Tax Accounting

BY JAMES E. SALLES

This month's column is devoted to an extended discussion of *Ingram Industries, Inc. v. Commissioner*,[1] a recent Tax Court case that addresses the distinction between "repairs" and "improvements" to tangible property in the aftermath of *INDOPCO, Inc. v. Commissioner*.[2] Although a memorandum case, Ingram is significant as containing one of the more extensive post-*INDOPCO* judicial discussions of the issue, and also because it deals with the frequently thorny issue of how to treat periodic overhauls that have to be performed every few years. The first part of the discussion that follows summarizes the state of the law on "repairs" *versus* "improvements" and the gray area between the two. The remainder discusses the facts and holding of *Ingram*.

BASIC PRINCIPLES

As is nearly always the case in the capitalization area, the starting point for analysis is *INDOPCO*. The Supreme Court held that an expenditure might have to be capitalized because it produced "more than incidental . . . future benefit" even if it was not associated with a "separate and distinct asset." *INDOPCO* does not impose a "talismanic test" under which all expenditures must be capitalized if they produce *any* future benefit.[3] The future benefit has to be more than "incidental"[4] and extend "substantially" beyond the taxable year.[5] "Ordinary" costs that are routinely incurred should not have to be capitalized if they do not represent the creation or acquisition of a "separate and distinct asset." Recognizing this principle, the IRS has issued several rulings confirming that different types of routine costs remain currently deductible after INDOPCO, despite the presence of some future benefit.[6]

INDOPCO and most of the authorities referenced in the preceding paragraph involve an intangible future benefit, but the same principles extend to outlays that relate to real or tangible personal property. An expenditure that does not yield a "separate and distinct asset" should be deductible if the taxpayer can show either that any future benefit is merely "incidental" or that, notwithstanding some future benefit, income would be more clearly reflected by a current deduction.[7] The latter test is likely to be met by a routine, repetitive outlay such as a traditional "repair."

These are essentially the same rules that have prevailed all along as to such expenditures. INDOPCO and its progeny may impart some additional sophistication to the analysis and make it easier to articulate, but they do not really change it.[8] The regulations have long provided that expenditures to "improve" or "restore" property, or that add to its value or substantially prolong its useful life, must be capitalized, while "incidental repairs" that do not add value or prolong life may be currently deducted.[9] The authorities consistently conclude that an expenditure that improves the property beyond its condition when acquired,[10] or fits it to a new use,[11] is capitalizable as an improvement. Otherwise, the issue becomes whether the expenditure adds to the property's value or prolongs its useful life within the meaning of the regulations.

PROLONGING USEFUL LIFE

Any repair worth performing will increase a property's value[12]—and likely its useful life[13]—compared to its unrepaired state. The real inquiry seems to be into the reasonable expectations concerning the property when it was placed into service. If the work performed is of a kind that the taxpayer would reasonably have expected from the outset to have to perform sooner or later; and does not increase the property's value beyond the expected value of a well-maintained property or increase its useful life beyond that initially contemplated, then it should be a currently deductible repair. Otherwise, it is capital.

Sometimes it may be disputed whether, for example, a given property has a forty-year useful life with a peri-

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odic maintenance overhaul needed every four years, or has a four-year useful life that may be renewed by a "rebuilding" or "reconditioning" every four years. In close cases, which analysis is applied may depend on the cost of the periodic outlay as compared to the original cost of the property.

For example, in *Ruane v. Commissioner*,[14] a partnership that manufactured coke from coal maintained 230 "beehive coke ovens" arranged on shelves. The ovens had to be reconditioned every three to four years due to deterioration from use. The issue was the treatment of a payment the partnership made to a contractor to recondition 60 ovens. The court held that the expenditure had to be capitalized, because

> [t]he work performed on the ovens appreciably prolonged their life and, in fact, gave them new life. According to normal experience, an oven would last from three to four years. It then fell into such a state of deterioration, that it became necessary to shut it down for renovation. As a result of the work performed the oven was substantially rebuilt, thereby obtaining a new life expectancy of three to four years.[15]

The evidence showed that the contractor had "rebuilt a complete front wall and crown" for each oven and relined it with brick, and it seems fair to infer that the cost of the work amounted to a substantial fraction, if indeed it did not exceed, the original cost of these simple structures.

Much more recently, *Vanalco, Inc. v. Commissioner*[16] addressed a similar issue involving an aluminum smelter. Aluminum is produced in a chemical bath through which an electrical current is run. In the taxpayer's plant, the process took place in several hundred steel "cells" connected in series. The cells themselves could be expected to last more than 50 years. However, it was necessary to replace the cell *lining*—carbon blocks and associated hardware—every three years. The lining, while not a separate asset from the cell itself, was "a substantial and essential component" necessary to its function, and the cost of its replacement was substantial in relation to the total cost of the cell. Therefore, the court held, the cells were "essentially . . . rebuilt" when they were relined, and the associated costs had to be capitalized.

