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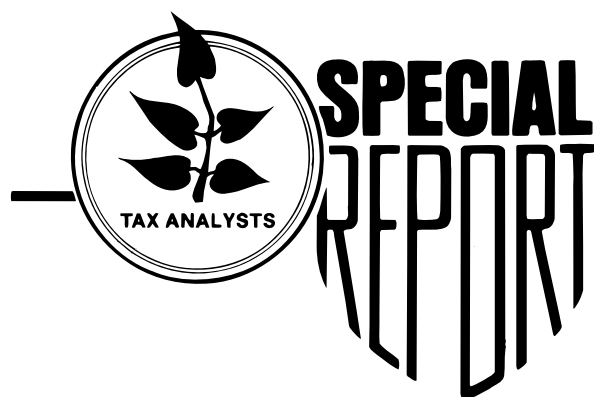
Deconstructing the General Plan of Rehabilitation

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DECONSTRUCTING THE GENERAL PLAN OF REHABILITATION DOCTRINE

By John W. Lee III

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The general plan of rehabilitation doctrine provides that expenses incurred as part of a plan of general rehabilitation must be capitalized even though the same expenses incurred separately would be deductible as ordinary and necessary repairs. The emerging general standard after *INDOPCO* for current deduction of an expenditure with future benefits, the case with most repair/improvement expenditures, is a balancing test: Whether the taxpayer's administrative and record keeping costs associated with capitalization outweigh the potential distortion of income from a current deduction of the future benefit expenditures. "Rough justice" rules for current deduction of future benefits expenditures, reflecting that balancing standard, include whether (1) the expenditure is relatively small or the future benefit is "incidental" to the current benefit, (2) the expenditures are regularly recurring, (3) future benefits are short-term or variable, and (4) the burdens of capitalization outweigh in general the revenue benefits to the Treasury from capitalization of the expenditure; for example, where the cost once capitalized may not be depreciated or depreciated only over a period longer than the expected future benefit (slow or no depreciation). The Service and courts often have incorrectly relied on the general plan of rehabilitation to capitalize post-*INDOPCO* repair or improvement costs, where one of these rough justice exceptions to capitalization should have been used.

This article maintains that the only sound basis for the general plan of rehabilitation doctrine is the rule of tax parity or horizontal equity, viz., equivalent treatment between a taxpayer who purchases a business asset and one who constructs it herself. Thus, a taxpayer who rehabilitates a run-down building should be treated the same as a taxpayer who purchases a renovated similar building. Applying this analysis this article discusses (1) the inapplicability of the general plan of rehabilitation doctrine to assets other than the particular asset being improved; (2) unavailability of depreciation or too slow depreciation as a basis for currently deducting remediation costs to avoid the distortion of income that would arise from no or too slow depreciation, so that a current deduction should be allowed, notwithstanding a concurrent general plan of rehabilitation under the "reverse" rule of tax parity; (3) such distortion of income reasoning does not apply where remediation is anticipated at time of purchase since the acquisition cost doctrine would then apply (under a rule of tax parity reasoning although not so articulated in the case law), even in the absence of a general plan of rehabilitation; (4) a minimum distortion of income analysis of repair versus improvement expenditures; (5) where cyclical repairs occur more frequently than the recovery period of the repaired asset, the cost of the repairs should be treated as a freestanding intangible and depreciated over the recurrence period or currently deductible if sufficiently insubstantial or short or variable term, or no or only slow depreciation would be available if capitalized; and (6) where those repairs occur in a cycle substantially identical to the recovery period of the repaired asset, their cost should be capitalized and depreciated over that recovery period to avoid distortion of income.

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I. Introduction

Cases, rulings, commentary, and news reports¹ evidence that revenue agents frequently rely in audit on the general plan of rehabilitation doctrine, which provides that expenses incurred as part of a plan of general rehabilitation must be capitalized even though the same expenses if incurred separately, would be deductible as ordinary and necessary.² Such reliance appears due to the possibility of thereby (1) bypassing the “restorative principle” of *Plainfield Union*,³ which permits current deduction under section 162 of the costs of repairs that merely restore property to its condition before the event necessitating the repair (or perhaps before the taxpayer’s discovery of the potential effects of such event); and (2) lumping together a number of expenditures without having to analyze whether capitalization under section 263 or a current deduction of each expenditure under section 162 would produce less distortion of the taxpayer’s income.

Part IV.C of this article shows that the emerging general standard after *INDOPCO, Inc. v. Commissioner*,⁴ for current deduction of an expenditure with future benefits, the case with most repair/improvement expenditures, is a balancing test: Whether the taxpayer’s “administrative and recordkeeping costs associated with capitalization” outweigh “the potential distortion of income” from currently deducting those future bene-

fit expenditures.⁵ “Rough justice”⁶ rules for current deduction of future benefits expenditures, explicitly or implicitly based on such a balancing standard, include whether (1) the future benefit from the expenditures does not last for more than 12 months, (2) the expenditure is relatively small or the future benefit is “incidental” to the current benefit, (3) the expenditures are regularly recurring, (4) future benefits are short-term or variable, or (5) the burdens of capitalization outweigh in general the revenue benefits to the Treasury from capitalization of the expenditure; for example, where the cost once capitalized may not be depreciated or depreciated only over a period longer than the expected future benefit (slow or no depreciation).⁷ If one or more of these rules apply to the expenditures by the taxpayer, their current deduction constitutes a method of tax accounting meeting the clear reflection of income mandate of section 446(a).⁸ The existing repair versus improvement rules in general

⁵“Advance Notice of Proposed Rulemaking, Guidance Regarding Deduction and Capitalization of Expenditures,” 67 *Fed. Reg.* 3461, 3462 (Jan. 24, 2002) (Advance Notice); *U.S. Freightways Corp. v. Commissioner*, 270 F.3d 1137, 1146, *Doc 2001-27961* (9 original pages), 2001 TNT 217-14 (7th Cir. 2001) (gain in precision for the taxing authorities from a more perfect matching of expense and income is outweighed by the administrative burden the taxpayer would bear in such matching); see generally John Lee, Eldridge Blanton, Veena Luthra, Glenn Walberg, and Darryl Whitesell, “Restating Capitalization Standards and Rules: The Case for Rough Justice Regulations (Part One),” 23 *Ohio Northern U. L. Rev.* 631, 647-48 (1997) (Lee, *et al.*, Rough Justice I). This article and (Part Two) 23 *Ohio Northern University Law Review* 1483 (1997) (Lee, *et al.*, Rough Justice II) are a polished version of my students’ and my submission to the Service in response to Notice 96-7, 1996-1 C.B. 359, *Doc 96-1983* (2 pages), 96 TNT 13-5.

⁶See note 106 *infra*.

⁷See note 108-117 *infra* and accompanying text. Other rough justice rules, which rarely if ever apply to repairs in the context of the general plan of rehabilitation doctrine, include (1) allocation of the expenditure between current and future benefits is difficult and (2) future benefits are speculative. I discuss all of these rough justice rules in more detail in “Transaction Costs Relating to the Acquisition or Enhancement of Intangible Property: A Populist, Political, But Practical Perspective,” forthcoming in the Fall 2002 issue of *Virginia Tax Review*.

⁸Section 446(a) and (b) provides that the taxpayer’s income is to be computed under her regular method of accounting unless she fails to employ a method or the method used does not clearly reflect income. In either case, income will be computed under such method as does clearly reflect income in the opinion of the Secretary of the Treasury. *Id.* Capitalization, depreciation, and clear reflection of income are “inextricably intertwined,” with the ultimate question being the success of the taxpayer’s method of tax accounting in clearly reflecting income. *Cincinnati, N.O., Tex. & Pac. RR v. United States*, 424 F.2d 563, 569 (Ct. Cl.1970) (relying on *Fort Howard Paper Co. v. Commissioner*, 49 T.C. 275, 283-84 (1967)); accord Advance Notice, *supra* note 5 at 3462 (“A fundamental purpose of section 263(a) is to prevent the distortion of taxable income through current deduction of expenditures relating to the production of income in future taxable years.”). A

¹E.g., FSA 200202026, *Doc 2002-826* (5 original pages), 2002 TNT 9-88; Rev. Rul. 2001-4, 2001-3 IRB 295, *Doc 2001-57* (19 original pages), 2000 TNT 247-5; *Vanalco Inc. v. Commissioner*, T.C. Memo. 1999-265, *Doc 1999-26420* (24 original pages), 1999 TNT 152-76, *aff’d sub nom. Smith v. Commissioner*, 300 F.3d 1023, *Doc 2002-18762* (26 original pages), 2002 TNT 157-6 (9th Cir. 2002) (the Ninth Circuit in affirming the Tax Court on this issue did not discuss the general plan of rehabilitation yet it did as to another issue); Glenn Carrington, “Capitalization After *INDOPCO* and Into the New Millennium,” *Tax Notes*, Nov. 5, 2001, p. 813; “Transcript of Sixth Invitational Biennial Conference on Tax Legislative Process, Day Two,” 2001 TNT 160-17 para. 504 (Aug. 17, 2001); Lee A. Sheppard, “News Analysis, The *INDOPCO* Grocery List,” *Tax Notes*, Oct. 15, 2001, p. 320.

²See notes 22-25 *infra* and accompanying text.

³*Plainfield Union Water Co. v. Commissioner*, 39 T.C. 333, 338 (1962), *nonacq.* 1964-2 C.B. 8.

⁴*INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 86-7, 92 TNT 44-1 (1992), rejected the rule that an expenditure not creating or enhancing a separate asset was per se currently deductible, in favor of a rule that an expenditure generating more than “incidental” future benefits should be capitalized to match the expense with these future benefits.

(Footnote 8 continued on next page.)

only imperfectly correspond with the above general rough justice exceptions.⁹ Moreover, to date the Service and the courts have overly and often incorrectly relied on the general plan of rehabilitation to capitalize post-*INDOPCO* repair or improvement costs where one of the rough justice exceptions to capitalization should have been used.¹⁰

taxpayer's practice of capitalizing or expensing certain items constitutes a method of accounting. *E.g.*, Rev. Rul. 95-74, 1995-2 C.B. 36, *Doc 95-9854* (10 pages), 95 *TNT* 212-35; Rev. Rul. 95-32, 1995-1 C.B. 8, *Doc 95-3224*; 95 *TNT* 59-14; GCM 39,328 (Jan. 23, 1985).

⁹See note 61 *infra*. Some repair decisions seem to treat lack of permanence [which implies a recurring expenditure] as an independent factor. *American Bemberg Corp. v. Commissioner*, 10 T.C. 361, 377, *aff'd* 177 F.2d 200 (6th Cir. 1948). Conversely, a very large and *infrequent* expenditure incurred in constructing a sea wall and raising drilling platforms to preserve existing offshore oil drilling operations was capitalized and depreciated over the 30-year recurrence cycle in TAM 9424002, 94 *TNT* 118-12.

"[E]xpenditures which are substantial in relation to the value of an asset cannot be characterized as 'incidental' repairs." Mary Lou Hopun, Note, "To Expense or to Capitalize? The Impact of Federal Income Tax Treatment of Environmental Cleanup Costs Under CERCLA," 19 *U. Dayton L. Rev.* 679, 703 (1984); *Stoeltzing v. Commissioner*, 266 F.2d 374 (3rd Cir. 1959) (building repair costs capitalized because they exceeded 200 percent of original cost). Conversely replacement of a small portion of a pipeline was held deductible in *Badger Pipe Line v. Commissioner*, T.C. Memo. 1997-457, *Doc 97-28098* (13 pages), 97 *TNT* 196-9. Nevertheless, contrary decisions as to the significance of large expenditures include *American Bemberg Corp. v. Commissioner*, 10 T.C. 360 (1948), *aff'd* 177 F.2d 200 (6th Cir. 1949), and *Buckland v. United States*, 66 F. Supp. 681 (D. Conn. 1946). Hence, conventional wisdom holds that "cost alone is not dispositive." Rev. Rul. 2001-4, note 1 *supra*.

The repair "increase in value" factor roughly corresponds with future benefit, although an expenditure may increase the property in value without increasing its useful life. Early on the courts pointed out that most repairs result in an increase in value. *Black Hardware Co. v. Commissioner*, 16 B.T.A. 55, 553-541 (B.T.A. 1929) ("it seems unreasonable that a building so located as to be free from the menace of storms and floods is not more valuable than the same building, or the same kind of building, not so favorably situated."), *aff'd* 39 F.2d 460 (5th Cir. 1939), *cert. denied* 282 U.S. 841 (1939). However, the Tax Court has said that while it "is true that most cases which have held expenditures to be deductible repairs have relied upon the fact that the work did not result in an increase in the valuation or prolongation of useful life, . . . this does not mean that unless there is an increase in value or useful life the expenditure cannot be a capital expense." *Seas Shipping Co., Inc. v. Commissioner*, 24 T.C.M. (CCH) 1222 (1965).

The "restoration" principle, see notes 83-97 *infra* and accompanying text, does not fit into a future benefits, rough justice exceptions model.

¹⁰See notes 142-44, 149-54 *infra* and accompanying text.

Treasury and the Service's 2002 "Guidance Regarding Deduction and Capitalization of Expenditures"¹¹ announced that the IRS and Treasury Department were considering separate guidance to address costs to repair or improve tangible property. Revenue Ruling 2001-4¹² is the Service's prior guidance as to the general plan of rehabilitation. Unfortunately, while ably describing factors present in the case law, that ruling fails to use a balancing-standard minimum distortion of income¹³ analysis as to either the doctrine or more significantly to cyclical expenses. This article asserts that this failure has led to some erroneous conclusions, or at least reasoning, in the ruling as well as in the post-*INDOPCO* repair/improvement case law.¹⁴ Furthermore, the ruling is not easily administrable; it does not define "'significant portion,' 'substantial structural part,' 'major component,' or 'material upgrade or addition,'"¹⁵ on which its holdings turn.

