rehabilitation of more than 32,000 historic properties; stimulation of more than $33 billion in private investment; Rehabilitation of more than 185,000 housing units and creation of 140,000 housing units of which over 75,000 are for low- and moderate-income families.[124]

Even though the maximum tax credit was lowered in 1986 from 25% to 20%, and restrictions were placed on who could qualify to use the credit, this incentive is still the most popular

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Id.

[120] Of all the properties on the National Register, only 3% meet the criteria for Landmark status. *Id.*

[121] *See supra* note 118.

[122] The National Trust, through their website, has developed a step-by-step guide to assist building owners and developers in determining whether a rehabilitation project is eligible for the tax credits and criteria for redemption of the credits. *Id.*

[123] *See supra* note 94, at 75.

[124] *See supra* note 115.

incentive for historic preservation projects.[125] It has been argued that the rehabilitation tax credit is largely a self-funding program.[126] Edward Rendell, then Mayor of Philadelphia, noted that "[w]hile a $1 million rehabilitation expenditure would cost the Treasury $200,000 in lost tax revenues, it would at the same time generate an estimated $779,478 in wages. Taxed at 28%, the investment would produce $218,254 in federal tax revenue."[127] On average, each rehabilitation project creates forty-two jobs.[128] The proven success of the federal RTC has prompted approximately half of the states to offer similar versions of income tax credits.[129] Individual states have different sets of criteria and tax credit percentages.[130]

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[125] It is also important to note that on June 30, 2005, Representatives Phil English (R-PA) and William Jefferson (D-LA) reintroduced a significant bill HR3159 (Community Restoration and Revitalization Act) amending the 1986 tax credit supporting rehabilitation of historic buildings. The bill would deepen the existing credit, improve it for smaller projects, and removes language that calls for the recapture of the credit in rehabilitations involving condominiums among other improvements. The proposed amendments are: (1) Basis Reduction – Eliminates the basis reduction would remove a large disincentive to the use of the rehab credit that is uniformly considered among its users to be the largest impediment to attracting a greater amount of private investment in historic buildings; (2) Historic Tax Credit for Historic Buildings in Difficult to Develop Areas – Allows for a greater eligible tax credit basis for projects located in a "Difficult-to-Develop-Area" or in a qualified census tract; (3) Harness the 10 Percent Credit for Affordable Housing – Amends Section 50(b)(2) to make the 10 percent historic tax credit eligible for housing. This proposal also includes changing the definition of "older building" from "built before 1936" to any property "fifty years old or older." *See generally* Community Restoration and Revitalization Act, H.R. 3159, 109th Cong. (2005).

[126] *See* Mann, *supra* note 7, at 221.

[127] Mayor Edward G. Rendell, Address at the National Press Club, *The New Urban Agenda* (Apr. 15, 1994).

[128] National Park Service, U.S. Dep't of the Interior, *Federal Tax Incentives for Rehabilitating Historic Buildings* (June 2001), *available at* http://www.cr.nps.gov/HPS/tps/tax/brochure1.htm.

[129] *Id.*

[130] *See* Norton, *supra* note 102.

B. FEDERAL LOW INCOME HOUSING TAX CREDIT

The Low-Income Housing Tax Credit ("LIHTC"), which was created as part of the Tax Reform Act of 1986[131] utilizes the Internal Revenue Code to provide an incentive for the construction and rehabilitation of low-income rental housing. By lowering the overall cost of producing housing units through the provision of tax credits to developers and owners of qualified rental projects, the intent of the LIHTC is to stimulate investment in low-income housing development.[132]

Many developers have experience with the federal Low Income Housing Tax Credit program.[133] Building low-income housing, with its lower rents and reduced sales prices, is generally a less attractive investment opportunity when compared to middle or upper income housing on the same site.[134] So the Tax Reform Act of 1986 offered developers incentives in the form of tax credits against the income from low-income housing. Developers may sell the credits to other investors to raise additional capital.[135] By reducing the amount of borrowing required to acquire or rehabilitate residential units, tax credits contribute to the affordability of housing.[136] This program has unquestionably resulted in a tremendous

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[131] The LIHTC was enacted as part of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended at 26 U.S.C. 42 (2000)), and it was permanently funded in the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312 (codified at 26 U.S.C. 1391-97D (2000)) (amended by the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 951-952, 111 Stat. 788, 885).

