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ENVIRONMENTAL CLEAN-UP EXPENSES: TAXING TIMES FOR THE BLM AND MINERS

SERGIO PAREJA†

ABSTRACT

In 2001, the BLM amended 43 C.F.R. Section 3809 to give the BLM the power to require that mining companies establish a trust fund to provide for long-term maintenance and water treatment. The amended regulations do not mention taxes, and there is no evidence in the legislative history that the BLM ever contemplated the income tax effect of utilizing a trust mechanism to provide for environmental clean-up. While a partner at a law firm, the author of this article had the privilege of being the primary drafter of the first two trust agreements ever required by the BLM under these relatively new regulations. This article focuses on the federal income tax issues related to drafting and funding these trusts. The author concludes that the law is currently unclear regarding the way they are taxed, and, as a result, the taxation of these trusts will depend on the way the trust agreement is drafted. The author offers a proposal to change the tax law to establish a general rule regarding how these trusts will be taxed. More specifically, this article proposes that mining companies should be allowed a present federal income tax deduction for any funds put into a trust at the request of the BLM. Furthermore, such trusts should be tax-exempt entities if the mining company agrees to forego any reversionary interest or, if it does not agree to forego its reversionary interest, entities that are taxable separate from the mining company.

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While a partner at HRO's office in Denver, Colorado, the author of this article had the privilege of being the primary drafter of the first two trust agreements ever required by the Bureau of Land Management (the "BLM") under 43 C.F.R. § 3809.552. The author developed this article after he spent well over a year working with the BLM, corporate trustees, and mining companies to draft trust agreements and to fund trusts that had been required by the BLM under 43 C.F.R. § 3809.552. Drafting these trust agreements was no small feat given the competing interests.

TABLE OF CONTENTS

In a cavern, in a canyon, excavating for a mine,
dwelt a miner forty-niner and his daughter Clementine.[1]

INTRODUCTION

Times have changed for miners since California's Gold Rush. In 1849, more than 80,000 "forty-niners" flooded into the western lands that the United States had recently acquired from Mexico to mine for gold, nearly tripling the population of that territory.[2] It was not long after this "Gold Rush" that Congress enacted the Lode Law of 1866,[3] the Placer Act of 1870,[4] and the General Mining Law of 1872;[5] laws that essentially codified what already was happening in California's gold fields: miners were freely entering public lands to initiate mining activity.[6] These laws were followed by a long series of federal laws that would eventually have a great impact on the way miners and mining companies do business.[7] Although the early laws gave miners great freedom to explore for precious minerals with almost no environmental constraints, more recent federal legislation in this area has focused on minimizing the environmental impact of mining activities.[8]

In addition to legislation by the United States Congress, rules issued recently by federal agencies also have had a major impact on mining activities.[9] One of the most significant of these rules is found at 43 Code

1. Excerpt of lyrics from the song "Clementine." National Institute of Health, Department of Health and Human Services, Clementine, http://www.niehs.nih.gov/kids/lyrics/clementine.htm (last visited Nov. 9, 2005). Copyright information for the song is unknown. *See id.* The words and music are generally attributed to Percy Montross, circa 1880. *Id.* The song is possibly based on another song entitled "Down by the River Liv'd a Maiden" by H. S. Thompson (1863). *Id.*

2. Geoffrey C. Ward & Dayton Duncan, New Perspectives on the West, http://www.pbs.org/weta/thewest/events/1840_1850.htm (last visited Nov. 9, 2005).

3. The Lode Law of 1866, ch. 262, 14 Stat. 251 (1866) (repealed 1872).

4. Placer Act of 1870, ch. 235, 16 Stat. 217 (1870).

5. General Mining Law of 1872, ch. 152, 17 Stat. 91 (1872) (codified as amended at 30 U.S.C. §§ 22–54 (2005)).

6. The Lode Law of 1866, 14 Stat. 251; Placer Act of 1870, 16 Stat. 217; General Mining Law of 1872, 17 Stat. 91. These laws were intended to give miners broad rights over valuable minerals that they had discovered. *See* Roger Flynn, *The 1872 Mining Law as an Impediment to Mineral Development on the Public Lands: A 19th Century Law Meets the Realities of Modern Mining*, 34 LAND & WATER L. REV. 301, 302 (1999).

7. *See, e.g.*, Building Stone Act of 1892, ch. 375, 27 Stat. 348 (1892); Saline Placer Act of 1901, ch. 186, 31 Stat. 745 (1901); Surface Resources Act of 1955, 30 U.S.C. §§ 611–15 (1955); Federal Land Policy and Management Act of 1976, 43 U.S.C. §§ 1701–82 (1976).

8. *See, e.g.*, Federal Land Policy and Management Act of 1976, 43 U.S.C. §§ 1701–82 (1976). *See also* F. K. Allgaier, *Environmental Effects of Mining*, *in* MINING ENVIRONMENTAL HANDBOOK: EFFECTS OF MINING ON THE ENVIRONMENT AND AMERICAN ENVIRONMENTAL CONTROLS ON MINING 132 (Jerrold J. Marcus ed., 1997) (noting that early hardrock miners "usually did not worry about land reclamation or the quality of surface and ground waters as a result of mining").

9. *See, e.g.*, 43 C.F.R. § 3809 (2005) and 36 C.F.R. § 228a (2005). Regulations affecting hardrock mining are predominantly issued by the Department of the Interior and the Department of Agriculture. Virtually all of the public lands in the United States open to hardrock mining are administered by the following two federal agencies that manage land: (1) the Bureau of Land Management (part of the Department of the Interior) and (2) the United States Forest Service (part of the Department of Agriculture). John F. Seymour, *Hardrock Mining and the Environment: Issues of*

of Federal Regulations ("C.F.R.") Section 3809.[10] These regulations were originally promulgated by the United States Department of the Interior's Bureau of Land Management (the "BLM") in 1980 and later amended in their entirety in 2001.[11] Significantly, the amended version of these regulations gave the BLM, for the first time, the power to require that mining companies establish a trust fund to provide for long-term maintenance and water treatment (an "environmental clean-up trust").[12] Specifically, 43 C.F.R. Section 3809.552(c) provides as follows:

> When [the] BLM identifies a need for it, [the mining company] must establish a trust fund or other funding mechanism available to [the] BLM to ensure the continuation of long-term treatment to achieve water quality standards and for other long-term, post-mining maintenance requirements. The funding must be adequate to provide for construction, long-term operation, maintenance, or replacement of any treatment facilities and infrastructure, for as long as the treatment and facilities are needed after mine closure. [The] BLM may identify the need for a trust fund or other funding mechanism during plan review or later.[13]

43 C.F.R. Section 3809 does not mention taxes, and there is no evidence in the legislative history of those regulations that the BLM ever contemplated the income tax effect of utilizing a trust mechanism to provide for environmental clean-up after mining activities. In fact, the only guidance that appears in those regulations regarding the structure of the trust agreement and administration of the trust fund is the following provision: "[The] BLM will periodically review the estimated cost of reclamation and the adequacy of any [trust fund] and require increased cov-

Federal Enforcement and Liability, 31 ECOLOGY L.Q. 795, 813 (2004). Specifically, the Bureau of Land Management manages about 260 million acres of land in the western United States (about one-eighth of all land in the United States), of which approximately 90% is open to hardrock mining, and the United States Forest Service manages about 160 million acres of land in the western United States, of which approximately 80% is open to hardrock mining. *Id.* at 811, 813; Thomas F. Darin, *The Bureau of Land Management's Proposed Surface Management Regulations for Locatable Mineral Operations: Preventing or Allowing Degradation of the Public Lands?*, 35 LAND & WATER L. REV. 309, 309 (2000).

10. 43 C.F.R. § 3809 (2005). These regulations are referred to as the "3809 Regulations" and the "Bureau of Land Management's Surface Management Regulations for Locatable Mineral Operations."

11. 65 C.F.R. § 6998 (2005). *See also* Darin, *supra* note 9, at 310.

12. 43 C.F.R. § 3809.552(c) (2005).

13. *Id.* Note that the BLM can require the use of a trust fund at any time, even after plan review or after mining work has commenced. 43 C.F.R. §§ 3809.552(b), (c) (2005). In the author's experience, however, the BLM intends to use this provision to require the creation of trust funds before it will issue a permit to start digging. To the author's knowledge, the BLM has not mandated the use of a trust by a mining company after issuing a permit to that mining company.

erage, if necessary."[14] The tax effects of this provision are ambiguous and vary widely, depending on how the provision is interpreted.[15]

Although a myriad of non-tax drafting issues arose while the author worked on the first two environmental clean-up trusts ever required by the BLM, this article focuses on the federal income tax issues related to drafting and funding environmental clean-up trusts.[16] Part I of this article addresses miners' historical clean-up obligations and discusses the history of federal legislation and agency rules regarding hardrock mining (with an emphasis on environmental issues).[17] Part II discusses federal income tax issues related to environmental clean-up, in general and, more specifically, focuses on federal income tax issues related to the use of environmental clean-up trusts.[18] This section concludes that the law is currently unclear regarding the way that environmental clean-up trusts are taxed, and the taxation of these trusts will depend heavily on the way the trust is drafted.[19] Part III proposes to change the tax law by establishing a clear rule regarding how these trusts will be taxed.[20] More specifically, this section proposes that mining companies should be allowed a present federal income tax deduction for any funds put into an environmental clean-up trust at the request of the BLM.[21] Furthermore, Part III proposes that such trusts should be tax-exempt entities if the mining company agrees to forego any reversionary interest.[22] Or, if the mining company does not agree to forego its reversionary interest, the environmental clean-up trusts should be taxed separate from the mining company.[23]

The proposed change to the law discussed in this article would provide tax certainty and simplicity for mining companies and the BLM when they are negotiating the terms of environmental clean-up trusts;

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14. § 3809.552(b). "Reclamation" generally means the "process of improving disturbed land (soil, vegetation, water) to achieve land capability equivalent to the predisturbed condition." University of Alberta, Land Reclamation, Remediation and Restoration, http://www.rr.ualberta.ca/Research/Index.asp?Page=LRRR (last visited Nov. 9, 2005). "Remediation" generally means the "process of removing, reducing or neutralizing industrial soil and sediment contaminants that threaten human health and/or ecosystem productivity and integrity." *Id.* For convenience and because the differences in meaning do not have an impact on the tax issues discussed in this article, the author has used the words "clean-up," "remediation," and "reclamation" interchangeably throughout this article.

15. *See infra* notes 251–53 and accompanying text.

16. Other issues included such things as the effect of the Rule Against Perpetuities, the situs of the trusts, the protection of trust assets from creditors in the event of bankruptcy of the mining company, the use of an investment director in addition to a trustee, and the identities of the trust grantor and beneficiary. In addition, state and local tax issues arose during negotiations. These issues are not addressed in this article.

17. *See infra* Part I.

18. *See infra* Part II.

19. *See id.*

20. *See infra* Part III.

