

IRS Determines Asbestos Removal is Capital Expenditure

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In an as-yet-unpublished technical advice memorandum, the IRS denied a deduction under Section 162 for the costs of removing and replacing asbestos insulation in certain manufacturing equipment. Instead, the taxpayer was required to capitalize those costs under Sections 263 and 263A .

The issues involved in this TAM were addressed by Eric R. Fox and Michael F. Solomon, partners in the Washington, D.C., law firm of Ivins, Phillips & Barker, in "Who Incurs Environmental Clean-Up Costs-And Why-May Determine Deductibility," . There, the authors suggest that, apart from situations involving asset acquisitions, improvements, and additions (which raise a separate set of deductibility issues), environmental clean-up costs are generally deductible. Messrs. Fox and Solomon comment on the TAM, which takes at least partial issue with their conclusions in the article.

Facts. The TAM involved a manufacturing corporation which, prior to the 1980s, had acquired manufacturing equipment insulated with asbestos. The equipment was typical of the kind being manufactured at that time. As a result of health concerns arising in the early 1980s about exposure to airborne asbestos fibers, the Occupational Safety and Health Administration (OSHA) issued an order in July of 1986 lowering the standard for concentration of airborne asbestos fibers allowable in the work place. In addition, the state in which the taxpayer's plant was located required employers to

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monitor airborne asbestos concentrations to ensure that they did not exceed certain levels.

The taxpayer's response to the OSHA and state regulations was to commence a program of replacing all of the asbestos insulation in its manufacturing equipment with other insulating material not known to be subject to any health risks. The taxpayer considered and rejected the alternative of continuously monitoring asbestos levels and taking control measures to bring them within acceptable levels in the course of machinery repairs. It believed that such an approach, although initially less costly than replacement, would eventually become more costly due to the likelihood of increased equipment down time and added costs of safeguarding employee health. The insulating material the taxpayer chose to replace the asbestos with was somewhat less efficient, and provided no energy savings or any other operating cost reduction benefits.

Prior law. In the authors' prior article, it was suggested that the appropriate test for deductibility of an environmental clean-up expense was whether the expense produced an asset that was more valuable after the expense had been incurred than the asset previously had been, "assuming the asset was already in working condition."

This line of reasoning has been clearly articulated in a number of cases, and finds direct support in *Plainfield-Union Water Co.*, 89 TC 333 , in which the taxpayer was permitted to deduct the cost of cleaning some 7,400 feet of pipe and lining it with cement to restore the pipe's original water-carrying capacity, which had been reduced gradually by a condition known as tuberculation. The Service claimed the expense should be capitalized, but the Tax Court allowed the deduction on the grounds that the expenditure in issue merely served to restore the property to the condition it had been in prior to the onset of deterioration and did not make the property more valuable, useful or longer lived. Specifically, the Tax Court held that "[a]n expenditure which returns property to the state it was in before the situation prompting the expenditure arose, and which does not make the relevant property more valuable, more useful, or longer-lived, is usually deemed a deductible repair." (See also *Niagara Mohawk Power Corp.*, 40 AFTR 2d 77-5279 , 214 Ct Cl 686 , 558 F2d 1379 , 77-2 USTC 9525 .)

As might be expected, the taxpayer in the TAM relied heavily on *Plainfield-Union*, arguing that the Service should compare the value of the equipment after its asbestos insulation had been replaced with its value before asbestos was known to be a health hazard. When analyzed in this manner, the cost of asbestos replacement is clearly deductible.

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IRS reasoning. The Service rejected the taxpayer's reliance on Plainfield-Union on several grounds. First, the Service concluded that the case only applied "in situations where repairs are necessary because the property has progressively deteriorated." This contention is ironic, because in arguing Plainfield- Union the Service contended that only the costs of remedying a relatively sudden, unexpected, or unusual condition qualified for deduction. In any event, Plainfield-Union in no way turns on the rapidity with which a taxpayer becomes faced with a condition which must be remedied. In fact, in most repair situations, a functioning piece of equipment breaks suddenly (rather than deteriorating gradually over time), and the cost of any such repair is nearly universally a deductible item.

The Service next addressed the central issue in Plainfield-Union, i.e., whether the expenditure increases the value of the affected asset, assuming that the asset had not been adversely affected by the condition to be remedied. The TAM concludes that the value of the taxpayer's equipment had been increased by the asbestos replacement because (1) property from which asbestos has been removed and replaced is inherently more valuable than property that contains asbestos insulation, (2) the property is more attractive to potential buyers, and (3) the taxpayer's risk of liability to contaminated employees is decreased.

In a truly disingenuous piece of reasoning, the Service noted that the asbestos was not removed because of its ineffectiveness as an insulating material but only to meet regulatory guidelines related to health. The Service also threw in the argument that the increase in the property's value following asbestos abatement is based on subjective factors (such as safer working conditions, improved marketability, etc.) that are not compatible with the objective measurements articulated by the Tax Court in Plainfield- Union.