We hope the guidance as to repairs versus improvements being considered will explicitly adopt such a balancing of burdens to taxpayer (or possibly to the government) with the benefits of more exact matching of expense and income standard, as does the "Advance Notice." Properly applying this balancing standard, such regulations would not incorporate the existing general plan of rehabilitation conceptual errors as Revenue Ruling 2001-4 does.¹⁶ At the same time ideally

¹¹67 *Fed. Reg.* 3461 (Jan. 24, 2002). Advance Notice, note 5 *supra* at 3462, addresses only "the application of section 263(a) of the Internal Revenue Code to expenditures that result in taxpayers acquiring, creating, or enhancing intangible assets or benefits." The IRS's "2000 Priorities for Tax Regulations and Other Administrative Guidance" (March 21, 2000), *Doc 2000-8725* (29 original pages), 2000 *TNT* 56-18, had provided the following examples of capitalization/expensing areas where "guidance" (in form of rulings) might be provided: "cyclical maintenance costs, sales commissions paid to obtain new customers, mutual fund launch costs, and loan origination costs." See also "TEI Suggests Guidance on Capitalization," *Doc 2000-7609* (7 original pages), 2000 *TNT* 57-30.

¹²Note 1 *supra*.

¹³For discussion of that standard, see note 99 *infra* and accompanying text.

¹⁴See notes 180-84 *infra* and accompanying text.

¹⁵FSA 200202026, note 1 *supra* ("Some of the terminology used in the ruling (i.e., 'significant portion,' 'substantial structural part,' 'major component,' or 'material upgrade or addition') is undefined. Pending clarification of these terms, this document is intended to provide guidance to examiners on the efficient use of time and resources in the examination of this issue. Based on the ruling, the commitment of staffing to examine airframes, which underwent the first or second HMV, is usually not an effective utilization of those resources. . . . At the beginning of an examination, you should contact the Air Transportation Technical Advisor group and obtain a listing of the taxpayer's fleet composition. . . . This list can be shared with the taxpayer and used to confirm the type and age of their fleet. From this, you will quickly see if the taxpayer has an aging fleet that would be subject to a third HMV or a newer one that would not be subject to it. If they have few aircraft subject to a third HMV, you should not spend significant resources on this issue.").

¹⁶See notes 181-85 *infra* and accompanying text.

they will treat cyclical expenditures in accordance with the above rough justice rules.

Part III of this article maintains that the only sound basis for the general plan of rehabilitation doctrine is the "rule of parity," viz., equivalent treatment between a taxpayer who purchases a business asset and one who constructs it herself.¹⁷ Thus, if a taxpayer purchasing an asset may not treat a particular expenditure (such as a repair-like expenditure) separately from the purchased asset, a taxpayer constructing an identical asset herself may not treat such an expenditure separately either. The best illustration is that a taxpayer who rehabilitates a rundown building should be treated the same as a taxpayer who purchases a renovated similar building.

Part IV discusses (1) the inapplicability of the general plan of rehabilitation doctrine to assets other than the particular asset being improved, now accepted by the Service;¹⁸ (2) unavailability of depreciation or too slow depreciation as a basis for currently deducting remediation costs to avoid the distortion of income that would arise from no or too slow depreciation, so that a current deduction should be allowed, notwithstanding a concurrent general plan of rehabilitation under the "reverse" rule of tax parity; (3) inapplicability of such distortion of income reasoning where remediation is anticipated at time of purchase since the acquisition cost doctrine would then apply (under a rule of tax parity reasoning although not so articulated in the case law), even in the absence of a general plan of rehabilitation; (4) a minimum distortion of income analysis of repair versus improvement expenditures; (5) when cyclical repairs occur more frequently than the recovery period of the repaired asset, how the cost of the repairs should be treated as a freestanding intangible and depreciated over the recurrence period or currently deductible if sufficiently insubstantial or short or variable term, or no or only slow depreciation would be available if capitalized; and (6) where the repairs occur in a cycle substantially identical to the recovery period of the repaired asset, how their cost should be capitalized and depreciated over the recovery period to avoid distortion of income.¹⁹

Any proposed repair versus improvement capitalization regulations should present the policy basis for the general plan of rehabilitation (buttressed in the preamble with citation to supporting substantial authorities, much like the Advance Notice);²⁰ and then illustrate application of this policy to numerous factual

variations, much like the excellent revised section 355 regulations.²¹

II. Conventional Wisdom

The "general plan of rehabilitation," a judicial doctrine originating in the Tax Court, traditionally holds that "[e]xpenses incurred as part of a plan of general rehabilitation must be capitalized even though the same expenses if incurred separately would be deductible as ordinary and necessary."²² The doctrine focuses on the results of the work performed and the substance of the overall transaction, rather than on the steps taken in the process.²³ It uses four factors: (1) whether there has been an increase in the fair market value of the property; and (2) the purpose; (3) nature; and (4) extent of the work.²⁴ In short, if repairs that standing alone could qualify for a current deduction constitute, when viewed together, an integrated plan to increase the useful life or value of an asset or adapt it to another use, they are capitalized to the tax cost or basis of that asset.²⁵ Some early authorities rest the general plan of rehabilitation doctrine on a principle of no fragmentation of expenditures.

The Code . . . does not envision the fragmentation of an over-all project for deduction for capitalization purposes. . . . The construction of a new building encompasses numerous steps, many of which, when viewed alone, might in the everyday, commonly accepted sense, be con-

²¹John W. Lee, "The Art of Regulation Drafting: Structured Discretionary Justice Under Section 355," *Tax Notes*, Aug. 28, 1989, p. 1029 at 1037-45; Lee, *et al.*, *Rough Justice II*, *supra* note 5 at 1484. The "Art of Regulation Drafting" article also tells the story of how John W. Lee, "Functional Divisions and Other Corporate Separations Under Section 355 After Rafferty," 27 *Tax L. Rev.* 453-98 (1972), served as the conceptual framework for these regulations. See also GCMs 36,387 (Aug. 25, 1975) and 36,069 (Nov. 5, 1974).

²²*Norwest Corp. v. Commissioner*, 108 T.C. 265, 280, 285, *Doc 97-11771 (81 pages)*, 97 *TNT* 82-8 (1997). The genesis of the doctrine is *Cowell v. Commissioner*, 18 B.T.A. 997 (1930); *United States v. Wehrli*, 400 F.2d 686, 689 (10th Cir. 1968), is the most frequently cited authority in this area.

²³J. Wendell Bayles and Clair R. Rich, "Repair or Capital Expenditure: The Tenth Circuit's General Plan of Betterment Rule," 1974 *Utah L. Rev.* 272, 283.

²⁴Wehrli, note 22 *supra* at 690; Rev. Rul 2002-4, note 1 *supra*; see generally Hopun, note 9 *supra* at 701-03; Jeffrey M. Gaba, "Tax Deduction of Hazardous Waste Cleanup Costs: Harmonizing Federal Tax and Environmental Policies," 20 *Harv. Envtl. L. Rev.* 61, 85 (1996); Christine Black, Comment, "Saving the Green: Who Should Pay for Environmental Cleanup Costs?" 20 *J. of Corp'n Law* 671, 676 n.39 (1995); Brian Pavano, Note, "Life in All Its Fullness: A Discussion of Capitalization v. Deduction," 39 *B.C. L. Rev.* 253, 267 (1997).

²⁵See Steven G. Black, Note, "The Continuing Saga of Environmental Cleanup Costs: Current Deduction Allowed Under the Restoration Principle of *Plainfield Union*," 1995 *BYU L. Rev.* 1321, 1324.

¹⁷See notes 38-43 *infra* and accompanying text.

¹⁸Rev. Rul. 2001-4, note 1 *supra*, citing *Moss v. Commissioner*, 831 F.2d 833, 839 (9th Cir. 1987).

¹⁹See notes 100-13 *infra* and accompanying text.

²⁰67 *Fed. Reg.* at 3462-64 (frequent citations); Lee, *et al.*, *Rough Justice I*, *supra* note 5 at 664 ("This article recommends that at the least the Service and Treasury issue 'interpretative' regulations, providing substantive guidance as to capitalization along the above 'rough justice' lines, with numerous examples drawn from the judicial and Service rulings. . . . Professor Lawrence Lokken describes this approach as 'rough cut' or common-law regulations.").

sidered repair items. But, taken as a whole, the cost of construction is capitalized.²⁶

Over time and with no recognition by the general plan of rehabilitation authorities, this no fragmentation notion came to be conceptually undercut by allowance under section 167 of "component depreciation," which in fact does break down or fragment for depreciation purposes components of real estate construction or purchased used real estate improvements if supported by appraisals of the components.²⁷ (Although component depreciation is prohibited by section 168 as to real estate improvements, with lengthening of the recovery period and elimination of accelerated depreciation as to nonresidential real estate improvements, that prohibition no longer seems that appropriate.)²⁸ Furthermore, the reasonable allowance for depreciation of short-lived components equivalent to

repairs should be a current deduction.²⁹ Moreover, the Tax Court on occasion has separated ordinary from capital expenditures using a *Cohan* equitable approximation while at the same time rejecting the Commissioner's broad-brush application of the general rule of rehabilitation.³⁰

In *Cowell*,³¹ the progenitor of the doctrine, the Board of Tax Appeals (predecessor to the Tax Court) rested on the *impracticality* of separating ordinary from capital expenditures in a large-scale rehabilitation,³² which, however, component depreciation demonstrates is not the case. The Tax Court in *Bloomfield Steamship Co. v.*

²⁶*Bank of Houston v. Commissioner*, T.C. Memo. 1960-110; accord TAM 9547002, 95 TNT 230-10.

²⁷*Shainberg v. Commissioner*, 33 T.C. 241 (1959) (component depreciation permitted as to newly constructed shopping center), *acq.* 1960-1 C.B. 5; Rev. Rul. 68-4, 1968-1 C.B. 77 (newly constructed property); Rev. Rul. 73-410, 1973-2 C.B. 53 (component depreciation can be used as to used property where supported by qualified appraisals), *considered in* GCM 35,322 (Apr. 27, 1973). See generally John W. Lee, "Start-Up Costs, Section 195 and Clear Reflection of Income: A Tale of Talismans, Tacked on Tax Reform and a Touch of Basics," 6 *Va. Tax Rev.* 1, 34-6 (1986) (Lee, Start Up Costs); Lee, *et al.*, *Rough Justice II*, *supra* note 5 at 1554-56.

²⁸Section 168(f)(1). This was sound policy under ERTA when the recovery period for real estate improvements was 15 years and the aggregate average component life for real estate improvements was 35 years. Over the years the varying recovery periods for real estate improvements under section 168 reflect at each turn political deals. The increase in the recovery period for real estate improvements from 15 years to 18 years in 1984 was a compromise instead of 20 years with the difference in revenues "paid for" in revenue scoring by changes to installment reporting (section 453(i) taxing all depreciation recapture in the year of sale). Daniel Bernick, "Real Estate Write-Off Change Approved by Finance Amidst Disagreements Within Industry," *Tax Notes*, Apr. 9, 1984, p. 117 at 119. This favored factory owners and realtors over real estate developers who tend more to churn. *Id.*; "How the Options Industry and Realtors Escaped the Tax Bill's Axe," 84 *TNT* 153-22. The increase in the recovery period in 1993 from 31 years to 39 years for nonresidential real estate improvements was to pay for the section 469(c)(7) real estate operator exception to PAL. "Unofficial Transcript of May 11 IRS Hearing on Passive Activity Losses" (May 11, 1995) (Statement of Toby Bradley, representing National Association of Realtors), *Doc 95-2863* (46 pages), 95 *TNT* 97-37.) Today the recovery period for nonresidential real estate at least is too short compared to economic depreciation. Treasury Department, Report to the Congress on Depreciation Recovery Periods and Methods paras. 16, 287, 288 (July 28, 2000).

²⁹See Lee, Start-Up Costs, *supra* note 27 at 50 n.219 (explicating *Goodwin v. Commissioner*, 75 T.C. 424, 433-34 n.9 (1980), *aff'd* mem. 691 F.2d 490 (3d Cir. 1982)). *Goodwin* approved the result, but not the reasoning, in *United States v. Manor Care, Inc.*, 490 F. Supp. 355 (D. Md. 1980). *Manor Care* allowed a current deduction in the first tax year a new business began to function as a going concern for expenditures paid earlier in the same year, but before the taxpayer's both obtaining a license to operate and operating the business. *Id.* at 362. In *Goodwin* the Tax Court disagreed with the *Manor Care* reasoning that the expenditures were deductible under section 162, on the ground they "were clearly pre-operating in nature." 75 T.C. at 433-34 n.8. Instead, *Goodwin* indicated the identical result of a current deduction could be reached by capitalizing the expenditures and then allowing — once the business began — amortization deductions over the period benefitted. *Id.* Further, the Tax Court implicitly reasoned that the period benefitted by such recurring pre-operating costs was a year or less; therefore, the "reasonable allowance" in the year the business commenced for depreciation of such capitalized pre-operating costs was the entire cost. See Marla A. Schuster, "Pre-Opening Costs — Recent Legislative and Judicial Attention," *Tax. Mgmt. Mem. No.* 81-8 (BNA) 3, 5-6 (1981)).

³⁰*Churchill Farms, Inc. v. Commissioner*, T.C. Memo. 1969-192, *aff'd on this ground sub nom. Bayou Verret Land Co. v. Commissioner*, 450 F.2d 850, 858 (5th Cir. 1971). *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930), pronounced a rule of equitable approximation under which the predecessor to the Tax Court was required to approximate the amount of an expenditure if the taxpayer proved that she had incurred some amount. See Lee, Start-Up Costs, *supra* note 27 at 39-40; Lee, *et al.*, *Rough Justice II*, *supra* note 5 at 1554-56 (where intangible is wasting *Cohan* approximation is required by *Northern Natural Gas Co. v. O'Malley*, 277 F.2d 128, 135, 138 (8th Cir. 1960)).

³¹*Cowell v. Commissioner*, 18 B.T.A. 997, 1000 (1930).