21. *See id.*

22. *See id.*

23. *See id.*

this certainty and simplicity, in turn, would greatly expedite the process of negotiating and funding these trusts.[24] Society as a whole would benefit from this because these trusts are one of the most effective ways to ensure that the environment will be cleaned up after mining activities.[25] By providing certainty regarding the taxation of these trusts and by giving mining companies a tax incentive to forego any reversionary interest, tax policy will expedite and encourage the adequate funding of trusts to ensure that the environment will be kept clean for future generations of Americans.[26]

I. ENVIRONMENTAL CLEAN-UP OBLIGATIONS OF MINERS

Before analyzing the taxation of environmental clean-up trusts, it is essential to understand the fascinating history of federal laws that regulate mining activity. These laws, which include both legislation by the United States Congress and rules by federal agencies, demonstrate that the government is increasingly responding to public pressure to ensure that the environment will be cleaned up after mining activities.[27] Furthermore, history demonstrates that trust funds are the latest in a long line of efforts to ensure that mining companies provide adequate funds to clean up the environment, and that those funds will be protected from the creditors of the mining companies.[28]

A. The General Mining Law of 1872[29]

The General Mining Law of 1872 (the "1872 Law"), which was signed into law by President Ulysses S. Grant on May 10, 1872, originally promoted westward expansion by allowing all U.S. citizens, as well as those planning to become U.S. citizens, to keep for themselves any valuable minerals that they might discover on federal land.[30]

The 1872 Law made no provision for reclamation of mined lands, did not impose environmental standards, and did not provide for gov-

24. *See id.*
25. *See id.*
26. *See id.*
27. *See infra* Part I.A–E. This section is not intended to list all mining laws. The purpose of this section is to give an overview of a few of the major laws that have had an impact on hardrock mining.
28. *See id.*
29. General Mining Law of 1872, ch. 152, 17 Stat. 91 (1872) (codified as amended at 30 U.S.C. §§ 22–54 (2005)).
30. *See* 30 U.S.C. §§ 22, 29 (2005). Specifically, the 1872 Law provides as follows:

> All valuable mineral deposits in lands belonging to the United States, both surveyed and unsurveyed, shall be free and open to exploration and purchase, and the lands in which they are found to occupation and purchase, by citizens of the United States and those who have declared their intention to become such . . . it shall be assumed that the applicant is entitled to a patent, upon the payment to the proper officer of $5 per acre . . . .

17 Stat. at 91.

ernment oversight of mining operations.[31] Although the original law applied to all "valuable mineral deposits" on government lands except coal,[32] subsequent changes to the law limited its application, especially with respect to minerals that could be used for fuel, such as oil and natural gas.[33]

Currently, the 1872 Law authorizes and governs prospecting and mining for hardrock or "locatable" minerals on public lands.[34] With respect to locatable minerals, the 1872 Law has remained remarkably unchanged since its enactment.[35] Generally, the two essential elements of a valid mining claim under the 1872 Law are "discovery" and "location."[36] A patent,[37] costing only $5.00 per acre,[38] gives the prospector title to the locatable minerals and the surface estate where the minerals are located for placer and lode claims.[39] The federal government does not collect any royalties for the extracted minerals.[40]

31. *See* Darin, *supra* note 9, at 310–12 (discussing the history of the BLM and the origin of 43 C.F.R. § 3809 (2005)).

32. *See id.* at 311.

33. *See id.* The Mineral Leasing Act of 1920, 30 U.S.C. §§ 181–96 (2005), removes oil, gas, oil shale, phosphates, sodium, and other minerals from the claim/patent system of the 1872 Law. *Id.* The Materials Act of 1947, 30 U.S.C. §§ 601–04 (2000), provides for the sale or public giveaway of certain minerals, such as sand or gravel. *Id.* The Multiple Mineral Development Act, 30 U.S.C. §§ 521–31 (2005), provides for the development of multiple minerals on the same tracts of public land. *Id.* The Multiple Surface Use Mining Act of 1955, 30 U.S.C. §§ 601, 603, 611–15 (2005), removes certain common varieties of minerals from the list of minerals to which the 1872 Law applies. *Id.* The Federal Land Policy and Management Act of 1976, 43 U.S.C. § 1701 (2005), redefines claim recording procedures and provides for abandonment if the procedures are not followed. *Id.*

34. *See* Darin, *supra* note 9, at 309–10. "Locatable mineral" is "[a] legal term that, for federal lands in the United States, defines a mineral or mineral commodity that is acquired through the [1872 Law]." NAT'L RESEARCH COUNCIL, HARDROCK MINING ON FEDERAL LANDS 14 (1999) (hereinafter NAT'L RESEARCH COUNCIL), *available at* http://books.nap.edu/html/hardrock_fed_lands/index.html (follow "Introduction" hyperlink). These are the base and precious metal ores, ferrous metal ores, and certain classes of industrial minerals. *Id.* Examples of locatable minerals include but are not limited to, gold, silver, copper, lead, zinc, magnesium, nickel, tungsten, . . . [and] uranium." *Id.* This term is often used interchangeably with "hardrock mineral." *Id.* at 12–13.

35. *See generally* Darin, *supra* note 9, at 311–12 (discussing history of the 1872 Law). This long period of minimal change with respect to "locatable minerals" occurred notwithstanding the fact that there have been many changes to land laws since the late nineteenth century. *See generally id.*

36. *See id.* Specifically, after a prospector makes a "discovery" of a valuable mineral on public land, a mining claim must then be "located." *Id.* A valid mining claim gives the locator the exclusive right of possession to the mineral deposit. *Id.*

37. A patent is not needed to extract the minerals from a mining claim. *Id.*

38. *Id.* A patent may also cost $2.50 per acre, in certain circumstances. *Id.* However, this difference is not relevant to the tax issues addressed in this article.

39. *Id.* "Placer claims" generally involve mineral-bearing gravels and sands. *Id.* "Lode claims" are located on bedrock. *Id.*

40. *Id.*

B. The Mining and Minerals Policy Act of 1970[41]

President Richard M. Nixon signed the Mining and Minerals Policy Act of 1970[42] (the "1970 Act") into law on December 31, 1970.[43] The 1970 Act expressly declared that it is the policy of the United States to reduce the adverse impact of mining activities on the environment.[44] Although the stated goals of the 1970 Act were lofty, after its passage, the federal government continued to refrain from overseeing and monitoring mining activities with respect to locatable minerals on public lands; indeed, the federal government was not privy to information regarding most locatable mineral mining claims until the enactment of the Federal Land Policy and Management Act of 1976.[45]

C. Federal Land Policy and Management Act of 1976[46]

On October 21, 1976, President Gerald R. Ford signed the Federal Land Policy and Management Act of 1976[47] (the "FLPMA") into law. This Act represented a drastic change to the law at that time.[48] The FLPMA gave the BLM its comprehensive mission to manage public lands for a variety of uses in order to benefit present and future generations.[49] The FLPMA also established numerous policies related to conservation, attempted to appease vastly different and competing concerns,[50] and declared that the Department of the Interior would manage

41. Mining and Minerals Policy Act of 1970, Pub. L. No. 91–631, 84 Stat. 1876 (1970) (codified as amended at 30 U.S.C. § 21a (2005)).

42. *Id.*

43. *Id.*

44. *Id.* Specifically, the 1970 Act declared that it is the policy of the United States to encourage:

> [T]he study and development of methods for the disposal, control, and reclamation of mineral waste products, and the reclamation of mined land, so as to lessen any adverse impact of mineral extraction and processing upon the physical environment that may result from mining or mineral activities.

Id.

45. *See* Darin, *supra* note 9, at 312.

46. 43 U.S.C. §§ 1701–82 (2005).

47. *Id.*

48. *See generally* Eleanor R. Schwartz, *A Capsule Examination of the Legislative History of the Federal Land Policy and Management Act of 1976*, 21 ARIZ. L. REV. 285, 285–86 (1979). Prior to the enactment of the FLPMA in 1976, there were several congressional efforts to pass comprehensive environmental legislation with respect to mining operations, but none of the bills that passed were signed into law. *See generally id.* at 286–96. Each of these bills possessed increasing complexity. *See generally id.*

49. Darin, *supra* note 9, at 312. The BLM originally had been established by a 1946 Executive Order, but the FLPMA gave it enforcement authority, a larger budget, and more coherence as an agency. *Id.*

50. *See* 43 U.S.C. § 1701(a)(8) (2005). Specifically relevant to mining activities, the FLPMA declared that:

> [I]t is the policy of the United States that . . . the public lands be managed in a manner that will protect the quality of scientific, scenic, historical, ecological, environmental, air and atmospheric, water resource, and archeological values; that, where appropriate, will preserve and protect certain public lands in their natural condition; that will provide food and habitat for fish and wildlife and domestic animals; and that will provide for outdoor recreation and human occupancy and use.

the land for various uses into the future[51] in a way that would prevent unnecessary degradation of the land.[52]

Although the Senate Committee on Energy and Natural Resources stated that requiring a bond or other security was one of the most important provisions of the Senate version of the bill that ultimately became the FLPMA,[53] the House bill did not include this provision.[54] Indeed, Congressional staff could not reconcile the House and Senate positions on this issue in its report to the conference committee,[55] and no provision requiring reclamation was included in the final legislation.[56]

D. Regulation of the Mining of Locatable Minerals by the BLM

In 1980, the BLM promulgated its first regulations affecting mining activities that disturb the land's surface (the "Original 3809 Regulations").[57] These regulations divided mining activities into the following three levels: (1) casual use, (2) notice-level, and (3) plan of operations-level.[58] "Casual use" means use that generally does not disturb the land.[59] "Notice-level" includes use that causes a cumulative surface disturbance of no more than five acres during any calendar year.[60] Finally, "plan of operations-level"[61] includes use that is greater than casual use and notice-level.[62]

The Original 3809 Regulations required reclamation of all mining operations, but bonding requirements for the various types of mining

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Id.

51. *See* § 1732(a). Specifically, the FLPMA states that the Secretary of the Interior "shall manage the public lands under principles of multiple use and sustained yield." *Id.*

52. § 1732(b). The FLPMA states that "In managing the public lands the Secretary shall, by regulation or otherwise, take any action necessary to prevent unnecessary or undue degradation of the lands." *Id.*

53. S. COMM. ON ENERGY AND NATURAL RESOURCES, LEGIS. HISTORY OF THE FED. LAND POLICY AND MANAGEMENT ACT OF 1976 (PUB. LAW 94–579) 68–69, 74, 91, 107 (Comm. Print 1978). This requirement in the Senate bill corresponded to a recommendation by the Public Land Law Review Commission that users of the land be held responsible for restoration when the use has an adverse impact on the environment. *Id.*

54. *Id.* at 745.

55. *Id.* at 748, 796.

56. *Id.* at 930.

57. 43 C.F.R. § 3809 (2005). *See* Darin, *supra* note 9, at 313.

58. *Id.* § 3809.1-1, .1-9(a), *reprinted in* U.S. DEP'T OF THE INTERIOR BUREAU OF LAND MGMT., SURFACE MANAGEMENT REGULATIONS FOR LOCATABLE MINERAL OPERATIONS (43 C.F.R. 3809) FINAL ENVIRONMENTAL IMPACT STATEMENT app. A (Oct. 2000) [hereinafter FINAL EIS], *available at* http://www.blm.gov/nhp/Commercial/SolidMineral/3809-EIS/1-cover.htm. Appendix A contains the version of 43 C.F.R. § 3809 that was in effect from 1980 until 2001. *See id.*

59. *See id.* § 3809.0–5(b), *reprinted in* FINAL EIS, *supra* note 58. Specifically, "casual use" is defined to mean "activities ordinarily resulting in only negligible disturbance of the Federal lands and resources." *Id.* The "casual use" level specifically does not include the use of earth-moving equipment, explosives, and the use of motorized vehicles in certain designated areas. *Id.*

60. *Id.* § 3809.1–3(a).

61. Also referred to herein as "operations-level" use.

62. *See* § 3809.1–4, *reprinted in* FINAL EIS, *supra* note 58. Specifically, operations-level use is use that (1) exceeds notice-level use, (2) is conducted in designated conservation, scenic, or wilderness areas, or (3) requires the use of motorized vehicles in certain designated areas. *See id.*

operations differed.[63] For example, no bonding was required to secure the mining company's obligation to reclaim casual use or notice-level mining activities.[64] Operations-level mining was left to the discretion of an "authorized officer" whether to require a bond.[65] In practice, bonding was required only when the operator had a record of noncompliance.[66]

In the 1990s, precious metal prices dropped significantly, and as a result, many locatable mineral mine operators on federal lands in the western Unites States abandoned their mines.[67] This experience demonstrated that reclamation requirements and bonds were often inadequate,[68] especially after a mine operator's bankruptcy, a bond issuer's default,[69] or when the bond expired long before the mining activity ceased.[70] In addition, the combined effect of advances in mining techniques, poor oversight on the part of the BLM, and mounting evidence of environmental "disasters" related to mining began to prompt calls for mining law and regulatory reform.[71]

In several reports issued in the mid-1980s, the General Accounting Office (the "GAO"), Congress' investigative arm, detailed many mining-related concerns, including the following: (1) the BLM's failure to require the posting of a reclamation bond by most miners,[72] (2) the BLM's failure to screen mining claims to ensure that those claims were not on land withdrawn from mineral development,[73] (3) the BLM's failure to inspect most mining operations in the western United States,[74] and (4) the BLM's failure to take action with respect to numerous unreclaimed mining sites.[75] The GAO concluded that mandatory bonding was necessary to help ensure proper reclamation.[76] In an additional re-

63. *See id.* § 3809.1-9.