Analysis. The IRS has established the correct test for determining whether an asbestos removal expense is deductible or capital, but has misapplied the facts to the test. For asbestos removal to be a capital expenditure, it must either extend the life of an asset or increase the value of the affected property. There is no issue in the TAM relative to extending the life of the equipment, and the sole question presented is whether the asbestos removal costs increase the value of the taxpayer's property. What is most surprising about the Service's conclusion that value has been increased is that there seems to be no claim that the value of the asbestos-insulated equipment has been increased by the asbestos removal operation. Rather, the increased value is attributed to safer working conditions, reduced risk of liability, and increased marketability.

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The Service's position is extremely strained. The taxpayer's equipment in the TAM, as a practical matter, did not increase in value after the removal of the asbestos insulation any more than the taxpayer's water pipes in Plainfield-Union did after repair of their tuberculated condition. In fact, because the replacement insulation was less efficient, it could be argued that the equipment actually declined in value. This is precisely the same conclusion as was reached in *Niagara Mohawk*, supra, where the court held that the repair of leaks by the clamp method did not increase the value of cast-iron pipelines in comparison with their original leak-free condition.

The Service included several citations that it claimed support its contention that modifications made to bring property into compliance with local regulations and requirements increase the value of affected property, and are therefore subject to capitalization. (*Teitelbaum*, 8 AFTR 2d 5348 , 294 F2d 541 , 61-2 USTC 9632 ; *RKO Theatres, Inc.*, 2 AFTR 2d 5485 , 143 Ct Cl 39 , 163 F Supp 598 , 58-2 USTC 9691 ; *Hotel Sulgrave, Inc.*, 21 TC 619 ; *Beaven, TCM*, 19471231, .) The TAM could be interpreted, although it is doubtful that the Service so intended, to hold that expenditures of this type are determined to be capital or expense based on whether the action is voluntary or involuntary. The case law, of course, articulates no such standard, and the Service is merely leaping to a conclusion that such involuntary expenditures result in the requisite increase in value. These cases, however, cited by the Service in the TAM, can all be distinguished as involving expenses that permanently altered assets in a way that effectively increased the value of the altered assets. As noted in the authors' previous article and reiterated above, expenses that create new, improved, and more valuable assets may be subject to capitalization, even if the expenses are incurred to meet government rules and regulations.

The only plausible argument that the Service puts forth in the TAM that could support its capitalization determination is also the most troublesome for taxpayers. As noted previously, the facts in the TAM are essentially consistent with *Plainfield Union* and *Niagara Mohawk* . These cases do not find an increase in property value when the comparison is based on the relative value both before the event necessitating the expense and the value after the expense is incurred. Neither case, however, addresses the value question in the context of the Supreme Court's recent decision in *INDOPCO, Inc.*, 69 AFTR 2d 92-694 , 503 US 79 , 117 L Ed 2d 226 , 92-1 USTC 50113 . Even though the equipment in question may not have had any increase in value by reason of the asbestos removal, has the expenditure resulted in a substantial future benefit to the taxpayer by providing safer working conditions for employees, reduced risk of liability for owners and investors, and increased marketability for the business and its assets? These intangible items have certainly resulted from the asbestos removal and replacement expenses.

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But these same effects can be said to occur as a result of incurring most repair expenses. These intangible future benefits result from many ordinary and necessary expenses incurred on a daily basis by business in general. Advertising, compensation, janitorial services, functional equipment repairs, and similar expense categories all result in some future benefit to a business. Are these expenses to be capitalized in contravention of the established precedents existing since the introduction of the income tax laws? If the Service plans to apply INDOPCO indiscriminately to repair and other similar cases, virtually no expense will be deductible because most of them will probably be of a significant benefit to taxpayers extending well into future tax years.

The Service may be understandably concerned about the enormous amount of environmental clean-up costs waiting to be deducted, but its TAM ruling cannot be squared with Plainfield-Union, Niagara Mohawk, Oberman Mfg. Co., 47 TC 471 ; Midland Empire Packing Co., 14 TC 635 ; or Buckland, 35 AFTR 161 , 66 F Supp 681 , 46-1 USTC 9273 , no matter how hard the Service tries to distinguish its holding. If a tree fell on the taxpayer's uninsured plant and severely damaged it, interrupting production, the cost of repairing the building would be deductible as a repair. The determination that asbestos is a health hazard rendered the taxpayer's equipment just as unfit for use as a tree falling on a factory might render the factory unfit for use. Perhaps in the latter case, the taxpayer might postpone the repair and put up a tent every time it rained rather than incur the up- front repair cost that would be more expensive in the short run, but the taxpayer's decision to restore its property to its pre-existing state of health immediately in no way precludes a repair or a loss deduction. Similarly, the taxpayer's taking immediate action in the TAM to remedy its asbestos situation immediately rather than deal with it piecemeal is no grounds for denying a deduction. In fact, if the Service is successful in this position, taxpayers might be advised from a tax standpoint to fail to clean up the asbestos, deduct the cost of defending the health suits brought by its employees, and deduct the cost of business interruption insurance purchased to offset the cost of equipment downtime necessitated by asbestos-related concerns when such equipment is repaired.

In short, in the TAM, the Service allowed revenue considerations to interfere with reasoned analysis. The issue may be factual, but on the facts presented, the legal rules dictate an opposite result.

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