[132] U.S. Department of Housing and Urban Development, Community Planning And Redevelopment, *Home and Low Income Housing Credits*, *available at* http://www.hud.gov/offices/fheo/lihtcmou.cfm (last visited Feb. 2, 2007).

[133] For examples of this see *id.*

[134] *Id.*

[135] *Id.*

[136] *Id.*

number of low-income housing units being built and these units now are found across the country in almost every community.[137]

A good example of the success of the tax credit stems from Trenton, New Jersey, which forged an early success for housing tax credits in redeveloping the contaminated Circle F manufacturing site. Completed in 1997, the project assembled $9.1 million in funding to clean up the site and build affordable senior citizens' housing. Trenton officials selected Lutheran Social Ministries of New Jersey (LSM), a long-time local nonprofit developer, to undertake the project. The city subdivided the site, targeting the older front half of the parcel for 70 units of senior citizen housing. LSM fronted $553,000 for site cleanup and preparation, which became part of its project equity. LSM also applied for and received an allocation of approximately $5.4 million in federal low-income housing tax credits from New Jersey. These credits are distributed by states according to their own criteria. The tax credits attracted Nat West bank, a private lender, which helped finance the project with a $4.1-million construction loan. The bank assumed the role of a limited partner in the project in order to obtain the tax credit benefit. In addition, the project obtained $1.4 million from the New Jersey Department of Community Affairs Balanced Housing program, $326,000 in State Regional Contribution Agreement funds, $150,000 in City HOME funds, and $420,000 in Federal Home Loan Bank funds. LSM also obtained a $517,000-development loan and a $330,000-loan from Thrift Institutions Community Investment Corporation of New Jersey.[138]

The LIHTC allows owners of qualified low-income rental housing to claim a tax credit annually over a ten-year period.[139] Only "qualified low-income projects" are eligible to receive a low-income housing tax credit.[140] Both the new construction and

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[137] Charles Bartsch & Barbara Wells, *Financing Strategies for Brownfield Cleanup and Redevelopment Northeast-Midwest Institute* June 2003, *available at* http://www.epa.gov/brownfields/mmatters.htm. (last visited March 9, 2006).

[138] *Id.*

[139] *Id.*

[140] I.R.C. § 42(c)(2), (g) (2000).

the substantial rehabilitation of eligible residential rental properties may qualify for the tax credit program.[141] To qualify for the credit, the building must be a residential rental property and must set aside a minimum number of rent-restricted residential units.[142] Accordingly, the owner of a LIHTC rental project must elect to have either 20% or more of the building's residential units rent-restricted and occupied by renters whose income is 50% or less of area median gross income, or have at least 40% or more of its residential units rent-restricted and rented to tenants whose income is no greater than 60% of the area median gross income.[143] The LIHTC also places restrictions on the amount of rent that may be charged for the low-income units.[144]

The dollar amount of the tax credit that is awarded to an owner of a qualified building is calculated as a percentage of the owner's basis in the rental units that are set aside for low-income tenants.[145] Qualified basis is determined by multiplying a building's eligible basis by the "applicable fraction."[146] The applicable fraction is the lesser of the unit fraction, which is the ratio of low-income units to total units in the building, or the floor space fraction, which is the ratio of total floor space of the

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[141] *Id.* §§ 42(d), (e). In addition, a taxpayer who places an existing building in service as a low-income project may qualify for the tax credit as long as the building was acquired by purchase, was not previously placed in service by the taxpayer or related party and has not changed ownership or undergone major improvements for the past ten years. *Id.* § 42(d)(2).

[142] *Id.* § 42(g).