64. *Id.* § 3809.1-9(a).

65. *Id.* § 3809.1-9(b). An "authorized officer" is "any employee of the Bureau of Land Management to whom authority has been delegated to perform the duties described." *Id.* § 3809.0-5(a).

66. *See* FINAL EIS, *supra* note 58, at "Summary."

67. U.S. DEP'T OF AGRIC. – FOREST SERV., TRAINING GUIDE FOR RECLAMATION BOND ESTIMATION AND ADMINISTRATION: FOR MINERAL PLANS OF OPERATION AUTHORIZED AND ADMINISTERED UNDER 36 C.F.R. § 228A 4 (2004) (hereinafter "TRAINING GUIDE"), *available at* http://www.fs.fed.us/geology/bond_guide_042004.pdf.

68. *Id.*

69. For example, the operator of the Summitville Mine in south-central Colorado declared bankruptcy in 1992, and the mine was added to the Superfund National Priorities List in 1994. U.S. E.P.A., Region 8-Superfund, Summitville Mine, http://www.epa.gov/region8/superfund/co/summitville/index.html (last visited Nov. 9, 2005). To date, the cleanup has cost an estimated $210 million, and reclamation still is not complete. *Id.*

70. Ronald W. Cattany, Remarks at the Colo. Dep't of Natural Res. Annual Membership Meeting, http://www.coloradomining.org/cattany121202.html (last visited Nov. 9, 2005).

71. *See* Darin, *supra* note 9, at 315–18 (detailing General Accounting Office reports of mining's environmental impact and the lack of effective BLM oversight).

72. *Id.* at 316.

73. *Id.*

74. *Id.*

75. *Id.* at 317.

76. *Id.* at 335. This was already the practice with mining activities on lands administered by the United States Forest Service. *Id.* at 337 n.42.

port, the GAO also described the large amount of damage to public lands that had resulted from mining activities.[77]

In light of the BLM's experiences in administering the Original 3809 Regulations, as described above, and in light of the increasing difficulty in obtaining surety bonds, in 1991, the BLM published its intent to revise the bonding requirements.[78] The proposed changes would have expanded the range of financial instruments acceptable as financial guarantees.[79] This would have allowed mine operators considerable flexibility in structuring financial guarantees.[80]

By 1992, it became apparent that Congress intended to reform the 1872 Law.[81] As a result, the BLM stopped its efforts to revise the Original 3809 Regulations.[82] Unfortunately, although the House and the Senate each passed their own bill in 1993 that would have revised the 1872 Law, the House and Senate could not reach an agreement on either bill, and neither was enacted.[83]

In 1997, several years after the House and Senate failed to reach an agreement regarding changes to the 1872 Law, the BLM published an amendment to the Original 3809 Regulations (the "1997 Amendment").[84] The 1997 Amendment required financial guarantees from all mining activity exceeding "casual use" and expanded the scope of acceptable financial instruments that would provide these guarantees.[85] Despite the general increase in forms of financial security that the BLM could seek, the 1997 Amendment did not allow the BLM to require mortgages on mining properties or liens on mining equipment.[86] In addition, the 1997

77. *Id.* at 317–18. According to this report, this damage covered hundreds of thousands of acres. *Id.*

78. *See* Mining Claims Under the General Mining Laws; Surface Management, 56 Fed. Reg. 31,602, 31,602 (July 11, 1991) (to be codified at 43 C.F.R. § 3809). This appears to have been, in part, in response to a GAO report regarding the declining availability of surety bonds due to tightened requirements in the surety industry in the 1980s. *See id.*; Darin, *supra* note 9, at 318.

79. Mining Claims Under the General Mining Laws; Surface Management, 56 Fed. Reg. at 31,602 (discussed in the BLM's Statement of Intent).

80. *See id.* at 31,603. Mine operators would be given flexibility to "structure financial guarantees in a fashion that would not [threaten] a firm's liquidity and [that would not] harm its ability to continue exploration and development activities on Federal Lands or to reclaim disturbed land." *Id.*

81. Darin, *supra* note 9, at 318.

82. *Id.*

83. *Id.* The Senate bill would not have imposed any new standards for reclamation, but it would have required a surety or bond in an amount sufficient to complete the reclamation of mined lands. *Id.* at 318–19. The House bill would have established a payment of royalties to the Government for reclamation projects and would have imposed strict standards for reclamation. *See id.* at 319–21.

84. *Id.*

85. Mining Claims Under the General Mining Laws; Surface Management, 62 Fed. Reg. 9093 (Feb. 28, 1997) (to be codified at 43 C.F.R. § 3809).

86. *Id.* at 9095. There also was some concern expressed about the liquidity of various security instruments and market fluctuations, but the BLM determined that the risk of inadequate security due to these concerns was acceptable, in light of the financial guarantees being equal to reclamation costs, the provision for periodic review of security instruments to ensure they equal reclamation costs, and the potential for criminal penalties and civil enforcement. *Id.* at 9097.

Amendment merely relied upon a "certification" from the operator of the mine that a financial guarantee was in place prior to mining.[87]

Shortly after the 1997 Amendment was adopted, the Northwest Mining Association, a mining trade association, successfully challenged it in the D.C. District Court.[88] The court remanded the 1997 Amendment to the BLM for changes because it failed to comply with the terms of the Regulatory Flexibility Act[89] in its rulemaking process.[90]

In light of the remand and changes in mining technology and processes,[91] the BLM proposed to completely revise the Original 3809 Regulations, rather than just to amend them.[92] A "significant aspect" of this decision was "to respond to the remand [from the D.C. District Court] by re-promulgating strengthened financial guarantee provisions."[93] The proposed new rule would address financial guarantees differently from the way they were addressed in the 1997 Amendment in several ways.[94] The proposed new rule would require financial guarantees to be "actual" guarantees rather than just certifications, would require the guarantees be posted in the actual amount of the estimated reclamation costs, and would expand the permissible types of financial instruments.[95] Importantly, the proposed new rule would also allow the BLM to require "a long-term funding mechanism for water treatment and other post-mining maintenance requirements."[96]

Much of the BLM's motivation for adopting this proposed change to the Original 3809 Regulations resulted from its experiences with insolvent and bankrupt mine operators.[97] As a result, the BLM took the position that post-mining maintenance should be covered by these guarantees.[98]

87. *Id.* at 9096. The 1997 Amendment also imposed a requirement that the financial guarantees cover one hundred percent of the reclamation costs and imposed a floor of $1,000 per acre and $2,000 per acre for notice-level and operations-level activities, respectively. *Id.*

88. Nw. Mining Ass'n v. Babbitt, 5 F. Supp. 2d 9, 14–16 (D.D.C. 1998).

89. 5 U.S.C. § 601 (2005).

90. *Nw. Mining Ass'n*, 5 F. Supp. 2d at 14–16.

91. Mining Claims Under the General Mining Laws; Surface Management, 64 Fed. Reg. 6422, 6424 (Feb. 9, 1999) (to be codified at 43 C.F.R. § 3809).

92. *Id.* at 6423–24. The BLM's proposal to revise the Original 3809 Regulations was also prompted by the various GAO reports on mining. *Id.* at 6423.

93. *Id.* at 6424.

94. *Id.* at 6441.

95. *Id.*

96. *Id.*

97. *Id.* at 6442. With this provision, the BLM sought to overcome the financial constraints of mine operators without burdening the taxpayers, it expressed its view that reclamation obligations continue past bankruptcy, and it expressed its view that this provision may help prevent damage to the environment by allowing maintenance of a mining site when the operator has stopped operations. *Id.*

98. *See generally id. See also* FINAL EIS, *supra* note 58, at VOL. 2, COMMENTS AND RESPONSES § 14.

The proposed new rule would, in certain circumstances, allow the BLM to require the mine operator to fund a trust to provide funds to provide for future maintenance.[99] This provision was aimed at ensuring that enough funds would be available for clean-up if it appeared that a fully-reclaimed mine would continue to discharge pollutants well into the foreseeable future.[100]

In 1998, while the BLM was working on its new proposed rule, Congress commissioned the National Academy of Sciences to study the hardrock mining regulations of both the Department of the Interior and the Department of Agriculture.[101] This study (the "1999 Study"), released by the National Research Council (the "NRC") in September of 1999, recommended numerous changes that would effectively bring the Original 3809 Regulations into closer alignment with the analogous United States Forest Service ("USFS") regulations.[102] The 1999 Study identified numerous problems with then-current practices.[103] The issue of financial guarantees appeared in the context of necessary improvements in the regulations,[104] differential treatment of smaller mining operations (notice-level),[105] and planning for future uses of the land and monitoring.[106]

The NRC's first formal recommendation relating to financial guarantees was that they should be required for any disturbance to the land greater than "casual use."[107] Justification for this recommendation included the cumulative impact of a large number of smaller mining operations.[108]

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99. Mining Claims Under the General Mining Laws; Surface Management, 64 Fed. Reg. 6422, 6442 (Feb. 9, 1999) (to be codified at 43 C.F.R. § 3809). Specifically, the trust would be used to ensure "the continuation of long-term water treatment to achieve water quality standards or [to provide funds] for other long-term, post-mining maintenance requirements." *Id.*

100. *Id.* Specifically, the provision was "designed to deal with the situation where an otherwise fully reclaimed mining operation will continue for the foreseeable future to discharge pollutants, such as acid mine drainage, into surface waters" and required the operator to set aside sufficient funds which, when invested, would generate "income sufficient to pay for the ongoing cost of whatever treatment is required to meet applicable water quality standards for as long as the treatment is necessary." *Id. See also* 43 C.F.R. § 3809.552(c) (2005).

101. Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriations Act of 1999, Pub. L. No. 105-277, § 120, 112 Stat. 2681, 257–58 (1998).

102. Press Release, The National Academies, Action Needed to Improve Effectiveness of Laws that Govern Mineral Mining on Federal Lands (Sept. 29, 1999) (on file with author), *available at* http://www4.nationalacademies.org/news.nsf/isbn/0309065968?OpenDocument. *See also* NAT'L RESEARCH COUNCIL, *supra* note 34.

103. Press Release, *supra* note 102. Identified problems included, for example, the lack of any time constraints on how long a mine could be shut down "temporarily" and go without reclamation and the failure to require bonding of smaller mining operations on BLM lands. *Id.*

104. NAT'L RESEARCH COUNCIL, *supra* note 34, at 65.

105. *Id.* at 71.

106. *Id.* at 83–86.

107. *Id.* at 93. Specifically, the NRC recommended that "[f]inancial assurance should be required for reclamation of disturbances to the environment caused by all mining activities beyond those classified as casual use, even if the area disturbed is less than 5 acres." *Id.*

108. *Id.* at 93–94.