PERIODIC OVERHAULS: *PLAINFIELD-UNION*

The line between a repair and an improvement also gets a little blurry when an overhaul may provide benefits over several years, but does not fundamentally change the property or its use. The cases are not always easy to reconcile, but the weight of authority is that the costs of such periodic maintenance are currently deductible if nothing else is going on. Taxpayers seeking a current deduction can point to one of the most-cited capitalization cases, *Plainfield-Union Water Co. v. Commissioner*,[17] in which the Tax Court allowed a utility a current deduction for the cost of lining some of its water pipes with cement.

The pipes had been installed in 1910. In 1950, because of changes to the water system, the pipes began carrying more acidic water that resulted in their becoming clogged with iron oxide. As a result, to maintain capacity, the pipes had to be cleaned every few years. Such a cleaning was in fact performed in 1954. In 1957-58, the taxpayer not only cleaned the pipes again but also lined them with cement. While sooner or later the cement lining itself would degrade and have to be replaced, lining the pipes was intended to forestall the clogging and make further maintenance unnecessary for an extended period. Nonetheless, the court held that the expense was an ordinary one, because the cement lining did not materially enhance "the value, use, life expectancy, strength, or capacity" of the pipe as compared with its original, unclogged state.

Plainfield-Union stands for the proposition, among others, that the mere fact that an expenditure reduces or eliminates future repair costs does not necessarily make it an improvement.[18] This reflects the general principle that reducing future outlays, by itself, does not establish a "future benefit" worthy of capitalization under *INDOPCO*.

Similarly, a current deduction is not precluded because such maintenance costs might be incurred only once every several years. The taxpayer in *Moss v. Commissioner*[19] owned an interest in a hotel partnership. The hotel made periodic repairs and renovations to hotel rooms along with purchasing new furniture and fixtures. The furniture and fixtures themselves had useful lives of three to five years and were separately depreciated. The controversy concerned the remaining costs of the renovations, such as the costs of repainting, replacing wallpaper, and so forth. The court found that these costs were currently deductible as a periodic repair that worked no permanent "improvement" to the hotel. The court explicitly found it irrelevant that the costs were incurred unevenly and that the hotel had actually renovated two-thirds of its rooms in the year at issue.

THE *WOLFSEN LAND* CONUNDRUM

In *Wolfsen Land & Cattle Co. v. Commissioner*,[20] the taxpayer owned an interest in a cattle ranch. The ranch was served by an irrigation system made up of trenches of different dimensions through which water was delivered and drained. Unmaintained, the trenches would gradually become blocked by the buildup of sediment and plants, and some of the associated earthworks would likewise decay. The ranch did not have a plan of annual repairs or maintenance, but instead "dragged" (cleared) the trenches, and rebuilt the earthworks, as they became impaired. Depending on the feature concerned, the work could be expected to last from five to thirty years. The taxpayer claimed depreciation on the portion of the ranch's original cost that was allocated to the irrigation system, while treating the costs of restoring the system as capital when they were incurred. The Tax Court held that this treatment was correct.

One potentially troubling aspect of *Wolfsen* is that the repairs only restored the property to its initial utility. Some have suggested that a current deduction should have been allowed because, while several years' maintenance costs were effectively being paid at once, these were *past* years, rather than future years. However, this analysis overlooks the crucial fact that the original cost of the irrigation system was itself being depreciated. The periodic overhauls restored both the property and its basis (assuming constant costs) to their original state. Probably the best view of *Wolfsen* is that the court treated the irrigation system as an asset separate from the ranch, or at least as a "substantial and essential component."[21] The irrigation system was being depreciated over its initially determined useful life. That life was being extended as portions of the system were restored to their original state, making the associated expenditures capital.

Some questions remain unanswered: for example, would depreciating the system's initial cost still have been proper if the taxpayer had performed yearly maintenance instead? However, it is dangerous to assign too much lofty theoretical baggage to what the court itself described as an individualized and factually driven holding. The consensus appears to be that *Wolfsen* has limited direct precedential value outside of the specific situation described by the court: a periodic overhaul of property that itself has an indefinite useful life. While it may loom over other "repairs *versus* improvements" controversies, it does so for the most part in the very distant background.

AND FINALLY, INGRAM

The taxpayer in *Ingram Industries* was the parent of a consolidated group of corporations. Some of the members were engaged in the barge transportation business, and maintained a fleet of "towboats" used to push groups of barges along the waterway. A representative towboat cost a bit over $6 million new (or a little over $2 million in used condition) and included two diesel engines that standing alone might cost about $1.5 million new or $600,000 used.

About every three to four years, a towboat would be taken out of service for about 10 or 12 days to permit a general cleaning and inspection of the engines. A few low-cost parts (pistons and rings) were always replaced, but other parts were repaired or replaced only if they fell outside reasonable tolerances for used parts. (By contrast, in a more extensive process known as "repowering," an engine would be rebuilt to "like new" specifications.) The total cost of this maintenance averaged approximately $100,000, about two-thirds representing the cost of parts and the rest labor.

For book purposes, the taxpayer related the cost of an overhaul to *prior* periods. In other words, the expected cost would be accrued over the period elapsing between one overhaul and the next. The taxpayer did not contend that it was entitled to the same treatment for tax purposes,[22] but claimed a current deduction once the expenditures were actually incurred.