[143] *Id.* § 42(g)(1). These two elections are commonly referred to as the "20-50 test" and the "40-60 test." Once the election is made, it is irrevocable. *Id.* § 42(g). Furthermore, tax credits are available only for the number of units in the rental project that are rent-restricted and occupied by qualifying low-income tenants. *Id.* §§ 42(c), (g)

[144] For these units, the gross rent, including utilities but excluding any payment made under the Section 8 program, may not exceed 30% of qualifying income, using a family size equal to 1.5 times the number of bedrooms in the unit. *Id.* § 42(g)(2).

[145] *Id.* §§ 42(a), (c).

[146] *Id.* § 42(c).

low-income units to the total floor space of all residential rental units, whether occupied or not.[147]

A higher credit is awarded to buildings located in an area specifically designated by the Secretary of Housing and Urban Development as a "qualified census tract" or "difficult development area."[148] A qualified census tract is an area in which 50% or more of the households have an income that is less than 60% of area median gross income.[149] A difficult development area is an area in which there are high construction, land and utility costs relative to area median gross income.[150]

A qualifying taxpayer may take the tax credit annually for ten taxable years, beginning the year in which the project is placed in service.[151] A credit recipient also must agree to maintain the building's qualifying low-income status for at least fifteen years.[152] The LIHTC requires that eligible projects maintain an

[147] I.R.C. § 42(c)(1) (2000). For purposes of the credit, the eligible basis is the building's adjusted basis at the end of the first taxable year of the credit period. *Id.* § 42(d). The "applicable percentage" for LIHTC purposes depends on the characteristics of the building being placed in service. The applicable percentage is determined monthly by the Treasury Department, and it is set so as to yield, over the ten-year period in which the credit may be claimed, a credit with a present value equal to 70% or 30% of the building's qualified basis, depending on the building's characteristics. *Id.* § 42(b). *See* Jeanne L. Peterson, *The Low-Income Housing Tax Credit*, 73 MICH. BAR J. 1154, 1155 (1994). For new and substantially rehabilitated buildings that do not receive additional federal subsidies, the present value of the credit is equal to 70% of qualified basis. *Id.* § 42(b)(2). For existing buildings that undergo substantial rehabilitation, the eligible acquisition costs qualify for the 30% credit, but the rehabilitation expenditures may receive the 70% present value credit. *Id.* § 42(e); *See* Rev. Rul. 91-38, 1991-26 I.R.B. 5 (1991).

[148] I.R.C. § 42(d)(5)(C) (2000).

[149] *Id.* § 42(d)(5)(C)(ii).

[150] *Id.* § 42(d)(5)(C)(iii). For new buildings constructed in a qualified census tract or difficult development area, the higher credit amount is achieved by increasing the property's eligible basis to 130% of the otherwise eligible basis. *Id.* § 42(d)(5)(C)(i)(I). For existing buildings, the rehabilitation expenditures included in the eligible basis are increased to 130% of total rehabilitation expenditures. *Id.* § 42(d)(5)(C)(i)(II).

[151] *Id.* § 42(f)(1).

[152] *Id.* § 42(h)(6).

extended commitment to low-income housing.[153] Accordingly, a qualified project must remain a rental property and continue to meet the income and rent requirements for a minimum fifteen-year period.[154] The Internal Revenue Code provides for the recapture of the low-income housing credit where, with limited exceptions, the LIHTC property fails to meet the income and rent limitation requirements.[155] However, the credit recapture amount phases out in the eleventh through fifteenth years.[156] Credit recapture may also occur when a project owner sells an interest in the property.[157]

LIHTC properties receive favorable tax treatment under the Internal Revenue Code's passive activity rules.[158] The Internal Revenue Code allows a taxpayer who "actively" participates in a rental real estate activity to deduct up to $25,000 of annual losses attributable to the rental real estate.[159] This allowance is subject to a phase-out reduction for taxpayers whose adjusted gross income exceeds $100,000.[160] However, the phase-out provision does not apply to investments in low-income housing funded by the credits.[161] Moreover, investors in LIHTC properties are not subject to the active participation requirement.[162] Therefore, an investor in a LIHTC project may

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[153] *Id.* § 42(h)(6).