³²While the characterization of some of the items is such that standing alone or made as periodic repairs they might be deductible as ordinary and necessary expenses, it is impractical from the evidence to make such a detailed classification of the items. . . . To fix a door or patch plaster might very well be treated as an expense when it is an incidental minor item arising in the use of the property in carrying on business, and yet, as here, be properly capitalized when involved in a greater plan of rehabilitation, enlargement and improvement of the entire property.

Id. at 1000. See Pasquale Sommella, Note and Comment, "Revenue Ruling 94-38: The Uncertainty Continues — A Look at Using the Tax Code to Effectuate Environmental Remediation," 13 *Pace Env't'l L. Rev.* 345, 376 (1995).

*Commissioner*³³ linked the general plan of rehabilitation doctrine with the regulatory proviso that deductible repairs be incidental.³⁴

"Incidental" imports that the repairs be necessary to some other action. . . . Deductible repair expenses are those incidental to maintaining business property, incidental to the keeping of the property in "an ordinarily efficient operating condition." Repairs incidental to capital expenditures for remodeling or renovation of the property are not deductible.³⁵

"Incidental" here is more a conclusion than a rationale. Ironically, the easiest to administer rule for repairs has been recognized for at least three decades³⁶ as a "repair allowance percentage," under the "asset depreciation range" regulations,³⁷ for example, percentage of unadjusted basis, which arguably could and should be adopted in any proposed repair versus improvement

regulations. (Then, after these proposals have undergone public scrutiny and the competition of ideas in the legislative marketplace, Congress could codify the regulations as it often has in the past, for example, family partnership and *Clifford* trust regulations, later the section 305 disproportionate stock distributions regulations, and in the closest analogy the post-facto statutory authorization for the "asset depreciation range" regulations.)

III. Rule of Tax Parity

The only defensible rationale for the general plan of rehabilitation doctrine is the "rule of parity," under which the tax treatment of a facility by a taxpayer who constructs or reconstructs her own business facilities and by one who hires an independent contractor (or purchases the facility turnkey from an unrelated party at fair market value) should be substantially the same.³⁸ The rule of parity rests on the fundamental tax policy of horizontal equity under which similarly situated taxpayers should be taxed the same in similar transactions.³⁹ Justice Blackmun's insight in *Commissioner v. Idaho Power Co.*⁴⁰ that a taxpayer self-constructing a plant ought not be tax advantaged over a taxpayer purchasing a plant or hiring an independent contractor to perform the construction work is bottomed on the rule of tax parity.⁴¹ In that case Justice Blackmun (who not coincidentally was the author of *INDOPCO*)⁴² re-

³³33 T.C. 75, 84 (1959), *aff'd per curiam* 285 F.2d 431 (5th Cir. 1961).

³⁴Treas. reg. section 1.162-4. Since 1918 the business expense regulations' test for a currently deductible "repair" has been an incidental expenditure which neither appreciably extends the life nor increases the value of property, but keeps it in efficient operating condition. Treas. Reg. 45, art. 103 (1918). See generally Black, Continuing Saga, note 25 *supra* at 1324-25; Roy Whitehead, *et al.*, "The IRS Plows New Ground in the Tax Treatment of Land Cleanup Costs," 48 *Okla L. Rev.* 417, 423 (1995).

³⁵*Bloomfield Steamship*, note 33 *supra*.

³⁶John Lee, "Doping Out the Capitalization Rules after *INDOPCO*," 57 *Tax Notes*, Nov. 2, 1992, p. 669 at 684 (Lee, Capitalization Rules); accord Amy Hamilton, "Treasury Official Assesses *INDOPCO* Coalition Proposal," *Tax Notes*, Nov. 5, 2001, p. 745 at 748 ("The administration has expressed an interest in the coalition's repair allowance proposals, [Christine M.] Turgeon [, senior tax law specialist in Treasury's Office of Tax Policy,] said. The question seems to come down to the government and coalition negotiating a compromise on the repair allowance percentages."); *INDOPCO* Grocery List, note 1 *supra*, at 323, 325 (Oct. 15, 2001); "*INDOPCO* Coalition Proposed Capitalization Principles," *Doc 2001-26125 (75 original pages)*, 2001 *TNT* 198-44 ("If the taxpayer elects MRAS [Modified Repair Allowance System], expenditures for repair, maintenance, rehabilitation or improvement of assets that are not Significant Capital Improvements are currently deductible up to the Repair Allowance for the tax year as defined in Part IV.B.6. Significant Capital Improvements and expenditures in excess of the Repair Allowance are capitalized.").

³⁷See withdrawn Treas. reg. section 1.167-11(d)(2). Professor Bittker argued that Treasury did not have the authority (before statutory authorization) to make such "extraordinary departures [ranges of class lives and 'repair deduction allowance' as to rehabilitation and improvement expenditures] from widely accepted principles regarding the division between current expenditures and capital items." Boris I. Bittker, "Treasury Authority to Issue the Proposed 'Asset Depreciation Range System' Regulations," 49 *Taxes* 265, 266-67 (1971). GCM 39,802 (Nov. 1, 1989) and GCM 38,788 (Aug. 26, 1981) reveal that the asset depreciation range regulation's rules were not exactly scientifically constructed. See generally Lee, *et al.*, Rough Justice I, *supra* note 5 at 673 n. 150 and 690 n. 235.

³⁸Lee, Capitalization Rules, note 36 *supra* at 677 (citing *California Casket Co. v. Commissioner*, 19 T.C. 32, 37-8 (1952) (acquisition of building with express intention of completely renovating an alternate to conform to specific requirements of business required capitalization of all integral parts of plan).

³⁹John W. Lee, Glenn Walberg, and Darryl D. Whitesell, "Capitalizing and Depreciating Cyclical Aircraft Maintenance Costs: More-Trouble-Than-It's-Worth?" 17 *Va. Tax Rev.* 161, 220 (1997) (Lee, *et al.*, Cyclical Aircraft Maintenance Costs). See Joseph T. Sneed, "The Criteria of Federal Income Tax Policy," 17 *Stanford L. Rev.* 567, 575-80 (1965).

⁴⁰See *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 14 (1974) (capitalization of construction-related depreciation by a taxpayer doing its own construction work is necessary to maintain tax equality with a taxpayer whose construction work is done by an independent contractor, since depreciation on the contractor's equipment would be an element of her charges, which would have to be capitalized by the taxpayer for whom the work was done). The Sixth Circuit similarly reasoned "that pre-opening expenses must be treated as capital to maintain parity with a taxpayer whose cost of purchasing an existing business is clearly capital." *Johnsen v. Commissioner*, 794 F.2d 1157, 1161 (6th Cir. 1986).

⁴¹*Pac. Power & Light Co. v. United States*, 644 F.2d 1358, 1360 (9th Cir. 1981); *Louisville & Nashville RR v. Commissioner*, 641 F.2d 435, 440 (6th Cir. 1981); GCM 37,171, pp. 11, 17 (June 20, 1997); Lee, Start-Up Costs, note 27 *supra* at 34-5; Robert A. Green, "Justice Blackmun's Federal Tax Jurisprudence," 26 *Hastings Const. L. Q.* 109, 131-32 (1998) (Green, Blackmun's Tax Jurisprudence).

⁴²Green, Blackmun's Tax Jurisprudence, note 41 *supra* at 109, 111-13, 124-39 (describing Justice Blackmun's background as a tax practitioner, affinity for tax decisions on the Court while other Justices regarded tax cases as "dogs," and his capitalization cases).

quired capitalization to the basis or cost of a self-constructed electricity generating plant of the amount of otherwise allowable tax depreciation on the vehicles the utility company used to transport the construction workers to the very remote job site to maintain tax parity between self-construction and purchasing an improvement. The notion is that since a hypothetical contractor would have included those costs in her contract price thus affecting the taxpayer's tax cost in the plant, a self-constructing taxpayer likewise must include that depreciation in her basis in the plant.⁴³

Two oft-cited general plan of rehabilitation authorities in effect bottom the doctrine on tax parity reasoning. *Jones v. Commissioner*⁴⁴ applied the general plan of rehabilitation doctrine to the restoration of a historical building in New Orleans' French Quarter that was in complete disrepair.⁴⁵ *Jones* reasoned that had the city permitted the taxpayer to demolish the property as requested,⁴⁶ he would have constructed an entirely new building, the expense of which would not have been deductible.⁴⁷ More explicitly, *Stoeltzing v. Commissioner*⁴⁸ concluded that the taxpayer "bought an old building and made a new and different building, commercially useful, out of it."⁴⁹

In addition to the foregoing, we are persuaded by the position of the Tax Court that it is "more realistic to treat the project as a whole." If the expenditure for each item of repair were considered individually, without relation to other

items, it may be correct to classify some of them as deductible expenses. But the Tax Court stated, "we see no justification for making such a separate treatment of the items on the record before us." The principle is made clear in *Jones v. Commissioner of Internal Revenue*, 5 Cir., 1957, 242 F.2d 616, 619, quoting 4 Mertens, *Federal Taxation*, section 25.41, wherein it was said: "The difficulty inherent in determining the character of a particular expenditure is illustrated by the fact that a particular item, standing alone or made as periodic repairs, might be deductible as an ordinary and necessary business expense, but if made as a part of an entire capital investment in the improved property, may be treated as a capital expenditure." *If Stoeltzing had erected a completely new building, items of work which the contractor might have undertaken to prepare the building for occupancy such as carting away refuse or painting or even washing windows, could hardly be separated from the whole cost and deducted as expenses.* Since the Tax Court found in substance that Stoeltzing renovated an untenable building, we can perceive no effective distinction between the circumstances of the cited case and those of the case at bar.⁵⁰

Jones and *Stoeltzing* thus in effect rested on a "rule of tax parity" or horizontal equity between self-construction and purchase of a new facility. Under this rule of tax parity, for instance, while replacing small items alone, such as shingles on a roof or a door, would be currently deductible, their cost should be capitalized when part of an owner's rehabilitation of a structure.⁵¹ For if these costs were incurred by a contractor in a turnkey project, she would include these items in her sales price. The costs would then be part of the purchaser's overall cost in the construction project and be depreciated as part of the improvement under the composite method.

⁴³Note that section 198, permitting deduction of otherwise capitalizable environmental remediation costs as to pre-existing contamination in "brownfield" sites (once limited to "targeted" low-income urban and rural areas, but now extending to any "qualified contaminated site"), carves out depreciable assets and costs capitalized under *Idaho Power* or section 263A. See generally John W. Lee and W. Eugene Seago, "Policy Entrepreneurship, Public Choice, and Symbolic Reform Analysis of Section 198, The Brownfields Tax Incentive; Carrot or Stick or Just Never Mind?" 26 *Wm. & Mary Env'tl. L. & Pol'y Rev.* 613 (2002).

⁴⁴242 F.2d 616 (5th Cir. 1957).

⁴⁵See *id.* at 617.

⁴⁶In this case, the taxpayer did not want to make the repairs. He wished instead to demolish the structure and rebuild on it. The city, however, refused to allow the taxpayer to demolish the property because it was considered a historical building. See *id.* at 617.

⁴⁷See *id.* at 620.

⁴⁸266 F.2d 374 (3rd Cir. 1959).

⁴⁹*Id.* at 375, 377 (taxpayer purchased a "untenable" building in "bad state of repair" and "made a new and different building, commercially useful, out of it"). *Moss v. Commissioner*, note 18 *supra* at 839, agreed with the taxpayer that "every case in which the rehabilitation doctrine has been applied to date has involved substantial capital improvements and repairs to the same specific asset, usually a structure in a state of disrepair." *Ingram Indus., Inc. v. Commissioner*, T.C. Memo. 2000-323, *Doc 2000-26952* (33 original pages), 2000 TNT 203-6, thought it significant that the engine rebuilding at issue was performed at a time when the engine was completely serviceable. For criticism of this notion see notes 181-85 *infra* and accompanying text.

⁵⁰*Stoeltzing*, note 48 *supra* at 377 (emphasis supplied). This no fragmentation premise is contrary to component depreciation. See note 27 *supra* and accompanying text.

⁵¹*Badger Pipe Line Co. v. Commissioner*, T.C. Memo. 1997-457 ("replacement of a small number of slate tiles in a roof . . . [constitutes] repairs, while . . . a replacement of the roof or a major portion thereof . . . [is] capital in nature"); *Crowell*, note 22 *supra* at 1001 ("To fix a door or patch plaster might very well be treated as an expense when it is an incidental minor item arising in the use of the property in carrying on business, and yet, as here, be properly capitalized when involved in a greater plan of rehabilitation, enlargement and improvement of the entire property"). *Campbell v. Commissioner*, T.C. Summary Opinion 2002-117, *Doc 2002-20576* (5 original pages), 2002 TNT 174-10, however, ruled that removing the existing top layers of a roof in a rental house and recovering it with fiberglass sheets and hot asphalt at a cost of \$8,000 constituted a deductible repair, reasoning that there was "no replacement or substitution of the roof." My brother the roofer would disagree, but then he doesn't do hot tar roofs, only shingle roofs. The costs of removal should have been deductible, but the costs of recovering should have been capitalized. See reasoning in note 82 *infra*.

Reaching a strikingly similar conclusion to the *Stoeltzing* general plan of rehabilitation example of preparing a building for occupancy by "carting away refuse," the Tax Court in *Shainberg v. Commissioner*⁵² capitalized expenses of cleaning up for the grand opening of a shopping center, implicitly based on the acquisition cost doctrine.⁵³ The origin-of-the-claim or acquisition cost doctrine capitalizes, and adds to the basis of the asset acquired,⁵⁴ recurring short-lived costs (which frequently otherwise would be deductible) incurred in connection with the acquisition of an asset used in the taxpayer's business.⁵⁵ This usage occurs

⁵²*Shainberg*, note 27 *supra*.

⁵³See *Perlmutter v. Commissioner*, 44 T.C. 382, 404 (1965), *aff'd* 373 F.2d 45 (10th Cir. 1967).