The NRC's second formal recommendation relating to financial guarantees was that the government needed to plan for long-term management of mining sites after the mining was complete.[109] This was justified by a need for post-closure maintenance and management of mining operations after the release of reclamation bonds.[110] Thus, the NRC deemed long-term financial assurances to be necessary to truly accomplish the missions of both the BLM and the [USFS] and to prevent the financial burden of long-term and monitoring costs from falling on the taxpayers.[111]

After the 1999 Study, the BLM published its new proposed rule on November 21, 2000.[112] The BLM expressed its agreement in principle with the NRC's recommendations with respect to financial guarantees.[113] The fact that the BLM's new proposed rule was in line with the 1999 Study is not a coincidence; Congress had mandated that any changes to the Original 3809 Regulations were to be "not inconsistent" with the 1999 Study.[114]

The comment period occurred in late 2000 and early 2001.[115] The comments regarding the use of trusts for mining reclamation purposes varied widely; environmental groups were often "supportive," while the mining industry "strongly opposed" the proposed new rule.[116] With respect to trust funds, the BLM stated that it would identify the "need" for

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109. *Id.* at 118. Specifically, the NRC determined that the "BLM and the [USFS] should plan for and assure the long-term post-closure management of mine sites on federal lands." *Id.*

110. *Id.* at 118–19.

111. *Id.* at 118–20.

112. *See* MARC HUMPHRIES, MINING ON FEDERAL LANDS 14 (2005), http://www.ncseonline.org/nle/crsreports/05Feb/IB89130.pdf; Mining Claims Under the General Mining Laws; Surface Management, 65 Fed. Reg. 69,998, 69,998 (Nov. 21, 2000) (to be codified at 43 C.F.R. § 3809).

113. Mining Claims Under the General Mining Laws; Surface Management, 65 Fed. Reg. at 69,998–99. The BLM also used the NRC's second recommendation regarding financial guarantees to bolster its case for adopting the trust fund mechanism and to reiterate its position that a "bond release" does not release mine operators from their reclamation obligations. Mining Claims Under the General Mining Laws; Surface Management, 64 Fed. Reg. 57,613, 57,617 (Oct. 26, 1999) (to be codified at 43 C.F.R. § 3809).

114. Mining Claims Under the General Mining Laws; Surface Management, 65 Fed. Reg. at 69,998. *See also* Department of the Interior and Related Agencies Appropriations Act of 2001, Pub. L. No. 106–291, § 156, 114 Stat. 922, 962 (2000).

115. Mining Claims Under the General Mining Laws; Surface Management, 65 Fed. Reg. at 69,998. The new rule had an initial effective date of January 20, 2001. *Id.* The Bush Administration proposed suspending this in its entirety on March 23, 2001 to allow the BLM to address legal and policy concerns that the Administration raised. Mining Claims Under the General Mining Laws; Surface Management, 66 Fed. Reg. 16,162, 16,162 (Mar. 23, 2001) (to be codified at 43 C.F.R. § 3809). After additional comments through May 7, 2001, as well as additional amendments, the final rule was published on October 30, 2001; it had an effective date of December 31, 2001. Mining Claims Under the General Mining Laws; Surface Management, 66 Fed. Reg. 54,834, 54,834 (Oct. 30, 2001) (to be codified at 43 C.F.R. § 3809).

116. Mining Claims Under the General Mining Laws; Surface Management, 65 Fed. Reg. at 70,065–66.

one on a case-by-case basis,[117] but that sometimes a trust would be necessary.[118]

On October 30, 2001, after the comment period, the BLM adopted the new rule.[119] Although the new rule had been suspended[120] and substantially revised[121] in the early days of the Bush Administration, the provisions regarding financial guarantees were not.[122] In its current form, the new rule (the "New 3809 Regulations") requires a financial guarantee for any mining activity in excess of "casual use."[123]

E. Regulation of the Mining of Locatable Minerals by the USFS

Although this Article is intended to analyze trusts created under the New 3809 Regulations, it is interesting to compare reclamation requirements on property under the control of USFS. As mentioned above, the USFS and the BLM are the two federal agencies that administer nearly all public land open to hardrock mining.[124] The USFS derives its authority from the Organic Administration Act of 1897[125] (the "Organic Act").[126] The Organic Act states that that the Department of Agriculture will issue regulations to protect certain public lands from degradation,[127] but that those regulations will not prohibit mining on the certain public lands.[128]

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117. *Id.* at 70,070.

118. *Id.* at 70,069. Specifically, the BLM stated that "In some circumstances, an important or perhaps the only way an operator may protect water quality from unnecessary or undue degradation is to provide for long-term water treatment. The trust fund or other funding mechanism is appropriate to assure that long-term treatment and other maintenance will continue." *Id.* at 70,069.

119. Mining Claims Under the General Mining Laws; Surface Management, 66 Fed. Reg. 54,834, 54,834 (Oct. 30, 2001) (to be codified at 43 C.F.R. § 3809).

120. Mining Claims Under the General Mining Laws; Surface Management, 66 Fed. Reg. 16,162, 16,162 (Mar. 23, 2001) (to be codified at 43 C.F.R. § 3809).

121. Mining Claims Under the General Mining Laws; Surface Management, 66 Fed. Reg. at 54,834.

122. *Id.* at 54,842.

123. *Id.* The New 3809 Regulations eliminated several of the more substantive provisions of the rules promulgated in 2000 so as not to "disrupt" or "confuse" the mining industry and the various state regulatory bodies. *Id.* at 54,835. *See* Roger Flynn & Jeffrey C. Parsons, *The Right to Say No: Federal Authority over Hardrock Mining on Public Lands*, 16 J. ENVTL. L. & LITIG. 249, 326–29 (2001) (detailing many of the revisions to 43 C.F.R. § 3809 and the changes made thereto by the BLM under the Bush Administration).

124. *See supra* text accompanying note 9.

125. Flynn & Parsons, *supra* note 123, at 260.

126. *Id.*

127. *Id.* Specifically, the Organic Act states:

> The Secretary of Agriculture shall make provisions for the protection against destruction by fire and depredations upon the public forests and national forests . . . and he may make such rules and regulations and establish such service as will insure the objects of such reservations, namely, to regulate their occupancy and use and to preserve the forests thereon from destruction.

Id. (quoting 16 U.S.C. § 551 (1994)).

128. *Id.* The Organic Act further states that "[n]othing in [the language in Note 127] shall be construed as prohibiting . . . any person from entering upon such national forests for all proper and

The USFS promulgated its rules regarding hardrock mining in 1974 (the "USFS Regulations").[129] Like the New 3809 Regulations, the USFS Regulations are in accordance with the policies of the 1872 Law.[130] Unlike the New 3809 Regulations, the USFS Regulations require anyone desiring to operate a mine in a National Forest to submit a notice and plan of operations if there will be any "significant" disturbance of the surface.[131]

The USFS Regulations are somewhat more streamlined than the New 3809 Regulations.[132] The USFS Regulations also specify what reclamation work is required and when it must be performed.[133] Reclamation must be started upon exhaustion of the mineral deposit or other earliest practicable time, or within one year of ceasing operations, unless otherwise allowed by the USFS.[134] This work includes controlling erosion, landslides, and water runoff; isolating, removing, or controlling toxic materials; reshaping and revegetating disturbed areas; and rehabilitating fisheries and wildlife habitats.[135]

With respect to financial guarantees, any operator required to file a plan of operations[136] is required to furnish a bond on request of the USFS.[137] However, the USFS has learned lessons from other land management agencies regarding operator bankruptcy and abandonment of mining operations and has found that in many cases bond amounts were inadequate to cover reclamation costs.[138] As with the BLM, the USFS has changed its practices to include long-term maintenance and monitoring in reclamation cost estimates, and is also in the process of defining financial arrangements, such as trusts, which could be used to fund long-term obligations.[139] If such an instrument is deemed necessary, coordination with the Office of General Counsel and regional and national staff is required.[140]

Factors considered in the decision of whether to require a long-term funding mechanism to secure the reclamation obligation are complex, and the USFS has expressed a general preference for avoiding the need

lawful purposes, including that of prospecting, locating, and developing the mineral resources thereof." *Id.* (quoting 16 U.S.C. § 478 (2005)).

129. NAT'L RESEARCH COUNCIL, *supra* note 34, at 41 (discussing 36 C.F.R. § 228A (2005).

130. *See* United States v. Weiss 642 F.2d 296, 299 (9th Cir. 1981).

131. NAT'L RESEARCH COUNCIL, *supra* note 34, at 41–42. *See also* 36 C.F.R. § 228.4 (2005).

132. For example, there are express requirements for environmental protection in the USFS Regulations that reference applicable standards in other federal environmental protection statutes, such as the Clean Air Act. 36 C.F.R. § 228.8 (2005).

133. 36 C.F.R. § 228.8(g) (2005).

134. *Id.*

135. *Id.*

136. 36 C.F.R. § 228.4 (2005). Any operator whose activity will significantly disturb the surface must file a plan of operations. *Id.*

137. 36 C.F.R. § 228.13(a) (2005).

138. TRAINING GUIDE, *supra* note 67, at 4–5.

139. *Id.* at 4.

140. *Id.* at 24.

for a long-term funding mechanism.[141] Such long-term costs are broken down into two categories: (1) "actions with a finite life"[142] and (2) actions with an open-ended or extended timeframe.[143] Both of these types of long-term costs should also account for replacement costs for capital goods and equipment[144] as well as other assumed expenses.[145]

Bonds may be prohibitively expensive or impossible to acquire for long-term, indefinite, or costly work as described above, and, by using a present net value analysis to determine the initial deposit, a trust fund could potentially be utilized to pay for these costs.[146] In this case, the trustee would invest the trust corpus in "conservative instruments such as federal securities."[147]

II. INCOME TAX ISSUES RELATED TO THE USE OF TRUSTS TO FUND ENVIRONMENTAL CLEAN-UP OBLIGATIONS

With respect to environmental clean-up trusts, the following two related tax questions arise: (a) when may a mining company deduct expenses for reclamation work paid out of trust funds,[148] and (b) who is the taxpayer with respect to income and deductions of an environmental clean-up trust?[149]

A. Deduction or Capitalization

Before analyzing the deductibility of environmental clean-up expenses when a trust is used, it is necessary to understand the general deductibility of these expenses when a mining company makes a payment for environmental clean-up directly, without the use of a trust. The broad issue is whether a payment is deductible or whether it must be capitalized.[150] A deduction, if available, would be likely to fall under Sections

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141. *Id.* at 23. To do so, the USFS has built features into the plan of operations that will mitigate or eliminate the need for long-term operation, maintenance, and monitoring costs. *Id.*

142. *Id.* Actions with a finite life include, for example, "fencing, road closures, or other means until such time as long-term stability, erosion control, and revegetation have been successfully established." *Id.*

143. *Id.* Open-ended actions include "road maintenance, . . . diversion ditches, dams, water treatment plants, fencing, gates, and signs," with the assumption that the "engineered" items will require periodic maintenance, monitoring, and testing. *Id.*

144. *Id.* at 32.

145. *Id.* at 38–39.

146. *Id.* at 24.

147. *Id.*

148. In the author's opinion, the potential reasonable answers are: (1) when the mining company pays the money to the trustee, (2) when the trustee pays money out of the trust to do reclamation work, (3) ratably, as mining work is done, and the obligation to do clean-up work accrues regardless of the time of payment, or (4) never.

149. In the author's opinion, the potential reasonable answers are: (1) the mining company, (2) the trust, or (3) the BLM.

150. Steven G. Black, *The Continuing Saga of Environmental Cleanup Costs: Current Deduction Allowed Under the Restoration Principle of Plainfield-Union*, 1995 BYU L. REV. 1321, 1321. If it is deductible, the payment can potentially reduce that year's income; if it is capitalized, the

162, 198, or 468[151] of the Internal Revenue Code of 1986.[152] Capitalization is covered by Section 263.[153]

In general, if the deduction is available under Section 162, the year in which the deduction may be taken will be determined primarily by whether the company is a cash or accrual method taxpayer.[154] If, on the other hand, the deduction is available under Section 198 or 468, the deduction may be taken in the year that the expense accrues regardless of the taxpayer's accounting method.[155]

In summary, there are two steps to analyzing the deductibility of environmental clean-up expenses. First, one must determine if a payment is deductible or if it must be capitalized. Second, assuming that the payment is deductible, one must determine the appropriate year of the deduction.