[154] *Id.* §§ 42(g)(2), (h)(6), (i)(1). Owners must continually monitor and re-certify tenant incomes in order to ensure compliance since an increase in a tenant's income may disqualify the tenant. *See* Andrew Z. Blatter & Elena Marty-Nelson, *An Overview of The Low Income Housing Tax Credit,* 17 U. BALT. L. REV. 253, 260 (1988).

[155] I.R.C. § 42(j) (2000).

[156] *Id.*

[157] *Id.*

[158] *Id.*

[159] I.R.C. § 469(i) (2000).

[160] *Id.* § 469(i)(3)(A).

[161] *Id.* § 469(i)(3)(C).

[162] *Id.* § 469(i)(6)(B).

take advantage of the $25,000 offset regardless of the investor's level of participation.[163] This favorable tax treatment under the passive activity rules may further encourage investment in low-income housing.

The credit is a "major component of Federal housing policy," and "has produced more than 600,000 units of rental housing since its enactment."[164] HUD describes the LIHTC as "a key element in the Administration's strategy for adding to the stock of rental housing that is affordable without additional subsidy for families who have low-incomes."[165] Housing experts agree that the LIHTC program "has proven widely successful in building [affordable] housing."[166] The program has been called "the most important subsidization available to the builder of affordable homes over the last five to ten years."[167] In 1997, the United States General Accounting Office reported that the LIHTC program was "one of the most successful and efficient federal initiatives ever."[168]

C. NEW MARKETS TAX CREDITS

On December 21, 2000 President Clinton signed into law the New Market Tax Credit Program ("NMTC")[169] as part of the Community Renewal Tax Relief Act.[170] The purpose of the

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[163] *Id.*

[164] HUD Strategic Plan, Strategic Objective #3, *available at* http://www.hud.gov/reform/sps03.html.

[165] *Id.*

[166] Steve Bergsman, *Corporate Taxation: Taking Credit*, CFO MAG. FOR SENIOR FIN. EXECUTIVES, Nov. 1, 1997, at 21.

[167] F. Willis Caruso & Mark Brennan, *Public Housing Privatization Using Section 8 Vouchers and I.R.C. Section 42 Low-income Housing Tax Credits in Connection with the Use of Lease to Purchase Options*, 16 ST. LOUIS U. PUB. L. REV. 355, 377 (1997).

[168] *See* Bergsman, *supra* note 166, at 18.

[169] *Id.*

[170] Susan R. Jones, *Will New Markets Tax Credits Enhance Community Economic Development,* 8 J. SMALL & EMERGING BUS. L. 229, 230 (2004).

credit is to stimulate increased investment and economic growth in low-income communities.[171] The NMTC Program permits taxpayers to receive a credit against Federal income taxes for making qualified equity investments in designated Community Development Entities ("CDEs").[172] Substantially all of the qualified equity investment must in turn be used by those CDE to provide investments in low-income communities.[173]

To qualify as a CDE, an entity must be a domestic corporation or partnership that: 1) has a mission of serving, or providing investment capital for, low-income communities or low-income persons; 2) maintains accountability to residents of low-income communities through their representation on a governing board of or advisory board to the entity; and 3) has been certified as a CDE by the CDFI Fund.[174]

The credit provided to the investor totals 39% of the cost of the investment and is claimed over a seven-year credit allowance period.[175] In each of the first three years, the investor receives a credit equal to 5% of the total amount paid for the stock or capital interest at the time of purchase.[176] For the final four years, the value of the credit is 6% annually. Investors may not redeem their investments in CDEs prior to the conclusion of the seven-year period.[177]

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[171] *Id.*

[172] A CDE is a domestic corporation with a track record in community development, which is accountable to low-income communities. An example of a CDE is a Community Development Corporation, a Community Development Financial Institution, a private financial institution or a Small Business Investment Company. Non-profit organizations participating in the NMTC typically establish for-profit subsidiary corporations to take equity investments related to the New Markets Tax Credit. *Id.*

[173] CDE's use capital derived from tax credits to make loans to or investments in businesses and projects in low-income communities. *Id.*

[174] *See* United States Department of the Treasury, New Markets Tax Credit Program, *available at* http://www.cdfifund.gov/what_we_do/programs_id.asp?programID=5 (last visited Apr. 14, 2007).