⁵⁴See John W. Lee and Nina R. Murphy, "Capital Expenditures: A Result in Search of a Rationale," 15 *U. Richmond L. Rev.* 473, 482 (1981). The Claims Court explained the decisions that relied on a capitalization basis for denying current deductibility of start up costs as follows:

Although the rationale of these decisions is not fully articulated, they appear to accept or assume the underlying theory that where a business requires substantial start-up expenditures before it can begin operations, which are not directly for the purchase of tangible assets and which will not ordinarily be recovered out of revenues for the same year, the capital investment is in the business as a whole rather than merely in the tangibles, and it includes the start-up costs.

Cleveland Elec. Illuminating Co. v. United States, 7 Cl. Ct. 220, 228 (1985). This implicitly future benefit rationale logically would deny, however, a current deduction for identical expenditures incurred once the business commenced. See Lee, *Start-Up Costs*, note 27 *supra* at 31 nn 131, 132.

⁵⁵The origin of the claim doctrine provides that the origin and character of a claim determine the deductibility of an expense. See *Woodward v. Commissioner*, 397 U.S. 572 (1970); *United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970); *United States v. Gilmore*, 372 U.S. 39 (1963). The characterization of costs depends on the nature of the activities giving rise to the claim and does not depend on consequence or result. *Gilmore*, 372 U.S. at 47-48. See also *Keller Street Dev. Co. v. Commissioner*, 688 F.2d 675 (9th Cir. 1982); TAM 9731001, para. 14, *Doc 97-22351* (7 pages), 97 *TNT* 149-31 (origin of severance pay agreement between target and key target employees negotiated in takeover was employment relationship and not take over); TAM 9527005, 95 *TNT* 133-7; Rev. Rul. 94-77, 1994-2 C.B. 19, *Doc 94-10592*, 94 *TNT* 234-10, apparently based on TAM 9326001, 93 *TNT* 141-18; GCM 38,126 (Oct. 3, 1979), considering Rev. Rul. 80-119, 1980-1 C.B. 40. *Wells Fargo & Co. v. Commissioner*, 224 F.3d 874, *Doc 2000-22578* (30 original pages), 2000 *TNT* 169-18 (8th Cir. 2000), inappropriately limited the acquisition cost doctrine by allowing current deduction of the entire salaries of corporate officers who worked on various aspects of the corporation's acquisition on the grounds that to the extent that their services were incident to the acquisition, they were only incidentally connected with a future benefit. But see *Perlmutter*, note 53 *supra* at 402, 403-05 ("dealt with the deductibility or capitalization of overhead expenses incurred by a corporation in constructing both a rental property and residential properties for sale. The Commissioner allocated the overhead expenses (officers' [regular] salaries, other overhead salaries, depreciation, in-

although identical costs incurred after, and not anticipated at the time of, acquisition are currently deducted, usually as maintenance costs. Analyzing the farm preparatory cost doctrine,⁵⁶ Tax Court Judge Raum used an example strikingly similar to the classic replacement of a few shingles or a door illustration of the general plan of rehabilitation doctrine:

[T]he cost of painting a building . . . generally is considered a deductible business expense. Yet the cost of putting the final coat of paint on a building in the course of construction is plainly a capital expenditure. Both involve painting and may be identical in physical character; however, one is incurred in ordinary maintenance while the other is one of the components of cost in acquiring a complete capital asset.⁵⁷

The general plan of rehabilitation doctrine, the origin of the claim doctrine, and the acquisition cost doctrine are all bottomed on the notion that the costs of acquiring (or the functional equivalent in a substantial rehabilitation) a capital asset must be capitalized to avoid distortion of income. If a portion of that cost,

insurance, legal and audit, office expense, truck expense and utilities) between the rental property and the sale properties in proportion to the direct costs of each. Reasoning that salaries paid officers for services in managing the construction of new buildings, sales taxes on construction materials, accounting service fees for construction activities and insurance during construction are capital expenditures in connection with the acquisition of a capital asset, the court held that how much of each of the listed items was attributable to constructing the rental property was a question of fact, and therefore upheld the Commissioner's allocation in the absence of a better allocation by the corporation. GCM 38,788 (Aug. 26, 1981), approvingly cited by *Idaho Power*, note 40 *supra* at 13, for the proposition that "when wages are paid in connection with the construction or acquisition of a capital asset, they must be capitalized and are then entitled to be amortized over the life of the capital asset so acquired." *Accord Lychuk v. Commissioner*, 116 T.C. 374, 390, *Doc 2001-15494* (102 original pages), 2001 *TNT* 106-4 (2001) (reviewed); David Lupi-Sher, "Tax Bar Applauds Eighth Circuit's Decision in *Wells Fargo*," *Tax Notes*, Sept. 11, 2000, p. 1303. *Lychuk*, 116 T.C. at 404-05, appropriately limited *Wells Fargo* to where the officers' performance of services on a capital transactions were a "relatively small portion" of their time, i.e., *de minimis*. Ironically, the employees' services in *Lychuk* were recurring and incident to acquisition of short-lived capital assets, *id.* at 420, and hence should have been currently deducted in any event along with the overhead costs under rough justice exceptions to future benefit capitalization. See notes 101-02 *infra* and accompanying text for discussion of those exceptions.

⁵⁶For descriptions of the farm preparatory cost doctrine under which developmental costs may be expensed or capitalized at the farmer's option, see *Maple v. Commissioner*, 440 F.2d 1055, 1056-57 (9th Cir. 1971); Department of the Treasury, 91st Cong., 1st Sess., *Tax Reform Studies and Proposals* 153 (Comm. Print 1969) (issued jointly by the House Comm. on Ways and Means and Senate Comm. on Finance). See generally sources cited in John W. Lee, "A Blend of Old Wines in a New Wineskin: Section 183 and Beyond," 29 *Tax L. Rev.* 347, 465 n. 498 and 467 (1974).

⁵⁷*Estate of Wilbur v. Commissioner*, 43 T.C. 322, 327 n.6 (1964), *acq.* 1965-2 C.B. 7.

(Footnote 55 continued in next column.)

however, is of substantially shorter duration than that asset as a whole, it should be treated as a separate asset and currently deducted or amortized over the period of recurrence depending on the length of that recurrence cycle and perhaps the materiality of that so separated cost.⁵⁸

IV. Critique of Broad Application

Given that the function of capitalization is to produce minimum distortion of the taxpayer's income,⁵⁹ on the surface a rule that requires capitalization of otherwise currently deductible items appears counterintuitive.⁶⁰ As Glenn Carrington, a leading expert on capitalization, pointed out while still in Chief Counsel's office: "[t]he plan of rehabilitation doctrine is secondary to failure under one of the four prongs of the [traditional repair versus replacement] test. 'Rehabilitation alone in my view does not make you capitalize the costs; you must fail under one of these four prongs' . . . The key is the general test, and whether individual repair expenditures would come together to represent a capital investment is a 'facts and circumstances' situation. . . ."⁶¹

⁵⁸Cf. Lee, Start-Up Costs, *supra* note 27 at 27-8. See notes 196-99 *infra* and accompanying text for discussion of these factors.

⁵⁹B. Bittker and L. Lokken, *Federal Income Taxation of Income, Estates & Gifts* para. 20.4.1 (3rd ed. 1998) (basic objective of sections 162, 263 and 446(b) in this context is "whether income will be better reflected by deducting or by capitalizing the amount in question"); accord Respondent's Brief at 29, *INDOPCO* (No. 90-1278); Lee, *et al.*, Rough Justice I, *supra* note 5 at 639 n. 20, 692"; Lee, *et al.*, Rough Justice II, *supra* note 5 at 1547-48 and n.268.

⁶⁰Burgess J.W. Raby and William L. Raby, "IRS Splits on 'General Plan of Renovation' Argument," *Tax Notes*, Aug. 4, 1997, p. 669 at 671 ("It is not so much that we think the appeals court is wrong in *Norwest* as a matter of law as that we think the result fails to properly match revenue with expense and illustrates what we consider a flaw in the tax law's approach to older properties.") (Raby and Raby, General Plan of Renovation); Sommella, *supra* note 32 at 390-94; Hopun, *supra* note 9 at 704-05, 708; Black, Continuing Saga, note 25 *supra* at 1239-40 (yet due to future benefits expenditure must be capitalized under *INDOPCO*). Cf. Denyse Finn Clancy, "Comment: The Deductibility of the Costs of Aircraft Maintenance," 64 *Air L. & Comm.* 539, 572 (1999).

⁶¹"Service Ponders Environmental Cleanup Costs; Carrington Uncertain of Outcome," 93 *TNT* 102-10 (May 12, 1993). The four factors or "prongs" are whether the expenditure (1) is more than merely incidental, (2) substantially increases the value, (3) appreciably extends the life, or (4) changes the use of the associated asset. Carrington used "incidental" as a proxy for substantiality of the cost based on *Wolfsen Land & Cattle v. Commissioner*, 72 T.C. 1, 8 (1979). The Service, however, holds that cost is not determinative as to deductible repair vs. capitalizable replacement. Rev. Rul. 2001-4, note 1 *supra* at 298. The rules would have developed much more logically and consistently as well as more in accord with the policy of minimum distortion of income (for the appropriate standard, see note 99 *infra* and accompanying text) had the amount of the cost and whether steady-state recurring been determinative. Lee, Capitalization Rules, note 36 *supra* at 678.

Before the shift in the burden of proof to the government where the taxpayer maintains adequate records,⁶² some argued that the rehabilitation doctrine unfairly increased the taxpayer's burden,⁶³ since she must first negate the general plan of rehabilitation, and then go on to prove the item constitutes a repair under the traditional three- or four-factor analysis.⁶⁴ This was thought to decrease the Service's incentive to settle cases with taxpayers, increasing litigation.⁶⁵

A. Limitation to Repairs to Same Asset

More significantly, the general plan of rehabilitation doctrine too often serves as a "license to lump unrelated items into one predominately capital item."⁶⁶ It thus obscures clear analysis, leading to income-distorting overcapitalization.⁶⁷ Instances of this tendency are the Tax Court opinion in *Moss v. Commissioner*,⁶⁸ reversed by the Ninth Circuit, and the examining agent's arguments reversed in TAM 199952075.⁶⁹ The Tax Court in *Moss* applied the doctrine to painting and wallpapering of guest rooms in a motel that were incident to replacement of furnishings and fixtures and upgrading and remodeling of common areas and restaurants which the taxpayer had capitalized. The examining agent in the TAM similarly applied the general plan of rehabilitation doctrine to toxic waste remediation that was incident to the clearly capital construction of new facilities at a contaminated site.

Given that the function of capitalization is to produce minimum distortion of the taxpayer's income, a rule that requires capitalization of otherwise currently deductible items appears counterintuitive.

The taxpayer in *Moss* cogently argued on appeal that the general plan of rehabilitation doctrine's conceptual basis is the analogy "to the treatment of repair-like expenditures incurred in the construction of a new asset. . . . When both substantial capital improvements and repairs are made to a particular asset at the same time, the distinction between the capital improvements and repairs disappears because all the expenditures

⁶²IRC section 7491, enacted as part of the Internal Revenue Service Restructuring and Reform Act of 1998.

⁶³See Bayles and Rich, note 23 *supra* at 285.

⁶⁴See *id.*

⁶⁵See *id.*

⁶⁶See Bayles and Rich, note 23 *supra* at 280, n.55.

⁶⁷See *id.* "[T]he fact finder's function could result in the sacrifice of many legitimate deductions merely to promote mechanical facility of decision." *Id.* at 287.

⁶⁸T.C. Memo. 1986-128, *rev'd* 831 F.2d 833, 839 (9th Cir. 1987).

⁶⁹TAM 199952075, Doc 2000-475 (12 original pages), 2000 *TNT* 1-6.

combine to change the asset's use, increase its value, or prolong its life."⁷⁰ The Ninth Circuit agreed that this theory was consistent with the case law, but declined to adopt the taxpayer's bright-line test of whether there were structural improvements, finding instead the general plan of rehabilitation doctrine inapplicable because the property (a motel) was tenantable, albeit "tired," and the doctrine "to date has involved substantial capital improvements and repairs to the same specific asset, usually a structure in a state of disrepair."⁷¹ The *Moss* limitation of the general plan of rehabilitation doctrine to repairs made to the same specific asset that is otherwise being improved is likely to be its most enduring contribution as evidenced by TAM 199952075⁷² and Revenue Ruling 2001-4⁷³ discussed below.

In TAM 199952075 the taxpayer had purchased a manufactured gas plant that had been in operation for a number of years during which toxic waste byproducts were often disposed of on the plant site in unlined pits. After continuing to operate the plant for two years the taxpayer switched over to supplying natural gas and several years later decommissioned the existing buildings (which it had been using for storage and other functions) due to age and condition. Sometime thereafter EPA examined the site finding no immediate threat to the environment, but put it on the CERCLA Superfund list due to circumstantial evidence, for example, past industry practices of dumping toxic waste in unlined pits. Five years after abandoning the manufacture of natural gas, the tax-

payer in commencing plans to build a new operations facility on the site undertook an environmental study that disclosed widespread prior contamination. While building its new facility, the taxpayer performed extensive environmental cleanup operations on the site, the costs of which it deducted.