1. Section 162–Ordinary and Necessary Business Expenses

The Internal Revenue Service (the "Service") first addressed the deductibility of environmental remediation expenses in Revenue Ruling 94-38[156] (the "1994 Revenue Ruling"). In the 1994 Revenue Ruling, the Service declared that costs incurred to treat soil and groundwater contaminated by hazardous waste from the taxpayer's business could be deducted presently as ordinary and necessary business expenses under Section 162 rather than capitalized under Section 263.[157] The Service specifically found that these remedial actions did not permanently improve the property or otherwise provide significant future benefits which would require capitalization.[158] Remediation and groundwater treatment merely restored the property to the condition in which the owner held it prior to contamination, more akin to a repair than to a capital improvement; accordingly, the Service determined that this allowed a present deduction under the restoration principal of *Plainfield-Union Water Co.*

payment may be added to the mining company's income tax basis in the mine, reducing gain upon a subsequent sale. I.R.C. §§ 263, 446(b) (2005).

151. I.R.C. §§ 162, 198, 468 (2005). Section 162 is the general section for deducting ordinary and necessary business expenses. *Id.* Sections 198 and 468 are special deductions specifically related to environmental clean-up. *Id.* Section 162 does not specify the year in which the deduction may be taken, while Sections 198 and 468 do. *Id.*

152. All references to the "Code" are references to the Internal Revenue Code of 1986, as amended. All references to a "Section," unless otherwise specified, are to a Section of the Code.

153. I.R.C. § 263 (2005).

154. § 162. *See also* Black, *supra* note 150, at 1323.

155. §§ 198, 468.

156. Rev. Rul. 94–38, 1994–1 C.B. 35.

157. *Id.* Under the facts of the 1994 Revenue Ruling, the taxpayer had decided to remediate soil and groundwater contaminated by its manufacturing activities. *Id.* The taxpayer constructed various groundwater treatment facilities to extract, treat, and monitor groundwater contamination. *Id.*

158. *Id.*

v. Commissioner.[159] With respect to expenses to construct a groundwater treatment facility, however, the Service ruled that the taxpayer had to capitalize those expenses.[160]

One year later, in Technical Advice Memorandum 95-41-005[161] (the "1995 TAM"), the Service determined that the 1994 Revenue Ruling did not allow for the deduction of collateral costs associated with environmental remediation.[162] The Service also determined that the restoration principle it had applied in the 1994 Revenue Ruling and the court had applied in *Plainfield-Union Water Co.* did not apply in situations in which the taxpayer acquired the property in a contaminated condition.[163]

In *United Dairy Farmers, Inc. v. United States*,[164] the U.S. District Court for the Southern District of Ohio rejected the taxpayer's contention that it was entitled to deduct under Section 162[165] expenses incurred for environmental remediation.[166] The court emphasized the fact that the two sites at issue had contaminated soil at the time of purchase by the taxpayer.[167] Furthermore, the taxpayer's business activities did not produce the contamination.[168] As a logical consequence, the taxpayer's remediation efforts did not return the property to the condition it was in when the taxpayer acquired it.[169] Therefore, the taxpayer had to capitalize those expenses.[170]

After the 1995 TAM and *United Dairy Farmers*, the deductibility of environmental remediation expenses appeared to turn entirely upon whether the taxpayer's normal business activities produced the contami-

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159. *Id. See* 39 T.C. 333, 333, 338 (1962), *nonacq. on other grounds*, 1964–2 C.B. 8 (holding that certain expenses incurred in cleaning and lining water pipes were deductible repairs because they did not materially add to the value of the property or prolong its useful life; instead, they restored the pipeline to its condition before the damage). This is referred to hereinafter as the "restoration principle."

160. Rev. Rul. 94–38, 1994–1 C.B. 35. The expenses had to be capitalized under Section 263(a) because their useful life extended beyond one year. *Id.*

161. I.R.S. Tech. Adv. Mem. 95–41–005 (Sept. 27, 1995).

162. *Id.* "Collateral costs" include consulting contracts, costs of assessing contamination and remediation alternatives, and legal fees for negotiating a consent decree with the Environmental Protection Agency. *Id.*

163. *Id.* The Service noted that "the restoration principle envisions that the taxpayer acquired the property in a clean condition, contaminated the property in the course of its everyday business operations, and incurred costs to restore the property to its condition at the time the taxpayer acquired the property." *Id.*

164. 107 F. Supp. 2d 937 (S.D. Ohio 2000).

165. Rather, the court concluded that the taxpayer was required to capitalize its expenses incurred for environmental remediation. *United Dairy Farmers*, 107 F. Supp. 2d at 943.

166. *Id.* at 937.

167. *Id.* at 942.

168. *Id.* at 942–43.

169. *Id.* at 943. The taxpayer argued that it was unaware of the properties' contaminated condition when it purchased them and that restoration merely returned the properties to the value the taxpayer initially believed they possessed. *Id.* The court noted that deductibility did not turn on one's subjective beliefs as to the value of property. *Id.*

170. *Id.*

nation. The subsequent enactment of Section 198 changed this in certain situations, at least temporarily.[171]

2. Section 198–Qualified Environmental Remediation Expenditures

Section 198 allows "qualified environmental remediation expenditures" paid or incurred by a taxpayer to be deducted in the year actually paid or incurred even if the taxpayer acquired the property in a contaminated state.[172] "'Qualified environmental remediation expenditure' means any expenditure . . . which is paid or incurred in connection with the abatement or control of hazardous substances at 'qualified contamination site.'"[173] "Qualified contamination sites" generally include business or investment property.[174] In order to presently deduct the expense, this Section also mandates that the taxpayers acquire from the appropriate state agency a statement that there has been a release, threat of release, or disposal of a hazardous substance on the property.[175] Significantly, Section 198 does "not apply to expenditures paid or incurred after December 31, 2005."[176]

3. Section 162–Revisited

In 2004, the Service issued Revenue Ruling 2004-18[177] (the "2004 Revenue Ruling"), which addresses the extent to which environmental remediation costs can be deducted under Section 162 if they cannot be deducted under Section 198.[178] The factual situation in the 2004 Revenue Ruling is similar to the one found in the 1994 Revenue Ruling.[179] Unlike the 1994 Revenue Ruling which had allowed a deduction of these costs, in this newer ruling, the Service reached the opposite result, finding that the soil and groundwater remediation costs had to be capital-

171. *See* discussion *infra* Part III.B regarding the timing of the deduction. It is important to remember that the above discussion of Section 162 does not address the issue of timing if a deduction (rather than capitalization) is allowed. *See id.*

172. I.R.C. § 198(a) (2005).

173. I.R.C. § 198(b)(2) (2005). This occurs provided that these expenditures are not otherwise required to be capitalized. I.R.C. § 198(b)(1) (2005).

174. I.R.C. § 198(c)(1) (2005). Specifically, "[t]he term 'qualified contamination site' means an area . . . at or on which there has been a release (or threat of release) or disposal of any hazardous substance" and "which (1) is held for use in a trade or business or for the production of income or (2) is property [that qualifies as a capital asset] in the hands of the taxpayer." *Id.*; I.R.C. § 1221(a)(1) (2005).

175. I.R.C. § 198(c)(3) (2005). The chief executive officer of each state is allowed "to designate the appropriate state environmental agency within sixty days of the enactment of" I.R.C. § 198. I.R.C. § 198(c)(4) (2005). The Environmental Protection Agency possesses the authority to designate such an agency in the event that such a chief executive officer fails to do so. *Id.*

176. I.R.C. § 198(h) (2005).

177. Rev. Rul. 2004–18, 2004–1 C.B. 509.

178. *Id.*

179. *Compare* Rev. Rul. 94–38, 1994–1 C.B. 35 *with* Rev. Rul. 2004–18, 2004–18 C.B. 509 9this is true even if the taxpayer has not yet unconditionally made the payment of the expenses).

ized.[180] After the 2004 Revenue Ruling and through December 31, 2005, manufacturers generally cannot use Section 162 to deduct environmental remediation expenses that are not otherwise deductible under Section 198.

4. Section 468–Qualified Reclamation Expenses

Section 468 permits mining companies to elect to deduct, currently, certain future qualified reclamation expenses as those obligations are incurred.[181] More specifically, Section 468 allows taxpayers to elect to deduct an amount equal to the current estimated reclamation costs of property disturbed during the taxable year in connection with coal mining operations.[182] Current estimated reclamation costs equal the amount that the taxpayer would be required to pay for qualified reclamation costs if reclamation activities were performed currently.[183]

Qualified reclamation costs include expenses incurred in reclamation activities conducted in accordance with a reclamation plan submitted pursuant to the Surface Mining Control and Reclamation Act of 1977[184] (the "SMCRA") or which is submitted pursuant to any other state or federal law imposing surface mining reclamation and permit requirements "substantially similar" to those imposed by the SMCRA.[185] Because the SMCRA applies strictly to coal mine reclamation[186] and because the New 3809 Regulations do not apply to mining operations that involve coal,[187] the availability of Section 468 in connection with environmental reclamation trusts required under C.F.R. Section 3809.552(c) will turn on the ability of the taxpayer to qualify on these "substantially similar" grounds.

180. Rev. Rul. 2004–18, 2004–18 C.B. 509. The Service noted that these costs were "incurred by reason of" production activities within the meaning of Treas. Reg. § 1.263A–1(e)(3)(i) (as amended in 2005). *Id.* Because the costs were properly allocatable to property produced by the taxpayer that was inventory in the hands of the taxpayer, the Service took the position that the taxpayer needed to capitalize the remediation costs. *Id.* These costs must be treated as the costs of acquiring inventory under Treas. Reg. § 1.263A–1(c)(3) (as amended in 2005). *Id.*

181. I.R.C. § 468 (2005).

182. § 468(a)(1)(A).

183. § 468(d)(1). This section requires taxpayers to establish reserves for each property the taxpayer desires to have governed by Section 468. *Id.* The reserve is treated as having an opening balance of zero during the initial tax year. § 468(a)(2)(A). The reserve is increased each year by the amount of interest that would have been paid on the balance of the reserve at the beginning of a taxable year, had the federal short-term rates applied with semi-annual compounding. § 468(a)(2)(B). The reserve is decreased by amounts actually paid by the taxpayer for qualified reclamation costs and increased by the deduction allowed under the section. § 468(a)(2)(C), (D).

184. Surface Mining Control and Reclamation Act of 1977 (SMCRA), Pub. L. No. 95–87, 91 Stat. 445 (codified as amended in scattered sections of 30 U.S.C.).

185. I.R.C. § 468(d)(2)(A) (2005). As a general matter, Section 468 has not produced much case law or many administrative rulings, and the Service has not issued guidance as to what constitutes "substantially similar."

186. 91 Stat. at 445.

187. 43 C.F.R. § 3809.2(e) (2005).

B. Timing Issues

If it is determined that an expense may be deducted under Section 162, as opposed to capitalized under Section 263, it is necessary to determine the year in which that deduction will be allowed.[188] The timing of the deduction under Section 162 is determined primarily by the taxpayer's accounting method (cash or accrual).[189]

1. Accounting Methods

In general, a cash basis taxpayer may deduct a payment when "actually" made but not when "constructively" made.[190] Absent a special exception, this would mean that a cash basis mining company would be able to deduct reclamation expenses only as that taxpayer actually pays for reclamation work, not when the taxpayer puts money into a trust for future reclamation work. The Treasury Regulations provide the following special rule that is applicable in this situation: a "payment" occurs when payment is made to a creditor, either by written agreement or *pursuant to government, agency, or court order*.[191] This, in effect, means that a payment by a cash basis taxpayer to a trustee of a non-grantor trust upon order by the BLM is treated as a deductible payment by that taxpayer.[192]

While individual miners and small mining companies may be cash method taxpayers, large publicly-traded mining companies generally are accrual method taxpayers.[193] An accrual method taxpayer may deduct a payment only when "all events" have occurred fixing the liability, except for the passage of time, and if the amount can be determined with reasonable accuracy.[194] In addition, no deduction is allowed until there has

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188. Recall that the timing issues discussed herein relate only to Section 162 and not to Section 198 or 468. If the deduction is allowed under Section 198 or 468, the deduction is allowed in the year the liability is incurred whether or not payment is made in that year. If the deduction is allowed under Section 198 or 468, then it is an estimated amount determined as described above. *See supra* Parts III.A.2, A.4.