[175] *Id.*

[176] *Id.*

[177] *Id.*

NMTCs are allocated annually by the Fund to CDEs under a competitive application process.[178] These CDEs then offer the credits to taxable investors in exchange for stock or a capital interest in the CDEs.[179] They can sell credits for cash to individuals or institutional investors in exchange for QEIs in CDEs, or they can keep the credits if they want to offset their own tax liability.[180] A CDE has five years to sell credits to investors, but if it fails to do so, it may transfer the unsold or unused credits to another CDE.[181] CDEs have twelve months to place substantially all (at least eighty-five) of investors' cash in qualifying investments.[182] A CDE runs the risk of subjecting the investors to a recapture event, which requires the repayment of the credits claimed, plus interest for failure to place substantially all the cash in qualifying investments.[183]

On May 6, 2004, U.S. Treasury Secretary John W. Snow announced that sixty-two organizations have been selected to receive $3.5 billion in tax credit allocations through the second round of the NMTC Program.[184] During the announcement, Snow commented, "From foresting businesses in the communities of north-central Maine, to a start-up

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[178] The NMTC program is administered by the United States Department of Treasury through its Community Development Financial Institutions (CDFI) Fund. NMTC applications are evaluated using the following four criteria: (1) business strategy; (2) capitalization strategy; (3) management capacity; and (4) community impact. *See* Jones, *supra* note 170, at 231.

[179] *See* Jones, *supra* note 170, at 231.

[180] *Id.*

[181] *Id.*

[182] *Id.*

[183] *Id.* A recapture also occurs if the CDE ceases to exist. *See generally,* Beth Mullen, *New Markets Tax Credits-Possibilities and Pitfalls*, 13 J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 31 (2003); Michael J. Novogradac*, Update on the New Markets Tax Credit,* 12 J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 447 (2003).

[184] Press Release, U.S. Treasury, Treasury Announces $3.5 Billion to Help Nation's Low Income Communities Through New Market Tax Credit Program (May 6, 2005), *available at* http://www.ustreas.gov/press/releases/js1518.html (last visited Mar. 7, 2006).

manufacturing business in south-eastern Ohio, to child-care facilities and needed shopping centers in many of our inner-city low-income neighborhoods, the New Markets Tax Credit Program has already begun to improve the communities in which these investments are being made," highlighting the work already underway by organizations that received allocations of tax credits last year.[185]

In a 2005 survey by the New Market Tax Credit Coalition, the Report found that CDEs are making much faster progress in marketing the Credit and securing qualified equity investments.[186] In the fall of 2003, the CDEs surveyed received a total of approximately $1.3 billion in New Markets Tax Credits.[187] By the end of 2004, CDEs had issued QEIs totaling $756 million or 58% of their total allocations.[188] By the end of 2005, QEIs are expected to reach $1.15 billion, 89% of the total allocation.[189]

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[185] *Id.*

[186] New Markets Tax Credit Coalition, New Markets Tax Credits, Progress Report May 2005, *available at* http://www.newmarketstaxcreditcoalition.org/RegETC/regule.frameset.htm (last visited Mar. 9, 2006). The purpose of this report is to provide policymakers with an update on the implementation of the New Market Tax Credit (NMTC) program. The New Markets Tax Credit Coalition, a national membership organization that advocates on behalf of the Credit, prepared this report. Throughout the life of the NMTC Program, the Fund is authorized to allocate to CDEs the authority to issue to their investors up to the aggregate amount of $15 billion in equity as to which NMTCs can be claimed. To date, the Fund has made 170 awards totaling $8 billion in allocation authority. The Fund released its fourth annual NMTC Program Notice of Allocation Availability (NOAA) on July 15, 2005. This NOAA invites CDEs to compete for tax credit allocations in support of an aggregate amount of $3.5 billion in qualified equity investments in CDEs. *Id.*