The Court's Analysis

The Tax Court found that the $100,000 repair cost was not material in comparison to the cost of either the towboat or the engine and did not extend their expected useful life (40 years). Moreover, any increase in value attributable to the maintenance was speculative and limited to the cost of performing the work; the towboats would continue to decline in value as the vessels aged. Applying the regulations' test for distinguishing a repair from an improvement—that is, whether the expenditure increased the asset's useful life or value—the court held that a current deduction was allowable.

As Ingram illustrates, the cost of routine maintenance may be currently deductible notwithstanding that the maintenance entails replacing some parts. On the other hand, that the expenditure relates exclusively to an individual component of the overall asset does not necessarily make it ordinary, either, as witness Vanalco. The parties in Vanalco agreed that the lining was not a separate asset from the cell, but the court held that "the difference between the cell lining as a separate asset and as a substantial and essential component [of the cell] is one of semantics, not substance" and that in replacing the lining the taxpayer "essentially . . . rebuilt" the cell.

The critical factor distinguishing *Vanalco* from *Ingram* was probably the *Vanalco* court's finding that "the cost of the lining as a percentage of the total cost of the cell unit [was] substantial"—more than 20 percent.[23] The cost of the engine maintenance in *Ingram* was relatively speaking much less. Even though the court held that the relevant "asset" was the towboat and not the engine, the opinion strongly suggests that the court would have reached a different result had the engines been replaced or "repowered" (completely overhauled so as to restore them to a "like new" condition).

Significantly, *Ingram* puts the Tax Court on record for the proposition that, as the IRS has already effectively conceded,[24] the core holding of *Plainfield-Union* survives *INDOPCO*. The court specifically noted that neither party disputed that *INDOPCO* did nothing to change existing law concerning repair and maintenance expenses. The law remains that if an expenditure does no more than restore property to its initially contemplated state—and is not so material in relation to the overall property that it amounts to a "rebuilding"—then it may be currently deducted as a repair, even though it may provide a benefit for the rest of the initially contemplated useful life of the property.

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1. 80 TCM (CCH) 532 (2000).
2. 503 US 79 (1992).
3. A.E. Staley Mfg Co v Comm'r, 119 F3d 482, 489 (7th Cir 1997).
4. *INDOPCO*, 503 US at 87.
5. Treas Reg §§ 1.263(a)-2(a), 1.446-1(a)(4)(ii), (c)(1)(ii), 1.461-1(a)(1), (a)(2)(i).
6. E.g., Rev Rul 96-62, 1996-2 CB 9 (employee training); Rev Rul 94-77, 1994-2 CB 19 (severance costs); Rev Rul 92-80, 1992-2 CB 57 (advertising).
7. See Cox v Comm'r, 64 TCM (CCH) 1123, 1126 (1992).
8. *Ingram*, 80 TCM (CCH) at 540; Rev Rul 94-12, 1994-1 CB 36.
9. Treas Reg §§ 1.162-4, 1.263(a)-1.
10. *E.g.*, United Dairy Farmers, Inc v United States, 107 F. Supp. 2d 937 (S.D. Oh. 2000), appeal docketed, No. 00-3800 (6th Cir. 2000), discussed in J Salles, *Tax Accounting*, 1(12) Corp. Bus. Tax'n Monthly at 25, 26-27 (Sept 2000).
11. *E.g.*, Dominion Resources, Inc v United States, 219 F3d 359 (4th Cir 2000), discussed in J Salles, *Tax Accounting*, 2(1) Corp. Bus. Tax'n Monthly at 36, 37-38 (Oct 2000).
12. *E.g.*, Plainfield-Union Water Co v Comm'r, 39 TC 333, 338 (1962), nonacq., 1964-2 CB 8; W. Raby, Two Wrongs Make a Right: The IRS View of Environmental Cleanup Costs, 59 Tax Notes 1091, 1092 (1993).
13. *See, e.g.*, Kansas City Southern Ry Co v United States, 112 F Supp. 164, 165 (Ct Cl 1953) ("it is not unusual that the repaired portion is better than *and will outlast* the parts that have not yet needed repairs") (emphasis added); L. Droller, *IRS Continues Flawed Analysis of Treatment of Environmental Treatment Costs*: TAM 9411002, 63 Tax Notes 611, 613 & n 11 (1994) and authorities cited.
14. 17 TCM (CCH) 865 (1958).
15. 17 TCM (CCH) at 871.
16. 78 TCM (CCH) 251 (1999).
17. 39 TC 333 (1962), *nonacq*. 1964-2 CB 8.
18. See 39 TC at 338.
19. 831 F2d 833 (9th Cir 1987)
20. 72 TC 1 (1979).
21. *Cf. Vanalco, supra*.
22. *Cf.* World Airways, Inc v Comm'r, 62 TC 786, 796-805 (1974), *aff'd*, 564 F2d 886 (9th Cir 1977).
23. 78 TCM (CCH) at 256 & n.8.
24. *See, e.g.*, Rev Rul 94-38, 1994-1 CB 35, allowing a current deduction for environmental remediation costs.