189. I.R.C. § 162(a) (2005).

190. A payment is "constructively" made when it is made available but not actually paid to the recipient. Vandel Poel, Francis & Co., Inc. v. Comm'r., 8 T.C. 407, 411 (1947).

191. Treas. Reg. § 1.461–2(c)(1) (as amended in 2004).

192. *See id.* This general rule does not appear to apply to payments by cash method taxpayers to "grantor trusts." A "grantor trust" is treated as not separate from the taxpayer for federal income tax purposes; accordingly, no payment is made for federal income tax purposes when money is transferred by a grantor to a trust that is a grantor trust with respect to that grantor. *See infra* notes 257–58 and accompanying text. A "non-grantor trust" is a trust that is treated as separate from the grantor for federal income tax purposes. *See infra* Parts III.D–E.

193. I.R.C. § 448 (2005). Corporations whose average annual gross receipts in the prior three years exceeded $5 million must use the accrual method of accounting. *Id.* It is worth noting that, regardless of the accounting method used, mining companies often are eligible for special tax benefits. For example, rather than depreciating an investment in a mine, the "cost depletion" method often may be used to recover basis of investments in natural resources. I.R.C. §§ 611–12 (2005).

194. Treas. Reg. § 1.446–1(c)(1)(ii) (as amended in 2003). This is known as the "all events" test. *Id.*

been "economic performance" by the taxpayer.[195] Economic performance generally does not occur when a taxpayer makes a contested payment to a third party, such as a trustee, for future payment to a creditor.[196]

2. Issues Unique to Utilizing Trusts for Remediation Costs

In general, the use of a trust to fund environmental clean-up obligations has no effect on whether an expense must be capitalized rather than deducted. The use of a trust, however, can have a significant impact on the year in which a deduction may be taken. This is primarily tied to whether the trust is a "grantor trust" or a "non-grantor trust" for federal income tax purposes. Accordingly, the discussion in this article regarding grantor and non-grantor trust status[197] is solely concerned with the timing of deductions and assumes that the expenses are not the type that must be capitalized.

When focusing on the timing of deductions, it is important to remember that any deduction that is allowed under Section 179 or 468 is allowed in the year that the liability accrues regardless of the accounting method used by the taxpayer.[198] Although this provides some convenience and simplicity for the taxpayer's accountant, it also is important to remember that Sections 179 and 468 only apply in limited situations[199] and that Section 179 expires at the end of 2005 unless Congress extends it.[200]

The timing of the deduction of "ordinary and necessary business expenses" under Section 162 turns in large part on whether the trust is a grantor trust and whether the taxpayer is an accrual or cash method taxpayer. Accordingly, the remainder of this discussion will assume that the taxpayer is seeking to deduct the environmental clean-up expenses under Section 162.

195. I.R.C. § 461(h) (2005).

196. Treas. Reg. § 1.461–4(g)(1)(i) (as amended in 1999). There are exceptions to this general rule. *Id.* For example, economic performance occurs when money is paid to the trustee of a designated settlement fund or a qualified settlement fund. *See infra* Parts III.C.2–3 for detailed discussion.

197. *See infra* Parts III.D–E.

198. I.R.C. §§ 179, 468 (2005). Under I.R.C. Sections 179 and 468, deductions are allowed (i.e., they accrue) as liabilities are "incurred" even if no payment is made that year. *Id.* Although there is no case law on this issue, it would appear that, with one exception, payment to a trust, in and of itself, for "future" clean-up obligations, even upon order of the BLM, should not allow for a present deduction under I.R.C. Sections 179 or 468 because the liability has not been incurred yet. The one exception, of course, occurs when a cash method taxpayer makes a payment to a non-grantor trust. Treas. Reg. § 1.461–2(c)(1) (as amended in 2004). In that case, a deduction for the full amount of the payment is allowed under Treas. Reg. § 1.461–2(c)(1). *Id. See supra* note 180 and accompanying text.

199. *See supra* Parts III.A.2, A.4.

200. I.R.C. § 198(h) (2005).

C. Special Situations

Three special situations merit discussion at this point. More specifically, the following three relevant types of trusts or funds[201] are specifically identified in either the Code or the Treasury Regulations: (1) environmental remediation trusts,[202] (2) designated settlement funds,[203] and (3) qualified settlement funds.[204] The Code or Treasury Regulations specify how and when each of these trusts is taxed.[205] Because the rules could potentially apply to trusts created under the New 3809 Regulations, each of the three types of trusts is specifically discussed below. In general, with a few exceptions that are discussed below, trusts created under the New 3809 Regulations are not likely to be environmental remediation trusts, designated settlement funds, or qualified settlement funds.

1. Environmental Remediation Trusts

Treasury Regulations Section 301.7701-4(e)[206] (the "Environmental Remediation Trust Regulations") specifically states that "environmental remediation trusts" are considered trusts for purposes of the Internal Revenue Code.[207] This Regulation also states that each grantor of the trust shall be treated as the owner for federal income tax purposes of the portion of the trust contributed by the grantor under Section 677.[208] As discussed in greater detail below,[209] Section 677 treats the grantor of the trust as the owner when he or she has the discretion to distribute trust income to himself or herself.[210] Treasury Regulations Section 301.7701-7(e)(1) defines an environmental remediation trust as:

> [A]n organization that is organized under state law as a trust; the primary purpose of the trust is collecting and distributing amounts for environmental remediation of an *existing waste site* to resolve, satisfy, mitigate, address, or prevent the liability or potential liability of persons imposed by federal, state, or local environmental laws; all contributors to the trust have actual or potential liability or a reasonable expectation of liability under federal, state, or local environmental laws for environmental remediation of the waste site; and the

201. Both "funds" and "trusts" are referred to merely as "trusts" herein for convenience.
202. Treas. Reg. § 301.7701–4(e) (as amended in 1996).
203. I.R.C. § 468B (2005).
204. Treas. Reg. § 1.468B–1 (as amended in 1993).
205. *Id.*; § 468B.
206. Treas. Reg. § 301.7701–4(e) (as amended in 1996).
207. *Id.*
208. § 301.7701–4(e)(2).
209. *See infra* Part III.D.
210. I.R.C. § 677 (2005).

trust is not a qualified settlement fund within the meaning of § 1.468B-1(a).[211]

The term "existing waste site," as used in the above text, is not defined in the Treasury Regulations or elsewhere. Members of the American Bar Association's Environmental Tax Committee had suggested that the regulations define an "existing waste site" to mean a "site at which an event (or related series of events) has occurred which has given or may give rise to at least one claim asserting liability under federal, state, or local environmental laws."[212] The Department of the Treasury (the "Treasury") responded to this request by noting that the final regulations would not adopt this definition because it is sufficiently clear that the rule applies to sites currently needing environmental remediation.[213]

As mentioned above, the BLM intends to use the New 3809 Regulations to require mining companies to establish a trust fund for environmental clean-up in order to secure a permit to start digging.[214] Because such a permit is likely to be sought at a site at which there has been no contamination or that does not "currently" requires remediation, the Environmental Remediation Trust Regulations generally do not appear to apply to trusts created under the New 3809 Regulations.[215]

2. Designated Settlement Funds

Code Section 468B[216] provides that "economic performance"[217] is deemed to occur when qualified payments are made by a taxpayer to a "designated settlement fund."[218] This rule means that, assuming there is a qualified payment, an accrual method taxpayer can deduct in the year of payment the full amount paid to a trustee of a trust that qualifies as a designated settlement fund.

Section 468B specifically defines a "qualified payment," with some exceptions, as "any money or property which is transferred to any desig-

211. § 301.7701-4(e)(1) (emphasis added).

212. *See* Jerold N. Cohen, *ABA Members Suggest Clarification of Definitions in Regs on Environmental Settlement Funds*, 95 TAX NOTES TODAY 290-44 (1995).

213. 26 C.F.R. Parts 1, 301, and 602, RIN 1545-AT02, at 13. Specifically, the Treasury stated that "[t]he term existing waste site should be sufficiently specific to allow taxpayers to establish an environmental remediation trust for any contaminated site *that currently requires remediation* under environmental laws." *Id.* (emphasis added).

214. *See supra* note 13 and accompanying text. Although the BLM may require a trust fund at any time, from the author's experience, the trust will need to be funded before the BLM will issue a permit to commence mining work.

215. This would not be the case, however, if the BLM were to require the creation of a trust after mining work has commenced, assuming there is then contamination at the site.

216. I.R.C. § 468B (2005).

217. *Id.* The effect of this section is to modify the "economic performance" requirement of I.R.C. § 461(h), applicable only to accrual method taxpayers, with respect to a specific situation. I.R.C. § 461(h) (2005). Accordingly, this section only applies to accrual method taxpayers. § 468B.

218. § 468B(a).

nated settlement fund pursuant to court order . . . ."[219] Furthermore, that section requires, among other things, that a designated settlement fund be used for tort claims arising out of personal or property damage.[220]

A designated settlement fund is taxed on all income earned by the fund, and it is allowed to deduct certain administration expenses.[221] It is allowed no other deductions, such as a deduction for distributions related to tort claims.[222] Thus, the basic idea is that a taxpayer is allowed a present deduction for all money paid into the trust for tort liabilities, the fund is taxed as a separate taxpayer on its income, and the trust cannot deduct payments to satisfy tort liabilities.[223]

A trust fund established under the New 3809 Regulations is not established pursuant to court order.[224] Furthermore, the trust fund generally does not extinguish a mining company's tort liability with respect to any future tort claims.[225] Therefore, a trust fund created under the New 3809 Regulations is not a designated settlement fund.

3. Qualified Settlement Funds

Treasury Regulations Section 1.468B-1[226] provides for the creation of "qualified settlement funds," which are treated the same as designated settlement funds for federal income tax purposes.[227] The definition of "qualified settlement funds" is much broader than the definition of "designated settlement funds" and specifically includes funds established or approved by order of the United States, any state, *or any agency* or instrumentality of the United States or any state.[228] These funds must be "established to resolve or satisfy one or more contested or uncontested claims that have resulted or may result from an event (or related series of events) *that has occurred* and that has given rise to at least one claim asserting liability . . . ."[229] under the Comprehensive Environmental Response, Compensation and Liability Act of 1980[230] ("CERCLA"), arising

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219. § 468B(d)(1).

220. § 468B(d)(1)(A). Specifically, a "designated settlement fund" must be "established pursuant to a court order and [it must be a fund] which extinguishes completely the taxpayer's tort liability with respect to [certain future tort claims arising out of personal injury, death, or property damage]." § 468B(d)(2)(A).

221. § 468B(b). The fund is taxable in its investment income at the rates found in I.R.C. § 1(e) (2005).

222. I.R.C. § 468B(b)(2) (2005).

223. *Id.* In short, this is a provision that allows accrual method taxpayers to take a full deduction much earlier than otherwise would be allowed (because of the economic performance requirement), but the provision also ensures that the fund will pay taxes on its income. *Id.*

224. 43 C.F.R. § 3809.552 (2005).

225. *Id.*

226. Treas. Reg. § 1.468B-1 (as amended in 1993).

227. *Id.*

228. § 1.468B-1(c)(1) (emphasis added).

229. § 1.468B-1(c)(2) (emphasis added).