[187] *Id.*

[188] *Id.*

[189] *Id.*

IV. ANALYSIS: NEW LEGISLATION

On December 8, 2005, ICSC and the Roundtable examined a proposal originated by Chairman Turner, called America's Brownfield Cleanup Act[190], which would dedicate a limited dollar amount for tax credits tied to the costs of remediating brownfield contamination.[191] This tax credit would be available prior to the actual expenditure of the remediation costs, allowing a pioneering developer to attract more capital with the equity created by the credit.[192]

By providing up-front equity in the form of a transferable tax credit that can be sold in advance, the Turner legislation creates a solid incentive for investment funds to position capital on brownfield projects for the simple reason that they are able to deploy their investment capital later in the remediation/redevelopment process, thus boosting the rate of return for their investors and enabling them to attract new sources of capital to remediate and redevelop additional brownfield sites.[193]

This proposal has the potential to stimulate numerous small and medium cleanup projects around the country.[194] As with the Low Income Housing Tax Credits program, the private sector would still provide much of the necessary funding for cleanup.[195] But the availability of a tax credit could tip the scales

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[190] *The Challenge of Brownfields: What are the Problems and Solutions in Redeveloping Pennsylvania's Lehigh Valley Communities? Hearing H.R. 4480 Before the Subcomm. on Federalism and the Census, Comm. on Government Reform*, 109th Cong. 4451-450 (2005) (statement of Congressman Michael Turner, Chairman).

[191] *See* Brownfields Revitaliziation Act of 2004, H.R. 4480, 108th Cong. §§ 2, 45G (2004) ("To amend the Internal Revenue Code of 1986 to allow taxpayers a credit against income taxes for expenditures to remediate contaminated sites."), *available at* http://thomas.loc.gov/cgi-bin/query/z?c108:H.R.4480.IH: (last visited Apr. 14, 2007).

[192] *Id.*

[193] *See generally id.*

[194] *Id.*

[195] *Id.*

in favor of proceeding with a project, rather than passing over an otherwise promising site. Under this proposal, tax credits would be available for up to 50% of the remediation costs, including both demolition costs and the cost of cleaning up petroleum contamination.[196] The tax credits only would be available under projects conducted pursuant to a state-approved remediation plan.

Making these credits transferable to third parties, such as banks, would leverage the capital necessary for cleanups. Last year's proposal would allocate up to $1 billion in tax credits among the states based on population.[197] State development agencies would be authorized to administer the program.[198]

These credits would be further limited to redevelopment projects within a jurisdiction that includes at least one census track with poverty in excess of 20%.[199] The states would apply various criteria to determine eligible projects, such as the extent of contamination remediated, the poverty at the location of the project, the number of jobs created, the position of the property within the central business district and the owner's financial commitment for redevelopment.[200]

V. CONCLUSION

It is clear that brownfield revitalization is one of the most important aspects to encourage urban renewal. However, the fear of liability from environmental statutes, and the confusion surrounding the proper tax treatment of remedial expenses has actually created a disincentive for prospective developers to invest capital to help alleviate the distressed area. Looking at the success of federal tax credits used in other contexts of urban renewal and economic revitalization, the most logical solution would be to extend the tax credits to brownfields permanently.

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[196] *See id.* § 45G(b)(1), (2).

[197] *See* H.R. 4480, § 45G(d)(2).

[198] *See generally* H.R. 4480.

[199] *See id.* § 45G(e)(1)(A).

[200] *See generally* H.R. 4480, § 45G(e).

Chairman Turner recently introduced House Bill 4480, which would create a transferable tax credit for this purpose. Transferable tax credits will expedite the cleanup of contaminated sites by providing investors with the ability to sell the credit to raise capital and encourages past polluters to take action as well.