The examining agent recommended capitalization of such cleanup costs on the grounds that (1) they were incurred to adapt the site to a new or different use, or alternatively (2) they constituted part of the costs of constructing the taxpayer's new operations facility, and in any event (3) they had to be capitalized under the general plan of rehabilitation doctrine.⁷⁴ The National Office ruled that the clean-up costs attributable to contamination occurring during the taxpayer's use of the site did not adapt the site to a new or different use but merely restored it to the condition that existed when the taxpayer acquired the property⁷⁵ and for the same reason did not constitute land preparation costs (which improve and add value to land).⁷⁶ The TAM also declined to apply the general plan of rehabilitation to the clean-up costs because like *Moss*, and unlike *Norwest Corp.*, they related to a different asset (the land) than that being improved (the new facility).⁷⁷ Similarly, Revenue Ruling 2001-4, in restating the general plan of rehabilitation doctrine noted that it was inapplicable "where the plan did not include substantial capital improvements and repairs to the same asset."⁷⁸

In addition to *Moss*, TAM 199952075 cited Revenue Ruling 70-392,⁷⁹ which held that the general plan of rehabilitation doctrine did not apply to a utility's labor and transportation costs for relocating existing capital assets even though these costs were incurred in conjunction with the installation of new assets intended to increase the utility's distribution voltage. That ruling concluded that the moving of the assets did not add to the value or prolong the life of the relocated assets and appears to have reversed TAM 6905269380A.⁸⁰ This reasoning suggests that *True v. United States*⁸¹ probably incorrectly applied the general plan of rehabilitation doctrine to the costs of moving gas processing machinery (which allowed it to be used longer since the old field was pumped out). An even simpler current deduction for removal costs is warranted when the old capital asset is removed and discarded and a new capital

⁷⁰*Moss v. Commissioner*, note 18 *supra* at 839. Limitation of the general plan of rehabilitation doctrine to structures in total disrepair has been accepted by some Tax Court authorities. See *Schroeder v. Commissioner*, T.C. Memo. 1996-336, *Doc 96-21076* (20 pages), 96 TNT 145-8. Such a tack is consistent with the rule of parity basis for the general plan of rehabilitation doctrine discussed above in Part II. The express holding to the contrary by *Norwest Corp.*, note 22 *supra* at 280, however, might result in the doctrine developing otherwise, at least in the Tax Court. See *Vanalco, Inc.*, note 1 *supra* (the Ninth Circuit in affirming the Tax Court on this issue did not discuss the general plan of rehabilitation yet it did as to another issue). But see Clancy, note 60 *supra* at 571 (*dicta* in *Norwest*).

⁷¹*Moss*, note 18 *supra* at 839-40. In *Ingram Indus.*, note 49 *supra*, the taxpayer's towboats were "in operating condition and are operating when they are brought in to have the maintenance performed, and all of the significant components and systems that comprise the tow boats (including their engines) are in good working order immediately prior to the performance of the maintenance . . . and still operable." Accordingly, the Tax Court allowed a current deduction for the costs of cleaning and inspecting the engines every three to four years "to determine which of their parts are within acceptable operating tolerances and can be reused and which (if any) of these parts need to be reconditioned back to acceptable operating tolerances or replaced with appropriate replacements." While the result in *Ingram* may well have been correct, the "still operating" reasoning is inconsistent with a minimum distortion of income analysis. See notes 181-85 *infra* and accompanying text.

⁷²Note 69 *supra*.

⁷³Note 1 *supra*.

⁷⁴TAM 199952025, note 69 *supra* at para. 21. This approach is reminiscent of TAM 9315004 (capitalization of PCP toxic waste remediation costs based on four factors) overruled by Rev. Rul. 94-38, 1994-1 C.B. 35, *Doc 94-5264*, 94 TNT 107-12.

⁷⁵TAM 199952025, note 69 *supra* at para. 26.

⁷⁶*Id.* para. 27.

⁷⁷*Id.* para. 29.

⁷⁸Rev. Rul. 2001-4, note 1 *supra* at 298.

⁷⁹1970-2 C.B. 33.

⁸⁰(May 26, 1969).

⁸¹894 F.2d 1197 (10th Cir. 1990).

asset is installed in its place, for example, removal of telephone poles.⁸²

B. Restoration Principle and Toxic Waste Remediation

TAM 199952075 ruled that the clean-up costs allocable to contamination that occurred during the taxpayer's ownership and operation of the site were currently deductible under Revenue Ruling 94-38⁸³ because under *Plainfield Union*⁸⁴ they merely restored the site to the condition that existed when the taxpayer acquired the property.⁸⁵ In sharp contrast, however, the TAM required capitalization of the remediation of contamination present when the taxpayer acquired the site because "the cleanup of pre-existing contamination does more than restore the Site to the condition that existed at the time Taxpayer purchased it. Rather, these costs constitute an improvement or betterment to the Site compared to its condition when acquired."⁸⁶ This approach is too facile, as shown in section IV below.

Revenue Ruling 94-38 had "scatter cast" a handful of rationales to bolster the Service's allowance of a current deduction for soil remediation costs.⁸⁷ It

⁸²Rev. Rul. 2000-7, 2000-1 C.B. 712, *Doc 2000-3874* (5 original pages), 2000 TNT 27-22 (costs incurred in retirement and removal of a depreciable asset occurring in connection with the installation or production of a replacement asset are not required to be capitalized under section 263(a) or 263A as part of the cost of the replacement asset). Sheppard, *INDOPCO Grocery List*, note 1 *supra* at 320 ("The strained rationale of this ruling is that the removal of the old pole did not relate to assets having a useful life in the company's business that extended substantially beyond the tax year in which they were incurred, and was performed to retire the old poles, not to install the new poles. That is, the IRS ignored the pole replacement context of the removal."). Under the rule of reverse tax parity the costs of removing the old pole should be currently deductible on the theory that an outsider could not charge for the removal of the old pole in that the costs would not be present in installation of a new pole where no old pole had to be replaced. See notes 150-51 *infra* and accompanying text.

⁸³Note 74 *supra*; see generally articles cited in notes 24 and 25 *supra*.

⁸⁴*Plainfield Union Water Co. v. Commissioner*, note 3 *supra*.

⁸⁵TAM 199952075, note 69 *supra* at paras. 22, 26.

⁸⁶*Id.* at para. 32; accord. LTR 200108029, *Doc 2001-5469* (10 original pages), 2001 TNT 38-23.

⁸⁷The ruling contained both a *Plainfield Union* restoration principle and no amortization mandates no capitalization rationales. The widespread criticism on environmental policy grounds of the toxic waste remediation TAM 9315004, see, e.g., Juliann Avakian-Martin, "Does the IRS Need to Clean Up Its Ruling on Cleanup Costs?" *Tax Notes*, May 10, 1993, p. 728, probably underlay the Service's decision to grant a current deduction. I remain convinced that the TAM's amortization over some period was preferable to the revenue ruling's current deduction. While I have reason to believe that one of my capitalization articles played a role in that TAM, see Hearings on Miscellaneous Revenue Issues before the House Ways and Means Subcommittee on Select Revenue Measures (Part 2), 103d Cong., 1st Sess 1702 (1993) (Prepared statement of John W. Lee); I have long advocated the golden mean that TAM adopted and believe myself not biased despite my "vested interest," as Mike Thompson, then Tax Legislative Counsel for the Treasury Department, put it in a conversation with me about the TAM and its reversal by Rev. Rul. 94-38.

reasoned in part that the appropriate test for determining whether expenditures increase the value of the damaged property and thus must be capitalized is comparison under *Plainfield Union* of "the status of the asset after the expenditure with the status of that asset before the condition arose that necessitated the expenditure (that is, before the land was contaminated by X's hazardous waste)."⁸⁸ Most believe that the *Plainfield Union* restoration principle is the real basis for the ruling; the value of the contaminated land after remediation is not increased as compared with its value before contamination.⁸⁹ This article asserts that the restoration principle actually is the *less* sound basis.

The classic *Illinois Merchants Trust Co. v. Commissioner*⁹⁰ defined a "repair" as "to restore to sound state or to mend." The Tax Court then began to analyze whether the expenditure increased the useful life of the property or made it more valuable than it had been before the event necessitating the expenditure,⁹¹ culminating in the restoration principle of the landmark Tax Court decision in *Plainfield Union Water Co. v. Commissioner*.⁹² There the taxpayer was a public water company seeking to deduct the costs of replacing the lining in a water main after a switch from neutral well water to acidic river water caused tuberculation of the pipes, reducing their carrying capacity. The government asserted that the value of the piping to the taxpayer was materially increased by the expenditure. The Tax Court replied that "any properly performed repair adds value as compared with the situation existing immediately prior to that repair. The proper test is whether the expenditure materially enhances the value, use, life expectancy, strength, or capacity as compared with the status of the asset prior to the condition necessitating the expenditure."⁹³

⁸⁸Rev. Rul. 94-38, note 74 *supra* at 36; see Sheldon D. Pollack, "Tax Treatment of Environmental Transactions," 52 *Tax Law* 81, 98-9 (1998).

⁸⁹In addition to TAM 199952075, TAM 9541005, 95 TNT 201-14, *withdrawn for other reasons* TAM 9627002, *Doc 96-19322* (8 pages), 96 TNT 132-16, read Rev. Rul. 94-38 as based on the restoration principle of *Plainfield Union*.

⁹⁰4 B.T.A. 103, 106 (1926); see also *Regenstein v. Edwards*, 121 F. Supp. 952, 954 (M.D. Ga. 1954) (the cost of installing temporary steps, steel columns, and steel crossbeams were deductible repair expenses necessary to return the property to its original condition).

⁹¹*Midland Empire Packing Co. v. Commissioner*, 14 T.C. 635, 639, 641 (1950) (oilproofing meat packing basement after seepage from nearby oil wells so federal meat inspectors would not shut down packing plant).

⁹²Note 3 *supra*.

⁹³*Id.* at 338. Note that some see this doctrine as contrasting starkly with the general plan of rehabilitation doctrine. See Hopun, note 9 *supra* at 688-89.

The Service initially resisted the *Plainfield Union* restoration principle⁹⁴ but then reluctantly accepted it,⁹⁵ although first attempting to limit the rule to relatively sudden, unexpected, or unusual external factors⁹⁶ and then conversely to where the property has progressively deteriorated.⁹⁷ Revenue Rulings 94-38 and 2001-4 are the Service's latest concessions.

C. Minimum Distortion of Income

The emerging, better principled view is that while future benefits are a strong indicator of a capital expenditure as *INDOPCO* pointed out,⁹⁸ this indicator can be rebutted where the burdens to the taxpayer (and possibly to the government in contesting the taxpayer's deduction of the expenditures in question) of such capitalization with slow or no depreciation *outweigh the revenue benefits* to the government of more exact matching from capitalization.⁹⁹ Notwithstanding

⁹⁴The government explained that *Plainfield Union* was not appealed due to a "factual weakness" in its case. Action on Decision (Feb. 20, 1966) *Elizabethtown Water Co. (successor to Plainfield Union Water Co.) v. Commissioner*, T.C. Memo. 1966-235.

⁹⁵AOD CC-1978-35 (Dec. 13, 1977), *Niagra Mohawk Power Corp. v. United States*, 558 F.2d 1379 (Ct. Cl. 1977); accord Rev. Rul. 94-38 note 74 *supra*.

⁹⁶*Plainfield Union*, note 3 *supra* at 340-41 (this notion appears influenced by casualty loss concepts, see, e.g., Rev. Rul. 90-61, 1990-2 C.B. 39; Rev. Rul. 60-329, 1960-2 C.B. 67; GCM 39,427 (Oct. 25, 1985)). Rev. Rul. 94-38, note 74 *supra* at 36, cryptically noted that Rev. Rul. 88-57, 1988-1 C.B. 8 (capitalization of cyclical railroad car rehabilitation required because costs increased value and extended life), *considered* in GCM 39,743 (July 18, 1988), was modified to the extent that it implied that the value test established in *Plainfield Union* "cannot be an appropriate test in any case other than those in which there is a sudden and unanticipated damage to an asset."

⁹⁷TAM 9240004 (June 29, 1992) (distinguishing asbestos removal).

⁹⁸*INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 87-8 (1992).

⁹⁹*Southland Royalty Co. v. United States*, 582 F.2d 604, 618 (Ct. Cl. 1978) ("The useful life of the survey is very uncertain; as the trial judge found, the estimates in a reserve study are subject to change at any time and have to be updated every few years to take account of subsequent developments. In those circumstances, it is not compulsory to amortize such a recurring item over a fixed time-interval. Neither is it appropriate to require capitalization without amortization; such a requirement would clearly distort Southland's income."). Cf. *U.S. Freightways Corp. v. Commissioner*, note 5 *supra* at 1146 (gain in precision for the taxing authorities from a more perfect matching of expense and income is outweighed by the administrative burden the taxpayer would bear in such matching); "[T]he forthcoming notice of proposed rulemaking will recognize that many expenditures that create or enhance intangible assets or benefits do not create the type of future benefits for which capitalization under section 263(a) is appropriate, particularly when the administrative and record keeping costs associated with capitalization are weighed against the potential distortion of income. Advance Notice, note 5 *supra* at 3,462 (emphasis supplied); accord Lee, *et al.*, Rough Justice I, note 5 *supra* at 665; Lee, *et al.*, Rough Justice II, note 5 *supra* at 1520.

the restoration principle, most repairs do yield future benefits, else why would the taxpayer make them?

Many of the traditional repair rules can be justified under one or another of the "rough justice" balancing exceptions to future benefit capitalization, for example, (a) not more than 12-month benefit overlapping two tax years¹⁰⁰ (b) small or "incidental" in amount,¹⁰¹ (c) short-term or vari-

¹⁰⁰*U.S. Freightways*, note 5 *supra* at 1146; Advance Notice, note 5 *supra* at 3462 (Treasury and the IRS expect to propose a 12-month rule under which capitalization would not be required as to expenditures to create or acquire and intangible benefit unless its benefits "extend beyond the earlier of (i) 12 months after the date on which the taxpayer realizes the rights or benefits attributable to the expenditure, or (ii) the end of the taxable year following the taxable year in which the expenditure is incurred."); Lee, *et al.*, Rough Justice II, note 5 *supra* at 1522. Earlier authorities applied this rule to tangible property. Rev. Rul. 59-249, 1959-2 C.B. 55. Chief Counsel has acknowledged that this one-year life overlapping two tax years rule may result in some distortion of income, but some departure from a "strict reading of section 263" is called for here, i.e., minimum distortion of income as this article advocates. The one-year rule "is a 'rule of reason' that is clearly reasonable under the circumstances involved." GCM 34,959 (July 25, 1972). The Seventh Circuit in *U.S. Freightways* agrees. See also *NCNB Corp. v. Commissioner*, 651 F.2d 942,953 n.21 (4th Cir. 1981) (*NCNB I*), *rev'd* 684 F.2d 25 (4th Cir. 1982) (*en banc*), *overruled* *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992).

