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An Elusive Distinction

IRS Reexamines Classification of Deductible Repairs

By: Ronald A. Morris and Ezra Dyckman

People often complain about how voluminous the Internal Revenue Code is. Sometimes, however, the most concise rules turn out to be the most difficult to apply. Take, for example, the following simple rule: capital expenditures are capitalized, repairs are deductible. Sounds easy? The IRS recently issued Notice 2004-6, containing the following introduction:

> The Internal Revenue Service and Treasury Department intend to propose regulations that clarify the application of §§ 162 and 263 of the Internal Revenue Code to expenditures paid or incurred to repair, improve, or rehabilitate tangible property. This notice identifies issues the Service and Treasury Department may address in the regulations. The Service and Treasury Department want to provide clear, consistent and administrable rules that will reduce the uncertainty and controversy in this area, while also preventing the distortion of income. Accordingly, the Service and Treasury Department request public comments on whether these or other issues should be addressed in the regulations and, if so, what specific rules and principles should be provided.

The goal is relatively straightforward: to deduct costs in the year of benefit so that a taxpayer's annual income is a meaningful number. Yet, the distinction between deductible repair expenses and nondeductible capital expenditures has long been elusive and factually entangled. Section 162(a) of the Code provides:

> There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . .

Section 263 addresses the same issue in the negative:

> (a) General Rule: No deduction shall be allowed for –
>
> (1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate . . . .
>
> (2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

Each of these Code sections spawns a regulation. Treasury Regulation §1.162-4 provides:

> The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense . . . . Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall either be capitalized and depreciated in accordance with section 167 [or charged against the depreciation reserve if such an account is kept.]

Treasury Regulation §1.263(a)-1 provides:

> (a) Except as otherwise provided in chapter 1 of the Code, no deduction shall be allowed for –
>
> (1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate, or
>
> (2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made in the form of a deduction for depreciation, amortization, or depletion.
>
> (b) In general, the amounts referred to in paragraph (a) of this section include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. Amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures within the

> meaning of subparagraphs (1) and (2) of this paragraph.

The number of words the regulation devotes to the definition of a "repair" foreshadows the complexity to be found in the case law. Rather than adding rules and definitions, Notice 2004-6 begins by fundamentally questioning the rules just cited. The notice asks:

> What general principles of capitaliztion should apply to expenditures to repair or improve tangible property? The regulations currently require capitalization for expenditures that materially increase the value of property, substantially prolong the useful life of property, or adapt property to a new or different use. Sections 1.162-4; 1.263(a)-1(b) of the Income Tax Regulations. Are these the appropriate tests for capitalization? If so, how should the forthcoming guidance clarify the application of these standards? Alternatively, should different standards apply? If so, what different standards?

The notice goes on to raise questions about the meaning of almost every phrase in the regulations quoted above. Among them, the notice asks the following:

> In determining whether an expenditure materially increases the value of property or substantially prolongs the useful life of property, what is the proper starting point for comparison? Should the forthcoming guidance adopt the test in *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. (1962), *nonacq.* 1964-2 C.B. 8, which looks at "whether the expenditure materially enhances the value, use, life expectancy, strength, or capacity as compared with the status of the asset prior to the condition necessitating the expenditure"? Should the starting point be different depending on whether the expenditure was necessitated by a single event, such as a casualty, or from gradual wear and tear?

The *Plainfield* case discussed in the notice involved the deductibility of the cost of lining water pipes with cement. In 1950, the taxpayer, a New Jersey water company, began to run river water through its pipes. River water is substantially more acidic than well water which otherwise comprised the taxpayer's system. Tuberculation results from the attack by acidic water upon the metal of a pipe beneath the tar or asphalt lining. This attack often occurs at points where the lining does not completely cover the metal. The acidic water and metal produce an iron oxide which gradually pushes up the tar or asphalt coating, resulting in what is known as tuberculation. Tuberculation often results in the reduction of the pipe's carrying capacity.