230. Comprehensive Environmental Response, Compensation and Liability Act of 1980, 42 U.S.C. § 9601-75 (2005).

out of a tort, breach of contract, or violation of law, or designated by the Service in a revenue ruling or revenue procedure.[231]

Although a government agency (the BLM) is ordering the creation of the trust under the New 3809 Regulations, the environmental claims do not arise from CERCLA and, more importantly, generally do not arise from any event "that has occurred."[232] Instead, the fund generally is required in anticipation of an event that may occur (i.e., environmental contamination once mining operations commence).[233] Thus, a trust fund created under the New 3809 Regulations prior to the issuance of a permit to start digging generally will not be a qualified settlement fund.[234]

D. Grantor Trusts

Depending on the terms of a trust, for federal income tax purposes, its income and deductions may be treated as income and deductions of (a) the trust as a separate taxable entity, (b) the grantor of the trust, or (c) a third party.[235] Section 671 generally provides that when treated as the owner of the trust, income, deductions, and credits attributable to the trust shall be considered in calculating the taxable income of the grantor or the third party as if that grantor or third party, respectively, directly engaged in the trust's activities and transactions.[236]

Sections 673 through 677 determine when a grantor will be treated as the owner of a trust with a United States situs, Section 679 determines when a grantor will be treated as the owner of a foreign trust, and Section 678 determines when a third party will be treated as the owner of a trust in the United States.[237] Under Section 673, a grantor shall be treated as the owner of any portion of the trust when he or she retains a reversionary interest in the corpus or income from that portion if, as of the inception of that portion of the trust, the value of such interest exceeds five percent of the value of such portion.[238]

Under Section 674, the grantor shall be treated as the owner of the trust where the beneficial enjoyment of the corpus or the income is subject to a power of disposition, exercisable by the grantor or a nonadverse

231. § 1.468B-1(c)(2).
232. *See supra* note 13 and accompanying text.
233. 43 C.F.R. § 3809.552 (2005).
234. Because the New 3809 Regulations also allow the BLM to require the creation of a trust after work has begun, it is possible that the trust would be a qualified settlement fund under those circumstances. *See supra* text accompanying note 13.
235. I.R.C. § 671 (2005). The term "grantor trust" is generally used even if the taxpayer with respect to the trust is a third party rather than the grantor. Accordingly, for the sake of clarity, this article will frequently distinguish a "grantor trust with respect to the grantor" from a "grantor trust with respect to a third party."
236. *Id.*
237. I.R.C. §§ 673–79 (2005). The term "situs" as used in this context refers to the primary place of administration of the trust.
238. § 673(a).

party[239] without the approval or consent of an adverse party.[240] Section 675 provides that grantors with certain administrative powers shall be treated as the owners of trusts for federal income tax purposes.[241] The powers that cause the trust to be a grantor trust include the power to purchase, exchange, or otherwise deal with the corpus or income of the trust for less than adequate and full consideration, the power to borrow the corpus or income of the trust without adequate interest or security, and certain "general powers of administration."[242] This section also provides that when a grantor has directly or indirectly borrowed the corpus or income, and has not completely repaid the loan before the beginning of the taxable year, he or she will be treated as the owner of the trust.[243]

Under Section 676, a grantor shall be treated as the owner of a trust when the power to revest title in the grantor is exercisable by the grantor or a nonadverse party.[244] Section 677 states a grantor shall be treated as the owner of any trust whose income in the discretion of the grantor, may be distributed to the grantor or grantor's spouse, held or accumulated for future distribution to the grantor or his or her spouse, or applied to the payment of certain life insurance policies.[245]

Under Section 678, a person or entity other than a grantor[246] shall be treated as the owner of any portion of a trust with respect to which he or she either (1) has a power exercisable alone to vest the income or corpus in him or herself or (2) has previously partially released or modified such a power and after the release or modification retains such control as would cause a grantor to be treated as the owner.[247] Lastly, Section 679 notes a resident of the United States who directly or indirectly transfers property to a foreign trust is treated as the owner for the taxable year of

239. I.R.C. § 672(b) (2005). I.R.C. § 672(b) defines a nonadverse party simply as any person who is not an adverse party. *Id.*

240. I.R.C. § 672(a) (2005). I.R.C. § 672(a) defines adverse party as "any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power he possesses respecting the trust." *Id.* A general power of appointment over trust property is deemed to be a beneficial interest in the trust. *Id.* I.R.C. § 674(b) lists eight trust powers to which I.R.C. § 674 does not apply. § 674(b).

241. I.R.C. § 675 (2005).

242. *Id.* I.R.C. § 675(4) lists the following three specific powers that qualify as general powers of administration: (1) the power to vote stock of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control, (2) the power to control the investment of the trust funds, either by directing investments or reinvestments or by vetoing proposed investments or reinvestments, and (3) the power to reacquire the trust corpus by substituting other property of an equivalent value. § 675(4).

243. § 675(3).

244. I.R.C. § 676(a) (2005).

245. I.R.C. § 676(b) (2005), however, provides that Section 676(a) does not apply to a power the exercise of which can only affect the beneficial enjoyment after the occurrence of an event. I.R.C. § 676(b) (2005).

246. A person or entity other than a grantor is considered a third party.

247. I.R.C. § 678 (2005). This situation is referred to throughout this article as a "grantor trust with respect to a third party."

the portion attributable to that property if there is a United States beneficiary of any portion of the trust.[248]

A trust established to cover future environmental remediation expenses may qualify (and, in fact, is likely to qualify) as a grantor trust with respect to the grantor (i.e., the mining company) based on general tax principles and the Treasury Regulations issued under Section 677.[249] Treasury Regulations Section 1.677(a)-1(d)[250] provides "a grantor is, in general, treated as an owner of a portion of a trust whose income is, or in the discretion of the grantor or a nonadverse party, or both, may be applied in discharge of any legal obligation of the grantor . . . ."[251] This regulation reflects general economic neutrality principles articulated in *Old Colony Trust v. Commissioner*,[252] namely that the discharge of a legally enforceable obligation by a third party produces income to the obligor.[253] Thus, a trust established to fund future environmental remediation costs should be treated as a grantor trust if the income of the trust is used to discharge the grantor of liability at the time of payment under federal, state, or local environmental laws. Ultimately, however, the terms of the trust agreement and the arrangement with the BLM regarding the trust will determine if the trust is a grantor trust.[254] This is discussed in greater detail below.[255]

1. Deductions

When discussing deductions with respect to trusts, it is essential to remember that there are two relevant types of deductions. First, there is the possibility of deducting payments made by the grantor[256] to the trust for environmental clean-up. Second, there is the possibility of deducting amounts paid out of the trust, for administration expenses as well as environmental clean-up costs, over time.

With respect to a trust that is a grantor trust with respect to the grantor, a payment by the grantor to that trust is treated as having not been

248. I.R.C. § 679(a)(1) (2005).
249. Treas. Reg. § 1.677(a) (as amended in 1971).
250. § 1.677(a)–1(d).
251. *Id.*
252. 279 U.S. 716 (1929).
253. *Old Colony Trust Co.*, 279 U.S. at 729. In *Old Colony Trust Co.*, the court found that income taxes paid by an employer, on behalf of an employee, resulted in compensation to the employee. *Id.* The court found the arrangement economically equivalent to the employer paying the employee additional cash compensation, and the employee using this additional compensation to pay his own tax bill. *Id.* In the context of a trust established to cover future environmental remediation costs, discharging a grantor's obligation with income from the trust is equivalent to paying that income directly to the grantor, which would cause the trust to be treated as a grantor trust under I.R.C. § 677 and the rule of *Old Colony Trust*.
254. I.R.C. § 676(a) (2005).
255. *See infra* Part II.D.2.
256. In this situation, the grantor is the mining company.

made for federal income tax purposes.[257] Thus, a taxpayer cannot take a deduction solely by virtue of making such a payment regardless of whether the taxpayer is a cash or accrual method taxpayer.[258] When amounts are ultimately distributed out of the trust for environmental clean-up, those amounts may be deducted by the grantor if the grantor could deduct the payments if they had been made directly by the grantor for that clean-up.[259]

With respect to a trust that is a grantor trust with respect to a third party,[260] the analysis is somewhat different. When a cash method grantor makes a payment to that trust, it is as if the grantor paid the money directly to the third party.[261] Assuming that this payment is being made pursuant to an order of a government agency, such as the BLM, and assuming that the third party is a "creditor" of the grantor, then the payment should be deductible when made to the trust if a payment directly to that third party, by the taxpayer, would be deductible.[262] Subsequent income earned by the trust after the contribution to the trust is taxable to the third party.[263] This may provide a planning opportunity if it is possible to make a tax-exempt entity such as the BLM the third party to whom the trust income is taxable. This potentially can be accomplished with careful planning.[264]

2. Qualifying the Trust as a Grantor Trust with Respect to the Grantor

In general, it should not be very difficult to qualify the trust as a grantor trust with respect to the grantor.[265] First, if the grantor retains a reversionary interest equal to at least five percent of the initial trust value, then the trust will be a grantor trust under Section 676.[266] Because certain mining companies will want a reversionary interest if it turns out that the funds are not needed for environmental clean-up, there is a distinct possibility that the trust will be a grantor trust.[267] Other mining companies may view the requirement that they fund a trust for environmental clean-up as a cost of doing business; in this case they may be

257. Rev. Rul. 85-13, 1985-1 C.B. 184.

258. For federal tax purposes, it is as if no transfer has been made. This does not prevent the taxpayer from utilizing deductions that accrue regardless of payment. *E.g.*, I.R.C. §§ 179, 468 (2005).

259. That is when a payment is occurring for federal income tax purposes.

260. I.R.C. § 678 addresses such trusts. I.R.C. § 678 (2005).

261. For federal income tax purposes, the trust does not exist, and the third party is the taxpayer.

262. Treas. Reg. § 1.461-2(c)(1) (as amended in 2004).

263. I.R.C. §§ 671, 678 (2005).

264. *See* discussion *infra* Part II.D.3.

265. I.R.C. § 676 (2005). In fact, the author believes that environmental clean-up trusts will more commonly be treated as grantor trusts with respect to the grantor for federal income tax purposes.

266. *Id.*

267. This has been the author's personal experience.

willing to forego any reversionary interest.[268] The company could forego a reversionary intérest, for example, by directing that any funds left in the trust upon its termination will be paid to charity.[269] The company may want to do this, among other reasons, if doing so will sever its ties to the trust for federal income tax purposes.[270]

A second basis for ensuring that the trust will be a grantor trust with respect to the grantor, if this is desired, is to affirmatively establish that all income from the trust will be used to satisfy an on-going obligation of the grantor to clean-up the environment. This would appear to be the case if the grantor has an on-going clean-up obligation and if the trust funds are used to satisfy that obligation; it would not be the case if the grantor has completely satisfied its obligations to the BLM upon funding the trust.[271]

3. Qualifying the Trust as a Grantor Trust with Respect to the BLM

Attempting to make the BLM the taxpayer with respect to the trust is a novel idea, which, if it works, would have extremely favorable tax consequences.[272] The general idea is that the BLM could be given an unrestricted power each year to withdraw all trust income each year for a limited period of time.[273] Assuming that the grantor of the trust, i.e., the mining company, would not otherwise be treated as the owner of the income of the trust, then the BLM would be treated as the owner of the trust for federal income tax purposes.[274] Because the BLM is exempt

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268. This has been the author's personal experience.

269. *See* Treas. Reg. § 20.2055–1 (as amended in 1974).

270. Specifically, a company should consider doing so if it will make the trust a non-grantor trust.

271. *See supra* note 113. The BLM generally takes the position that a financial guarantee does not release the mining company of its clean-up obligations. *See supra* text accompanying note 113. That being said, it may be possible to negotiate an arrangement with the BLM under which the mining company would put an extra-large amount into trust in complete satisfaction of its clean-up obligations with respect to the permit that it is seeking to obtain.