¹⁰¹*Cincinnati*, note 8 *supra* at 572 ("Where the burden on both taxpayers and Service to account for each item of property separately is great, and the likelihood of distortion of income is nil or minimal, the Code is not so rigid and so impracticable that it demands that nevertheless all items be accounted for individually, no matter what the trouble or the onus. . . . The burden on plaintiff, if the minimum rule is not to be followed for income tax purposes, would be heavy; at the same time, the clearer reflection of income would be exceedingly slight if there were any at all."); *Sharon v. Commissioner*, 66 T.C. 515, 527 (1976), *aff'd* 591 F.2d 1273 (9th Cir. 1978), *cert. denied* 442 U.S. 941 (1979); Advance Notice, note 5 *supra* at 3462 (proposed regulations expected to provide "de minimis" rules, under which certain types of expenditures less than a specified dollar amount are not required to be capitalized); Lee, Capitalization Rules, *supra* note 36 at 680; Lee, *et al.*, Rough Justice II, *supra* note 5 at 1523-27. Cf. sec. 1.162-12(a), Income Tax Regs., regarding the treatment of inexpensive tools. *Ingram Industries, Inc. v. Commissioner*, T.C. Memo. 2000-263, applies this factor to repairs. "If we were to assume that a new automobile cost \$30,000, then a 1.6 percent maintenance cost would equal \$480. Relatively and comparably, the \$100,000 and \$480 appear, at least in size, to represent an *incidental as opposed to a major repair, improvement, or procedure*" (emphasis added).

Professor McMahon has "argued that there is no statutory foundation for a *de minimis* rule." Lupi-Sher, *supra* note 36 at 807. For the contrary argument that Treasury has authority under the clear reflection of income mandate of section 446 to permit a *de minimis* rule determined with a balancing of burdens and benefits standard see Lee, *et al.*, "Rough Justice I," note 5 *supra* at 689 n.235 and 708; Lee, *et al.*, "Rough Justice II," note 5 *supra* at 1523-27; both citing GCM 34,959 (July 25, 1972) ("we believe section 461 gives the Commissioner authority to direct the timing of deductions in a manner that

(Footnote 101 continued on next page.)

able benefit,¹⁰² or (d) regularly recurring.¹⁰³ Even where these exceptions are not available, several au-

will clearly reflect income. Although the exercise of this authority has generally been aimed at proscribing methods that fail to clearly reflect income, there is little doubt that it is broad enough to permit the recognition of additional methods that allow a clear reflection of income, even though such methods may appear to be a variance with a narrow interpretation of specific language of the Code.”).

¹⁰²*Southland Royalty*, note 99 *supra* at 616-18; *Iowa-Des Moines Nat'l Bank v. Commissioner*, 592 F.2d 433, 436 (8th Cir. 1979) (“Any credit information is short-lived and subject to sudden change. Thus, credit information must be current to be valuable and the taxpayers soon had a history of who did or did not pay the credit card charges. This new information was far more useful to taxpayers than the information purchased with the payments in dispute here. The fact that there may be some ensuing benefit and future effect from the expenditure beyond the taxable year when paid is not controlling. *Commissioner v. Lincoln Savings & Loan Assn.*, 403 U.S. 345 (1971). Where the prospective benefit is very slight, capitalization is not easily supported.”). See generally Lee, Capitalization Rules, note 36 *supra* at 680; Lee, *et al.*, Rough Justice II, note 5 *supra* at 1527-28. The repair/improvement formulation is whether the expenditure makes the asset longer-lived. *Plainfield Union*, note 3 *supra*.

¹⁰³*U.S. Freightways*, note 5 *supra* at 1145 (“Because they recur every year, there is less distorting effect on income from future tax year benefits over time. In every year, that is, while Freightways will be able to reap the tax advantage of deduction for some part of the following twelve months, it will have ‘lost’ the deductions for the months covered by the prior year’s licenses, for which it has already received the benefit. In a hypothetical last year of Freightways’ corporate life, it would finally be entitled to only a prorated deduction for licenses (if any) that are acquired during that year, partially evening out the score with the first year of deductions.”); *Encyclopaedia Britannica, Inc. v. Commissioner*, 685 F.2d 212, 215 (7th Cir. 1982) (“[A]llocating these expenditures among the different books is not always necessary to produce the temporal matching of income and expenditures that the Code desiderates, because the taxable income of the author or publisher who is in a steady state (that is, whose output is neither increasing nor decreasing) will be at least approximately the same whether his costs are expensed or capitalized. Not the same on any given book — on each book expenses and receipts will be systematically mismatched — but the same on average. Under these conditions the benefits of capitalization are unlikely to exceed the accounting and other administrative costs entailed in capitalization.”) (*dictum*); Advance Notice, note 5 *supra* at 3462 (proposed regulations expected to provide “a ‘regular and recurring rule,’ under which transaction costs incurred in transactions that occur on a regular and recurring basis in the routine operation of a taxpayer’s trade or business are not required to be capitalized”); Lee, Capitalization Rules, note 36 *supra* at 680; Lee, *et al.*, Rough Justice II, note 5 *supra* at 1529-31, 1539-43; Lupi-Sher, Decision in *Wells Fargo*, note 55 *supra* at 1303 (“In light of the decisions in *Wells Fargo* and *PNC*, [Pamela] Olson believes that the reach of *INDOPCO* has been limited when the issue concerns expenses that were regular and recurring and incurred by a company in the ordinary course of conducting its business. ‘The goal in this area should be a clearer reflection of income and administrative ease,’ she said.”). For

thorities hold that if depreciation is not available, capitalization is not appropriate since capitalization without depreciation would distort the taxpayer’s income.¹⁰⁴ Even where depreciation is available, if the recovery period is much longer than the future benefit of the expenditure, distortion of income would also result. If so, a current deduction or amortization over an arbitrary period produces less distortion of income, that is, “minimum distortion of income,” than the *ideal* slow or no depreciation would cause.¹⁰⁵ This “second best” approach is demanded by clear reflection of income as a rule of equity or “rough justice.”¹⁰⁶

application of this factor in the repair versus improvement context, see *P. Dougherty Co. v. Commissioner*, 159 F.2d 269, 272 (4th Cir. 1946) (“The work done was more in the nature of a permanent betterment or restoration than a recurrent repair or upkeep. The benefits to petitioner were to last over a period of several years, perhaps for the remaining life of the barge. It was more like putting on a new roof . . .”) (emphasis supplied).

¹⁰⁴*Southland Royalty*, note 99 *supra* at 618; *Colorado Springs Nat'l Bank v. United States*, 505 F.2d 1185, 1190 (10th Cir. 1974) (“The start-up expenditures here challenged did not create a property interest. They produced nothing corporeal or salable. They are recurring. At the most they introduced a more efficient method of conducting an old business. The government suggests no way in which they could be amortized. The government’s theoretical approach ignores the practicalities of the situation, and permits a distortion of taxpayer’s financial situation. If an expenditure, concededly of temporal value, may be neither expensed nor amortized, the adoption of technological advances is discouraged.”); Lee, *et al.*, Rough Justice II, note 5 *supra* at 1549. In the repair versus improvement context Rev. Rul. 94-38 reasoned alternatively that where amortization is not available, capitalization is not appropriate. See notes 108-112 *infra* and accompanying text.

¹⁰⁵*Wolfen Land & Cattle Co. v. Commissioner*, note 61 *supra* at 27 (“To permit a current deduction of such a large expenditure with a beneficial effect lasting on the average of 10 years would surely distort that year’s income. Yet to deny even an amortization deduction for an expenditure with a specific demonstrable beneficial life on the grounds that its deductibility is contaminated by its relationship to an asset of indefinite life, i.e., the land, would similarly require an uneven reporting of income. Since a basic premise of the income tax laws is to relate expenses to the income which they helped earn, a reasonable solution to our conundrum is to hold that the expenses in issue should be written off over their useful life. In short we would subscribe independent status to those expenditures on the basis that they create a free-standing intangible asset with an amortizable 10-year life.”); Lee, Capitalization Rules, note 36 *supra* at 680. This approach was in effect followed in the repair versus improvement context in TAM 9315004, see note 109 *infra*.

¹⁰⁶The core idea of rough justice is the use of simple administrative rules that work well enough on average in lieu of either detailed rules pursuing theoretical purity or case law uncertainty. Its principal virtue is the reduction of administrative costs to the taxpayer, to the Service, or to both while yielding minimum distortion of income. Aside from reducing compliance and enforcement costs, rough justice connotes an approximation of the just result. In some cases, rough justice is a “second best” surrogate or proxy tax; however, it generally seeks to effect better rather than unjust

(Footnote 103 continued in next column.)

(Footnote 106 continued on next page.)

D. Nondepreciable Remediation Costs

Applying a restoration principle analysis logically to the facts in Revenue Ruling 94-38,¹⁰⁷ there was no increase in the value of the contaminated property compared before the contamination of the ground water with the value after the construction of the ground water pumping station *either*, yet the ruling required capitalization of the costs of such pumping station¹⁰⁸ because they created a capital asset that could be depreciated. Accordingly, I believe that Revenue Ruling 94-38's more significant statement is that where amortization is *not* available (since the costs of soil remediation would be added to the nondepreciable land),¹⁰⁹ capitalization is not appropriate *either*,¹¹⁰ presumably because capitalization without depreciation would distort the taxpayer's income more than a current deduction would.¹¹¹ For when a taxpayer's only

results — fair on average for a class of taxpayers but not necessarily just as to each affected taxpayer. Rough justice also may be viewed as equity versus rule (equity versus law in the Anglo-American lexicon) or as substance versus form — an age-old battle between the spirit and the letter of the law. Under this view, rough justice envisions equity overcoming the rule of law. Lee, *et al.*, Rough Justice I, note 5 *supra* at 712-13, 718-21; Lee, Start-Up Costs, note 27 *supra* at 5-6 and n.8. For a detailed discussion of "rough justice" both in the context of ease of administration and of the jurisprudential literature, from which the preceding is derived, see Lee, *et al.*, Rough Justice I, note 5 *supra* at 712-39.

¹⁰⁷Note 74 *supra*.

¹⁰⁸The Service's historical tendency has been to find some depreciable asset (e.g., a building, permit, license, or personal property such as natural gas piping) with which to associate the costs at issue, capitalize them to such asset and then permit depreciation. Lee, *et al.*, Rough Justice II, note 5 *supra* at 1550-52. Treating the costs as a freestanding amortizable deferred charge would be preferable.

¹⁰⁹In the prior TAM, TAM 9315004, in effect reversed by Rev. Rul. 94-38, the costs were capitalized to the chief operating asset of the taxpayer. Juliann Avakian-Martin, "INDOP-CO Guidance Likely to Cover Advertising, Repairs, Training," *Tax Notes*, Aug. 3, 1992, p. 545 (Carrington "let it slip that in that TAM, the cleanup costs were amortized to the piping system. That fact was blacked out when the TAM was released."); Glenn Carrington, "Capitalization After INDOP-CO," 2 *N.Y.U. Inst. On Fed. Tax.* chapter. 25, at 25-29 (1995) (taxpayer in TAM 9315004 operated a natural gas pipeline).

¹¹⁰Rev. Rul. 94-38, note 74 *supra* (reversing a TAM requiring the capitalization of soil remediation costs in part on the rationale that "since the land is not subject to an allowance for depreciation, amortization, or depletion, the amounts expended to restore the land to its original condition are not subject to capitalization").

¹¹¹*Cincinnati*, note 8 *supra* at 572 ("The burden on plaintiff, if the minimum rule is not to be followed for income tax purposes, would be heavy; at the same time, the clearer reflection of income would be exceedingly slight if there were any at all."); *Iowa-Des Moines Nat'l Bank*, note 102 *supra* at 436 ("Where the prospective benefit is very slight, capitalization is not easily supported."); *Encyclopaedia Britannica*, note 103 *supra* at 213-17 (Posner, J.) ("the benefits of capitalization are unlikely to exceed the accounting and other administrative costs entailed in capitalization."); *Southland Royalty*, note 99

options are a current deduction or capitalization without amortization for expenditures with temporally limited benefits, a current deduction generally creates less income distortion than capitalization without depreciation.¹¹² The goal is a tax accounting rule resulting in *minimum distortion of income*.¹¹³

To determine whether the taxpayer's method of tax accounting of tax accounting clearly reflects her income, the starting point is that capitalization, depreciation, and clear reflection of income are "inextricably intertwined."¹¹⁴ Income distortion, therefore, occurs when capitalized costs cannot be amortized to roughly match the expense with the associated income. Income distortion also occurs when the costs are deducted immediately but provide benefits substantially beyond the current period. Given the choice between these two income distorting methods, a current deduction is better because it produces *less* income distortion by at least matching some of the expense with the revenue produced in the current period — permanent capitalization never matches any part of the expense with revenue.¹¹⁵

Under this absence of depreciation rationale there is a difference between the pumping station costs and the soil remediation or reclamation costs in Revenue Ruling 94-38. The former, but not the latter, relate to a depreciable asset. Similarly under an absence of

supra at 618 ("In those circumstances, it is not compulsory to amortize such a recurring item over a fixed time interval. Neither is it appropriate to require capitalization without amortization; such a requirement would clearly distort Southland's income."); Lee, *et al.*, Rough Justice II, note 5 *supra* at 1549-53. Similar reasoning led courts to adopt the since discredited separate salable asset rule that permitted an immediate deduction when no separate, transferable asset was created by an expenditure. *E.g.*, *Colorado Springs Nat'l Bank*, note 104 *supra* at 1192. By adopting this rule, courts could avoid the harsh result of capitalizing nonamortizable expansion costs by claiming that no identifiable asset was present. See Lee, Start-Up Costs, note 27 *supra* at 51-57; Lee, Capitalization Rules, note 36 *supra* at 677.