The taxpayer did not have any tuberculation prior to 1950. Subsequent to the introduction in 1950 of the acidic river water, the pipes began to lose carrying capacity and by 1954 there was a substantial diminution in the pipe's carrying capacity. The taxpayer caused the pipe to be cleaned in 1954, in order to restore its carrying capacity to the pre-1950 level.

By 1957 the carrying capacity of the pipe had again been substantially diminished. The taxpayer then lined the pipe with a cement lining. This sort of cement lining is not permanent and will wash out eventually. However, cement lining usually eliminates the problem of tuberculation and the necessity of periodic cleaning for as long as the cement lining lasts.

In dealing with the question, the court set forth the rule that has become the standard in the area:

> Respondent contends that the value of the pipe to the taxpayer was materially increased by the expenditure and that it is, therefore, a capital expenditure. But any properly performed repair adds value as compared with the situation existing immediately prior to that repair. *The proper test is whether the expenditure matrially enhances the value, use, life expectancy, strength, or capacity as compared with the status of the asset prior to the condition necessitating the expenditure.* (Emphasis added)

The court then found that comparing the period before tuberculation and after expenditure, the useful life of the pipe was not increased by the cleaning and lining and that neither the strength nor the capacity of the pipe was enhanced.

The court added:

> Further, the river water could be, and was, used in the relevant pipes without cement lining. Periodic cleanings, clearly deductible ordinary expenses, would allow the taxpayer to use the [pipe]. . . at full capacity without cement linings. The cement lining was not a permanent addition to the pipe. By lining the pipes, the taxpayer merely eliminated, temporarily, a maintenance problem.
>
> We do not agree that the deduction in the instant case requires a relatively sudden, unexpected, or unusual external factor which results in casualty damage.

The facts in *Plainfield* raise a somewhat unusual repair question since nothing suddenly broke. Rather, the blockage in the pipe gradually developed over the course of years. The court, nevertheless, held that the appropriate test was whether the post-repair value was greater than the pre-condition value.

In addition, the court's conclusion seems at odds with the facts of the case. Isn't the pipe worth more post-repair than it was worth before the onset of tuberculation (after the lining, the pipe was tuberculation-proof against river water)? If so, a strict application of the court's rule would deny a deduction. Yet the court held that the cost of the cement lining was deductible. Perhaps, in the court's view, despite the inherent element of future benefit in the case, the cement lining was really in lieu of multiple (deductible) repairs.

A further look at Notice 2004-6 shows that the *Plainfield* test is merely the beginning. The notice goes on to ask an extended series of questions, including:

> If the expenditure relates to a component part, does the relative impor-

tance of the component part to the functionality of the underlying asset affect the starting point?

Should the test in *Plainfield* apply as well to expenditures incurred upon acquisition of the property and, if so, how would the test apply?

What is "value" for purposes of the "material increase in value" rule?

How should it be determined whether there has been a "material increase" in value?

What is "useful life" for purposes of the "substantially prolongs useful life" rule?

How should it be determined whether an expenditure "substantially prolongs" the useful life of the property?

Is §263(a)(2) (disallowing a deduction for an expenditure which reverses exhaustion for which depreciation deductions were taken) a different test from the "substantially prolongs the useful life of the property" test?

What factors are relevant in determining whether an expenditure adapts property to a new or different use?

What other factors should be considered in determining whether an expenditure must be capitalized?

What facts are relevant in determining whether a repair must be capitalized under the "plan of rehabilitation" doctrine?

Are there any situations in which the tax treatment of an expenditure to repair, improve, or rehabilitate tangible property should follow the financial or regulatory accounting treatment for that expenditure?

One's initial reaction to each question in this daunting list is: "Good question!" Although the ruling contains no answers, it demonstrates profound appreciation for the labor that lies ahead in this area. One thing is for certain: the regulations that emerge from this project, if ever they do, will be far longer than Notice 2004-6. Perhaps this is one area in which it is best to leave things alone, allow the law to develop case-by-case, and accept the notion that some concepts are inherently ambiguous, that more words in new regulations will not necessarily result in greater clarity or certainty.

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