272. The possibility of doing this was originally suggested by Bill Huff of HRO.

273. The withdrawal power should last at least 30 days each year. This type of withdrawal power, used in other contexts, is commonly referred to as a "Crummey power" as a result of the case of *Crummey v. Comm'r.*, 25 T.C.M. (CCH) 772 (1966). *See* 5 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 124.3.3 (2d ed. 1993) (using the term "Crummey power" to describe the unrestricted ability to withdraw trust income for a limited period of time). The holder of a Crummey power is the owner of the portion of the trust to which the power applies under I.R.C. § 678, provided that the grantor of the trust is not the owner of that portion by virtue of I.R.C. §§ 676, 677, or 679(a) (2005). *See* I.R.C. §§ 676–78, 679(a) (2005); BITTKER & LOKKEN, *supra*, ¶ 124.3.3; *infra* note 274.

274. I.R.C. § 678(b) (2005). It appears that if the BLM withdraws income earned by the Trust, it may be required to deposit that income in the United States Treasury "as soon as practicable without deduction for any charge or claim." If this is true, it would potentially mean that the BLM is not the beneficiary of the trust for federal income tax purposes, and therefore the trust would not be a grantor trust with respect to the BLM under I.R.C. § 678. The counter argument, brought to the author's attention by Kelly Berg and Chuck Ramunno at HRO, is that the United States government as a whole is the beneficiary, and the BLM is a part of the United States government. This means that the United States government is in effect the beneficiary and the holder of the withdrawal power. Note that if the neither the grantor of the trust nor any third party is treated as the owner for

from tax by virtue of the fact that the Code does not impose tax on government agencies, no taxes would be owed on account of income earned by the trust.[275]

The primary problems with this idea are: (1) it may be difficult to ensure that the trust is not a grantor trust with respect to the grantor,[276] and (2) the BLM may not be amenable to the idea due to concerns about its fiduciary responsibility or changes to the tax law with respect to its tax-exempt status.[277] It may be worth considering the use of this type of withdrawal power, however, in such a manner that they will become effective if and when the grantor goes out of business.[278] Assuming that the BLM would like to keep the trust in existence after the grantor no longer exists, then it would appear to be preferable to have the trust be tax-exempt at that time, if possible.[279]

E. Non-Grantor Trusts

A trust that is not a grantor trust will be a non-grantor trust. Although it may be difficult to structure an environmental clean-up trust as a non-grantor trust, it should not be impossible under the right circumstances. As mentioned above, two key elements are to ensure that the grantor does not retain a reversionary interest greater than five percent of the trust's initial value and to ensure that the trust income is not used to satisfy an ongoing obligation of the grantor.[280]

1. Deductibility of Payments to the Trust

If the trust is a non-grantor trust, payments to the trust upon order by the BLM will be deductible by cash method taxpayers as a result of Treasury Regulations Section 1.461-2(c)(1).[281] With respect to accrual method taxpayers, because the rules regarding designated settlement funds and qualified settlement funds generally will not apply to environ-

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federal income tax purposes, then the trust is taxed as a separate entity (i.e., a non-grantor trust). I.R.C. § 678 (2005).

275. It is interesting to note that, although I.R.C. § 170(c), allows for the deduction of contributions to government agencies, I.R.C. § 501, does not directly provide that government agencies are tax-exempt. I.R.C. §§ 170(c), 501 (2005). That would appear to be due to the fact that the Code does not tax those agencies in the first place.

276. This is because the grantor may be satisfying an on-going obligation with trust income. *See supra* notes 252–55 and accompanying text. Recall that if both the grantor and a third party could be treated as the owner of the trust for federal income tax purposes, then the grantor is treated as the owner. § 678(b).

277. These problems arose during the author's negotiations with the BLM.

278. One could call this a "springing Crummey power," or one that appears when the grantor disappears.

279. Remember that one of the primary reasons for creating these trusts in the first place is to ensure that funds are available for environmental clean-up in the event that the mining company declares bankruptcy or ceases to exist.

280. *See supra* Part II.D.2.

281. Treas. Reg. § 1.461–2(c)(1) (1996).

mental clean-up trusts,[282] the economic performance rule[283] will prevent the grantor from taking a deduction until the funds are actually distributed from the trust for environmental clean-up work.[284]

2. Taxation of Income Earned by the Trust

A non-grantor trust that may retain or distribute income is referred to as a complex trust.[285] Complex trusts are taxed on all trust income; however, the trust is a allowed deduction for administrative expenses as well as for income that has been distributed to a beneficiary.[286]

III. PROPOSAL FOR TAX LAW CHANGE

As is evident from the multitude of Code Sections and Treasury Regulations that are potentially applicable to environmental clean-up trusts,[287] Congress and the Treasury did not anticipate the creation of trusts under the New 3809 Regulations. Accordingly, in the interest of certainty for taxpayers and the BLM, Congress or the Treasury should take action to make the law clear with respect to these trusts.

A. The Options

There are two logical options with respect to these trusts. First, the Code could be amended to deem the trust to be a grantor trust with respect to the grantor, fully taxable to the grantor as if the trust did not exist.[288] In this case, no deduction would be allowed solely as a result of a contribution to the trust.[289] The grantor could take deductions as distributions are made from the trust in the future or, if deductions can be accrued earlier under Section 179 or 468, then they could be taken earlier.[290]

There is a sub-issue in this case regarding what happens if and when the grantor ceases to exist and if the trust is a grantor trust with respect to the grantor. In that case, the Code could make it clear that the trust either

282. *See* discussion *supra* Part II.C.2–3.

283. I.R.C. § 461(h) (2005); discussion *supra* Part II.B.1.

284. It is only at this point that "economic performance" will occur. *See* Treas. Reg. § 1.461-4(g)(1)(i) (2005).

285. *See* Clark Trust v. Comm'r., 49 T.C. 456, 458–59 (1968).

286. *Id. See also* I.R.C. §§ 651, 661 (2005).

287. *See, e.g.*, I.R.C. §§ 162, 198, 468, 468B (2005); Treas. Reg. § 301.7701–4(e) (as amended in 1996); Treas. Reg. § 1.468B–1 (as amended in 1993).

288. Absent careful planning, this is most likely how such a trust would be treated under I.R.C. § 671; however, the current state of the law imposes uncertainty on the Service and on mining companies. *See supra* Part II.D. In the author's experience, this uncertainty has caused the BLM to insist that the mining company obtain at least one Private Letter Ruling to determine the income tax consequences under the New 3809 Regulations.

289. A downside of this approach is the possibility that grantor trust status could increase the likelihood that a creditor could reach trust assets if the grantor declares bankruptcy. Bankruptcy issues are beyond the scope of this article.

290. *See* discussion *supra* Parts II.A.2, A.4.

becomes a fully-taxable independent entity or a tax-exempt entity. In the author's experience, tax-exempt status at that point would be the preferable option both from the standpoint of the BLM and from the standpoint of mining companies because it would greatly simplify the initial computation of the amounts needed to ensure that environmental clean-up work can be completed.[291] It also would make more money available for that purpose by not reducing the growth in the trust value by income taxes.

Second, Congress or the Treasury could deem these trusts to be separate taxpayers like designated settlement funds or qualified settlement funds. In this case, the mining company would be allowed a current deduction, and the fund would be taxable on its income as a separate entity. Alternatively, the fund could be deemed to be a separate entity that is tax-exempt. While this would have an impact on government revenue, it would maximize the growth of these funds for environmental clean-up work.[292]

B. Proposal

In the author's experience, mining companies and the BLM are seeking simplicity and certainty with respect to the taxation of trusts under the New 3809 Regulations. In addition, the BLM has a great interest in ensuring that trust funds are not reachable by the mining companies' creditors.[293] With this in mind, it seems that the most favorable approach would be to grant mining companies a present deduction for amounts contributed to environmental clean-up trusts whenever a trust is required by the BLM under the New 3809 Regulations. In addition, these trusts should be non-grantor trusts for income tax purposes. Allowing the deduction coupled with non-grantor trust status would help to disentangle mining companies from these trusts, which in turn should make the trust assets somewhat safer from the perspective of keeping them out of the reach of creditors. Because the decision regarding whether a trust will be required is entirely within the control of the BLM, there is also little chance that these trusts would be used for tax evasion.[294]

With respect to the non-grantor trust status of the trust once it is funded, it seems that an additional tax benefit could be used to give min-

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291. It is virtually impossible to accurately estimate how much is needed in a fund if: (1) the mining company pays all taxes on the fund while the company is in existence, and (2) the trust has to pay taxes out of the trust if and when the mining company ceases to exist.

292. It is axiomatic that a fund that grows tax-free will grow more quickly than a fund whose growth is reduced by the payment of taxes each year. *See* Spartech Corp. v. Opper, 890 F.2d 949, 955 (7th Cir. 1989) (describing taxes as expenses).

293. During the author's negotiations with the BLM in conjunction with the preparation of environmental clean-up trusts for his firm's clients, the concern that was most frequently conveyed by the BLM was that the funds would not be available to the mining company's creditors in the event that the mining company were to declare bankruptcy.

294. To further minimize the possibility of tax evasion, amounts that revert to the grantor upon termination of the trust, if any, should be included in the grantor's income.

ing companies an incentive to sever all potential reversionary interests in the trust: the trust should be tax-exempt if the mining company retains no reversionary interest in the trust whatsoever. For example, if the trust terms provide that unused trust funds ultimately pass to charity,[295] then the trust should be tax-exempt. This would mean that less money would be needed up-front to adequately fund the trust, giving mining companies an incentive to agree to this approach.[296] If the company refuses,[297] the trust would be a taxable entity. This would mean that the mining company would need to pay more money up-front to adequately fund the trust.[298]

CONCLUSION

The BLM enacted the New 3809 Regulations to ensure that trust funds would be available for environmental clean-up.[299] Because taxation has a great impact on how quickly a long-term trust fund will grow, this objective is not likely to be met as long as the Code does not provide certainty to mining companies and to the BLM regarding how these trusts will be taxed.[300]

Regardless of the ultimate approach used, Congress and the Treasury should create a clear rule. Because the funds are being set aside for long-term or indefinite periods of time, because the amounts put into these trusts have been computed by a government agency,[301] and because it is likely that the funds ultimately will be used in a way that will benefit the general public, the mining company should be given a present deduction for the total amount put into the trust and, once the trust is funded, the trust should be a tax-exempt entity if the mining company retains no reversionary interest in the trust.[302] Doing this will maximize the amount

295. For example, the trust funds could pass to the Nevada Division of Wildlife.

296. Less money would be needed up-front because the fund would grow faster if it is not reduced by taxes each year. *See supra* note 292.

297. Refusing, in this situation, would occur if the mining company insists on keeping a reversionary interest in the trust.

298. *See supra* note 292. It follows that more money would be needed up-front because the trust would have a lower anticipated growth rate as a result of its status as a taxable entity.

299. *See supra* Part I.D.

300. For example, assume that the BLM and "Clementine's Mining Company" agree that a trust will be set up as a grantor trust. In that case, they would project the growth of the trust under the assumption that the fund's growth rate will not be reduced by taxes each year. If Clementine's subsequently goes out of business and if the Service determines that the trust is not tax-exempt, then the trust fund will suddenly begin to be reduced by taxes. In that case, the assets left in the trust would probably be insufficient to fully fund the required environmental clean-up. Because it is impossible to predict if and when Clementine's will go out of business, current law would require a lot of speculation regarding whether the trust will ever be taxable. Clementine's would argue that it will never go out of business. The BLM would argue that it is going to go out of business at any moment. As the author can attest, this makes for some awkward negotiations.

301. In this situation, the computing agency would be the BLM.

302. As mentioned above, the tax exemption could be used to give mining companies an incentive to forego any reversionary interest. If the mining company chooses to keep a reversionary interest, the fund could be taxable, much like designated settlement funds and qualified settlement funds. *See supra* Parts II.C.2–3.

available for environmental clean-up. It also will provide mining companies and the BLM with certainty and clarity, and perhaps it will foster greater support for the New 3809 Regulations in the mining industry.