¹¹²Lee, Start-Up Costs, *supra* note 27 at 26; accord Hal I. Gann, "Capitalization: Get Back to Where You Once Belonged," 1 49th [So. Cal.] *Tax Inst. Major Tax Planning* 2-33, at para. 205.3 (1997).

¹¹³See *Liquid Paper Corp. v. United States*, 2 Cl. Ct. 284 (1983) (deduction of royalty payments as paid where purchase price constituted an open transaction accurately reflect the annual cost of patent with minimum distortion of income); *Newton Insert Co. v. Commissioner*, 61 T.C. 570 (1974); Rev. Rul. 67-136, 1967-1 C.B. 58.

¹¹⁴*Cincinnati*, note 8 *supra* at 569 (quoting *Fort Howard Paper Co. v. Commissioner*, 49 T.C. 275, 283-84 (1967) (Tannenwald, J.)).

¹¹⁵See the seminal Alan Gunn, "The Requirement That a Capital Expenditure Create or Enhance an Asset," 15 *B.C. Indus. & Comm'l. L. Rev.* 443, 492 (1974) ("In the absence of a feasible method of amortizing costs . . . a current deduction may be preferable to capitalization as a method of clearly reflecting income."); accord Lee, Start-Up Costs, note 27 *supra* at 73 n.315; Kenneth W. Gideon, "Assessing the Income Tax: Transparency, Simplicity, Fairness," *Tax Notes*, Nov. 23, 1998, p. 999 at 1003 (perpetual capitalization distorts the taxpayer's income).

(Footnote 111 continued in next column.)

depreciation analysis, remediation of both pre-existing contamination of unimproved real estate and of similar contamination attributable to the taxpayer's use would not create a depreciable cost. In many cases, however, the costs of cleaning up pre-existing contamination should be capitalized as a deferred purchase price for reasons other than the inapplicability of any "restoration" principle.

E. Capitalization of Anticipated Remediation

Are costs of remediating toxic waste contamination existing in a site when acquired by a taxpayer automatically currently deductible since amortization would not be available if these costs were capitalized? TAM 9541005¹¹⁶ reveals a valid rationale under which some such nondepreciable costs may nevertheless have to be capitalized. It held that hazardous waste remediation costs were not deductible under section 162 by a taxpayer who acquired the land in a contaminated state.¹¹⁷ One leg of TAM 9541005 presaged TAM 199952025 and *United Dairy Farmers, Inc., v. United States*¹¹⁸ by limiting the *Plainfield Union* or "restoration principle" of Revenue Ruling 94-28 to where "the taxpayer acquire[s] the property in a clean condition, contaminate[s] the property in the course of its everyday business operations, and incur[s] costs to restore the property to its condition at the time the taxpayer acquired the property." But TAM 9541005 alluded to a sounder basis for requiring a taxpayer to capitalize hazardous waste remediation costs when the taxpayer knowingly purchases property in a contaminated state by citing *Mt. Morris Drive-In Theatre v. Commissioner*.¹¹⁹

¹¹⁶Note 89 *supra*, revoked and superseded by TAM 9627002, note 89 *supra*.

¹¹⁷See 143 *Cong. Rec.* S 860 (Senate Jan. 30, 1997 Daily Ed.) (Remarks of Sen. D'Amato, R-N.Y.) ("Under current law, the IRS has determined that costs incurred to clean up land and ground water are deductible as business expenses, as long as the costs are incurred by the same taxpayer that contaminated the land, and that taxpayer plans to use the land after the cleanup for the same purposes used prior to the cleanup. That means that new owners who wish to use land suspected of environmental contamination for a new purpose, would be precluded from deducting the costs of cleanup in the year incurred. They would only be allowed to capitalize the costs and depreciate them over time.").

¹¹⁸107 F. Supp.2d 937, *Doc 2000-17988* (20 original pages), 2000 TNT 128-41 (S.D. Ohio 2000), *aff'd* 267 F.3d 510, *Doc 2001-25388* (29 original pages), 2001 TNT 193-5 (6th Cir. 2001), discussed at notes 142-44 *infra* and accompanying text.

¹¹⁹T.C. 272, 274 (1955) ("[I]t was obvious at the time when the drive-in theatre was constructed, that a drainage system would be required to properly dispose of the natural precipitation normally to be expected, and that until this was accomplished, petitioner's capital investment was incomplete. In addition, it should be emphasized that here there was no mere restoration or rearrangement of the original capital asset, but there was the acquisition and construction of a capital asset which petitioner had not previously had, namely, a new drainage system."), *aff'd per curiam* 238 F.2d 85 (6th Cir. 1956); TAM 9541005, note 89 *supra* (perceptively reading *Mt. Morris Drive-In* as an example of origin of claim doctrine); see generally Lee, Start-Up Costs, note 27 *supra* at 30 n.121.

The latter in effect holds that a cost incurred after acquisition, but anticipated at such time, must be capitalized as an acquisition cost under the rationale that until the anticipated cost is incurred the taxpayer's investment is not complete.¹²⁰ *Mt. Morris Drive-In* used language reminiscent of the *Arrowsmith* doctrine¹²¹ — "If petitioner had included in its original construction plans an expenditure for a proper drainage system no one could doubt that such an expenditure would have been capital in nature."¹²²

Where a taxpayer expects to incur further expense to remediate a defect known at the time of acquisition, she rationally discounts her original purchase price for the anticipated costs.¹²³ Thus, later payment of these costs constitutes payment of deferred acquisition costs. Accordingly, if the taxpayer in TAM 199952075 were aware of the pre-existing contamination and discounted its purchase price for anticipated remediation costs, such costs would constitute capitalizable *acquisition* costs. If, however, the taxpayer was not aware of the extent of the pre-existing contamination and therefore did not so reduce its purchase price, the remediation costs should not be capitalizable as [delayed] acquisition costs.¹²⁴ If the unanticipated costs were added to the basis of the land they would be nondepreciable and hence their capitalization would distort the tax-

¹²⁰*Cf.*, Bayles and Rich, note 23 *supra* at 284 ("Acquisition of a building and its immediate, substantial renovation is difficult to view as anything other than a single competed transaction."); accord *Haeder v. Commissioner*, T.C. Memo. 2001-7, *Doc 2001-1789* (47 original pages), 2001 TNT 12-19 ("The fact that petitioners had the rug appraised and repaired in the year of purchase suggests that those repairs were part of their capital investment in the rug.").

¹²¹*Arrowsmith v. Commissioner*, 344 U.S. 6, 8 (1952). See Lee and Murphy, *supra* note 54 at 499-509 (origin-of-the-claim doctrine, classic tax benefit doctrine, and *Arrowsmith-Skelly Oil* consider two transactions together to prevent distortion of income); Timothy A. Rodgers, Note: "The Transaction Approach to the Origin of the Claim Doctrine: A Proposed Cure for Chronic Inconsistency," 55 *Brooklyn L. Rev.* 905, 938 (1989) ("Arrowsmith 'open transaction' doctrine — an expense assumes the tax character of the original transaction from which it arises — is directly analogous to the origin of the claim doctrine.") (citing Lee and Murphy).

¹²²*Mt. Morris Drive-In*, note 119 *supra* at 274 ("In the instant case it was obvious at the time when the drive-in theatre was constructed, that a drainage system would be required to properly dispose of the natural precipitation normally to be expected, and that until this was accomplished, petitioner's capital investment was incomplete."). The Court in *Arrowsmith* stated that "It is not even denied that had this judgment been paid after liquidation, but during the year 1940, the losses would have been properly treated as capital ones. For payment during 1940 would simply have reduced the amount of capital gains taxpayers received during that year." *Arrowsmith*, note 121 *supra* at 8.

¹²³Blake Rubin, *et al.*, "The Tax Treatment of Environmental Cleanup Costs," 54th *N.Y.U. Inst. On Fed. Tax.*, 11-1, 11-15 (1996).

¹²⁴The contrary holding in *United Dairy Farmers* is criticized at note 143 *infra* and accompanying text.

payer's income.¹²⁵ Thus unanticipated clean-up costs should be currently deductible.

1. Restoration principle and contamination discovered after purchase. The same differentiation between known and unknown pre-existing contamination could be reached under one reading of the restoration principle. In *Norwest Corp. v. Commissioner* the Tax Court reasoned that absent the general plan of rehabilitation the costs of asbestos remediation would be deductible under the *Plainfield Union* restoration principle. Proponents of a current deduction of the costs of remediating asbestos for instance maintain that instead of the remediated property being valued for purposes of the *Plainfield Union* test as of just before the condition occurred¹²⁶ (original installation of the asbestos insulation), it should be valued as of just before the taxpayer came to know that the hazardous condition would necessitate repair or remediation.¹²⁷

One commentator suggests that the preferable alternative is to use the date after the problem was discovered as the "before" time because it more accurately reflects the economic reality of the taxpayer's decision to incur the cost: (1) the choice is forward-looking; (2) the property no longer performs as intended; (3) this creates more accurate results and simpler administration; and (4) the matching of income with the expenditure is better.¹²⁸ He notes that by applying *Plainfield Union* using the understanding of asbestos hazards as the "before" point a current deduction of asbestos encapsulation and monitoring costs should still be allowed.¹²⁹

¹²⁵In LTR 200108029, note 86 *supra*, the taxpayer requested a ruling that its costs for environmental remediation of contamination existing at the time of purchase be capitalized (apparently because it was to receive insurance proceeds for such costs). The ruling held that the costs should be capitalized because the taxpayer acquired the land in a contaminated state. "Therefore, the expenditures for the remediation operations increased the value of the land, by improving the land from a contaminated state to a remediated state." *Id.* at para. 32. The taxpayer was unaware of the contamination at purchase. *Id.* at paras. 4, 9, and 10. Hence, taxpayer would not have discounted its purchase price for the contamination discovered five and six years after its purchase. Since no depreciation would have been allowed for remediation costs capitalized to the land and *Mt. Morris Drive-In* would not apply, a current deduction should be allowed. See notes 119-22 *supra* and accompanying text.

¹²⁶Thomas H. Yancey, "Emerging Doctrines in the Tax Treatment of Environmental Cleanup Costs," 70 *Taxes* 948, 960 (1992). For a sound criticism of many of the articles in this niche, see Pollack, *supra* note 88 at 90-92.

¹²⁷See generally Letter from Bonnie V. Hancock of Carolina Power & Light Company to Internal Revenue Service dated May 6, 1996, *Doc 96-14603* (7 pages), 96 *TNT* 98-31; cf. David G. Coolidge, Note, "A Square Hole for a Square Peg: Section 165 and Environmental Cleanup Costs," 14 *Va. Tax Rev.* 779, 794-95 (1995).

¹²⁸See *id.* at 798-99.

¹²⁹See *id.* at 817 (citing to Professor Calvin Johnson, this commentator argues that removal costs should be capitalized, but that encapsulation and monitoring costs can be currently deducted).

The parties in *Norwest Corp.* not surprisingly disagreed as to the point at time at which "before" was determined under the *Plainfield Union* restoration principle. The taxpayer argued that "before" meant just before the point of discovery of the hazard from the asbestos insulation.¹³⁰ The Commissioner maintained that it meant before the installation of the asbestos so that the *Plainfield Union* doctrine did not apply. She reasoned that since the asbestos was present from the moment when the building was first placed in service,¹³¹ there was no time at which the building existed before the condition occurred with which to contrast the value of the building after the condition appeared.¹³² The Tax Court in *Norwest Corp.* implicitly rejected the Commissioner's argument. Noting that the parties had stipulated that asbestos removal [and re-insulation] did not increase the useful tax life of the building, the court agreed with the taxpayer that such removal did increase the building's value "compared to its value when it was known to contain a hazard."¹³³ (Asbestos substitutes generally are less efficient insulators.)¹³⁴ *Norwest Corp.* thus rebuffed the Commissioner's contention "that the expenditures for asbestos removal materially increased the value of the building so as to require them to be capitalized."¹³⁵ Implicitly the issue, therefore, was whether "before" in the *Plainfield Union* test meant before the discovery of the hazard, or before the date of the asbestos installment.¹³⁶ The court must have concluded the former, to say that asbestos removal itself did not increase the value of the building sufficiently as to require its cost to be capitalized.¹³⁷ In a 1993 House Ways and Means subcommittee hearing, some witnesses maintained that since environmental remediation added no value, its costs should be deductible as a repair.¹³⁸ This would lead to the conclusion that asbestos removal does not materially

¹³⁰*Norwest Corp.*, note 22 *supra* at 281.

¹³¹Treas. reg. section 1.167(a)-11(e)(1)(i) ("Property is first placed in service when first placed in a condition of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity or in a personal activity.").

¹³²*Norwest*, note 22 *supra* at 283.

¹³³*Id.* at 284 (emphasis supplied).

¹³⁴E.g., Coolidge, note 127 *supra* at 797; TAM 9240004, note 97 *supra*; Eileen S. Mazo, Note, "Taxing Our Way to a More Polluted Environment," 6 *Fordham Envtl. L.J.* 357, 373 (1995); Gaba, note 24 *supra* at 90.

¹³⁵*Norwest Corp.*, note 22 *supra* at 283. The Tax Court acknowledged that the asbestos removal did increase the value of the building compared to when it was known to contain a hazard.

¹³⁶*Id.* at 281, 284.

¹³⁷See *id.* at 284.

¹³⁸Hearings on Miscellaneous Revenue Issues before the House Ways and Means Subcommittee on Select Revenue Measures (Part 2), 103d Cong., 1st Sess 1608-10 (1993) (Prepared statement of Roy E. Hock, representing the Coalition to Preserve the current Deductibility of Environmental Remediation Costs).

increase the property's value from its value before discovery of the contamination or its effects.¹³⁹

Similarly where a taxpayer purchases property not knowing of contamination and subsequently uncovers it, remediation restores the property to its value before discovery. In the real world today buyers do usually undertake toxic waste surveys before purchasing property, but there are indications in TAM 199952075 that the taxpayer was not aware of the extent of contamination before disturbing the soil and undertaking a toxic waste survey for new construction. In LTR 200108029¹⁴⁰ the taxpayer was clearly unaware of the pre-existing contamination. Even if the taxpayer were aware of the contamination but did not anticipate at purchase remediating it, for example, anticipating continued use for the same purpose, a current deduction should be allowed when the taxpayer changes its plans triggering a remediation requirement because depreciation would be unavailable if the cost were capitalized and the cost would not constitute a deferred acquisition cost.¹⁴¹

The district court in *United Dairy Farmers, Inc. v. United States*,¹⁴² incorrectly, however, denied such a current deduction, holding that the restoration rule was inapplicable where the taxpayer acquired convenience stores not knowing of the underground contamination from previously removed gasoline pumps. It held the restoration principle of Revenue Ruling 94-28 did not apply because the property (a convenience store with paved-over, abandoned gasoline storage tanks) was contaminated when acquired.¹⁴³ Furthermore, the district court reasoned that the taxpayer overpaid for the properties because the market values were really lower due to the contamination; hence

had the prices of the properties been adjusted to reflect the contamination on the properties, its remediation expenditures would have increased the values of the properties, and, therefore those costs would have to have been capitalized. The Court sees no reason for the taxpayer's subjective belief as to the value of the property to control the determination of whether its remediation costs are deductible or whether they must be capitalized. Indeed, there are good policy reasons that it should not. Such a rule would discourage taxpayers from proceeding with appropriate diligence in making such an acquisition, sure in the knowledge that whatever costs they incurred to salvage their investment would be deductible

immediately. This does not seem to be a wise course to follow.¹⁴⁴

This approach is inconsistent with the Tax Court opinion in *Norwest Corp.*, where the "before" component of the "restoration" test was before the taxpayer became aware of the effects of the contamination.¹⁴⁵

Norwest Corp. won the Plainfield-Union battle over asbestos clean-up costs, but lost the capitalization war.

In affirming the district court, the Sixth Circuit agreed that the restoration principle was inapplicable to defects present when the taxpayer purchased the property and pointed out that clean-up costs of \$260,000 as to properties purchased for \$760,000 were not "incidental" expenditures.¹⁴⁶ It went on to "harmonize" *Dominion Resources* (discussed below),¹⁴⁷ *Plainfield Union*, and Revenue Ruling 94-38.

As noted by the government in its brief on appeal, when taken together, *Dominion Resources*, *Plainfield Union*, and Revenue Ruling 94-38 can be harmonized in a coherent framework. That is, three elements must be satisfied for a valid deduction under section 162 for environmental cleanup costs: first, the taxpayer contaminated the property in its ordinary course of business; second, the taxpayer cleaned up the contamination to restore the property to its pre-contamination state; third, the cleanup did not allow the taxpayer to put the property to a new use. In *Dominion Resources*, the taxpayer did not satisfy the third element, because the cleanup allowed the taxpayer to put the property to new use as a real estate development. *Dominion Res.*, 219 F.3d at 370. In this case, failure to satisfy the first element is sufficient for rejecting UDF's soil remediation claim.¹⁴⁸

F. Rule of Reverse Tax Parity

Norwest Corp. concluded that the asbestos removal was sufficiently intertwined by logistical and economic concerns with the clearly capital remodeling of the taxpayer's bank building to come under the general plan of rehabilitation doctrine. Thus *Norwest Corp.* won the *Plainfield Union* battle over asbestos clean-up costs, but lost the capitalization war. On the basis of doctrine and even more policy, I believe that the Tax Court in *Norwest Corp.* incorrectly applied the *Wehrli*¹⁴⁹ general plan of rehabilitation tax doctrine to asbestos removal costs. The asbestos remediation itself added

¹³⁹See Mazo, note 134 *supra* at 370.

¹⁴⁰Note 86 *supra*. The apparent source of the contamination was the unsuccessful attempt by an employee of the prior owner to distill the toxic substance and then freezing barrels containing the substance and dumping the ice mass at the top of the barrels on the ground. The taxpayer was unaware of any of this at time of purchase.

¹⁴¹The deduction might be more appropriate under section 165 than section 162. See Coolidge, note 127 *supra* at 802-11.

¹⁴²Note 118 *supra*.

¹⁴³*Id.* at 942.

¹⁴⁴*Id.*

¹⁴⁵See notes 128-39 *supra* and accompanying text.

¹⁴⁶*United Dairy Farmers*, note 118 *supra*.

¹⁴⁷See notes 154-61 *infra* and accompanying text.

¹⁴⁸*Id.* at 519.

¹⁴⁹*United States v. Wehrli*, note 22 *supra* at 689, is the most often cited modern authority adopting the general plan of rehabilitation doctrine.

no value, according to the Tax Court, while the overall remodeling presumably added close to its cost in value at least to the taxpayer. It is thus debatable whether the doctrine as traditionally construed should have applied in *Norwest Corp.*¹⁵⁰

A more fundamental objection to *Norwest Corp.* is that the reverse rule of tax parity should permit an ordinary deduction for asbestos remediation incurred in connection with remodeling. The rule of parity should apply in reverse so that a taxpayer self-constructing an item would not be tax disadvantaged as compared with a taxpayer purchasing the item.¹⁵¹ Assume that a taxpayer purchases a remodeled and remediated building for use in her business and the seller had removed existing asbestos insulation. In a fair market value purchase of that asbestos remediated property, the seller would bear the cost of asbestos remediation because a [new] comparable replacement building would have no asbestos insulation and hence no cost of remediation. The seller could not economically include the remediation cost in her sales price and be competitive with a comparable new building. (The seller may be allowed an ordinary deduction for that remediation.)¹⁵² Accordingly, under the rule of parity a taxpayer self-remediating asbestos insulation should not have to capitalize her cost under the general plan of rehabilitation doctrine even when undertaken in conjunction with remodeling as in *Norwest Corp.* Otherwise, a taxpayer undertaking the remodeling and removal of asbestos in a building will be tax disadvantaged compared to a taxpayer purchasing a comparable remodeled building as to which the seller removed the asbestos.¹⁵³

In *Dominion Resources, Inc. v. United States*,¹⁵⁴ the Fourth Circuit declined to place “the focus on how much value an improvement adds to property.”¹⁵⁵ Rather, it analyzed the nature of the improvement. “If the improvement permits the property to be utilized in a different way, the improvement is most appropriately considered a capital expenditure. If the improvement only restores value to the property that existed prior to deterioration or to a discrete event that damaged the property, the improvement may be properly treated as

a deductible repair expense.”¹⁵⁶ Significantly, the Fourth Circuit noted that “the cost of the environmental cleanup, \$2.2 million, may have dwarfed the value of the property itself prior to the cleanup — DLI paid \$870,167 for it, and the average appraised value was less than \$1.6 million.”¹⁵⁷ (After remediation, the appraised value was \$9 million.)¹⁵⁸ Rather than analyzing this case as a discounted purchase price, the Fourth Circuit applied a substantial alteration in character analysis.

In fact, the cleanup did even more than create the possibility of a new use for the property; it lifted the property out of what was essentially a condition of uselessness. DRI’s contention — that the property could be sold “as is” both before and after the improvements — would permit the taxpayer to deduct the cost of any improvement. Because the environmental cleanup substantially altered the character of the 12th Street property, enabling DRI to “put” the property to a wide range of new uses, *Estate of Walling*, 373 F.2d at 192, the cleanup costs permanently improved the property and so, as the district court found, must be capitalized.¹⁵⁹

Although only obliquely recognized by the cases,¹⁶⁰ the alteration of character notion also rests on the rule of tax parity.¹⁶¹ A taxpayer altering the character of the property should be treated the same as a taxpayer purchasing property for a new use. Accordingly, under the rule of reverse tax parity, if such a purchaser would not economically bear the cost of the seller’s remediation and hence would not in effect include the costs in her basis, then a taxpayer performing the remediation herself and thereby altering her use of the property should not be required to capitalize those costs and should be permitted to currently deduct them. If, however, the purchaser discounted its price for the remediation, she would be required to capitalize them as a deferred purchase price.

G. *Norwest Corp.* and Economic Inefficiency

The holding in *Norwest Corp.* as to capitalization of asbestos remediation under the general plan of rehabilitation doctrine results in economic inefficiency. The Tax Court noted that combining the asbestos remediation with remodeling was less expensive than carrying out each separately.¹⁶² After *Norwest Corp.* with its implication that asbestos remediation performed not in connection with remodeling would be currently deductible, tax advisers may be expected to recommend that asbestos remediation be so performed before remodeling. As long as the two activities are not

¹⁵⁰See text accompanying note 24 *supra*.

¹⁵¹*United Telecommunications, Inc. v. Commissioner*, 65 T.C. 278, 290 at 295 (1975) (Wilbur, J., concurring). Cf. *Iowa-Des Moines Nat’l Bank v. Commissioner*, note 102 *supra* at 435-36 (costs of purchased credit reports could be currently deducted because “had taxpayers directly acquired credit information, capitalization of the expense, including employee wages, would not have been required.”).

¹⁵²Michelle Kamen Friedman and Avi D. Liveson, “Tax Treatment of Environmental Clean Up Costs,” 26 *J. Real Estate Tax’n* 20, n.8 (1999).

¹⁵³See note 151 *supra* and accompanying text.

¹⁵⁴219 F.3d 359, Doc 2000-20314 (21 original pages), 2000 TNT 148-5, *aff’d* 48 F. Supp. 2d 527, Doc 1999-11413 (71 original pages), 1999 TNT 59-16 (E.D. Va. 1999).

¹⁵⁵*Dominion Resources*, 219 F.3d at 371.

¹⁵⁶*Id.*

¹⁵⁷*Id.* at 372.

¹⁵⁸*Dominion Resources*, 48 F. Supp.2d at 554.

¹⁵⁹*Dominion Resources*, 219 F.3d at 372.

¹⁶⁰*Stoelzing v. Commissioner*, note 48 *supra* (taxpayer bought an old building and made a new and different building, commercially useful, out of it).

¹⁶¹Lee, Capitalization Rules, note 36 *supra* at 678.

¹⁶²*Norwest Corp.*, note 22 *supra*.

linked under the step transaction doctrine,¹⁶³ the asbestos remediation would be currently deductible under the intimations in *Norwest Corp.* rather than being depreciable over almost 40 years. The tax savings surely would much more than offset any increased pre-tax costs of separately remediating and remodeling. The tax and not economic consequences thus will drive the structuring of the asbestos remediation.

Assume, as *Norwest Corp.* holds, that a taxpayer in Scenario A remodeling a building and hence hastening asbestos remediation must capitalize the asbestos remediation costs and then depreciate them straight-line over almost 40 years, but can take a current deduction if the asbestos remediation is taken apart from a remodeling. (The apparent difference is the, in my opinion, "erroneous" application of the "general plan of rehabilitation" doctrine because otherwise, according to *Norwest Corp.*, no value or increase in useful life is added by "restoration" to an asbestos-free state.) Taxpayers will instead simply structure the transaction differently.

In Scenario B the bank holding company instead of remodeling removes asbestos from the bank building, reinsulates, and sells it to another. At that point the asbestos remediation will either be currently deductible or possibly reduce the gain or increase the loss on the sale by the bank holding company of the asbestos-free building. (I understand anecdotally that any financial institution involved in the purchase would require asbestos remediation.)¹⁶⁴ Then the taxpayer can lease, buy, or build another bank building at current reproduction fair market value rates. (This hypothetical ignores any transaction costs in obtaining another branch bank permit.) The taxpayer could then have an ordinary loss for the asbestos remediation under the restoration principle¹⁶⁵ and a new fair market value basis in the replacement modern bank building.

In scenario C the taxpayer forgoes remodeling the bank building and instead rewraps or encapsulates the asbestos insulation as needed in the future (and never more than 25 percent at a time).¹⁶⁶ While this approach

perhaps best fits the clear reflection of income mandate, it probably is the more contrary to environmental policies, social policies (a remodeled bank building hiring local workers might help to stabilize a neighborhood),¹⁶⁷ and probably even sound business policies.

V. Cyclical Maintenance Costs

Still another problem arises with some frequency as to the general plan of rehabilitation. Assume a taxpayer cyclically repairs or rehabilitates depreciable property on a cycle shorter than the recovery period under section 168 for that property. The expenditure could be treated alternatively as (a) a current expenditure; (b) an addition to the basis of the longer-lived depreciable property and depreciated over that longer recovery period; or (c) as separate from the larger depreciable property and depreciated over the recovery period.

A. Current Deduction

The Commissioner inequitably sought in *Ingram Industries v. Commissioner*¹⁶⁸ to capitalize costs recurring every 3½ years over a 10-year recovery period under section 168.¹⁶⁹ Without discussing the general plan of

the taxpayer's property nor substantially prolonged its useful life. . . . [t]he taxpayer's encapsulation expenditures did not increase the value or prolong the useful life of the taxpayers property beyond what it was before the asbestos became damaged. The application of a canvas or plastic wrapping over damaged pipe insulation reduced, but did not eliminate, the threat of exposure to airborne asbestos fibers. Moreover, because of the continued presence of asbestos, the expenditure did not enable the taxpayer to operate on a changed, more efficient, or larger scale. Accordingly, the taxpayer's encapsulation expenditures did not materially enhance the value of the taxpayer's property, substantially prolong its life, or adapt such property to a new or different use. Moreover, the effects of the encapsulation on taxpayer's property are temporary.

¹⁶⁷Cf. Olivera Perkins, "8th District Hopefuls Focus on Improving Schools," *The Plain Dealer* B-6 (Apr. 5, 1998); "Pres. Clinton Delivers Remarks on the Environment in Kalamazoo, Mi.," 1996 *Presidential Campaign Press Materials* (Aug. 28, 1996) ("The most important thing that I am working on with the mayors of America today is cleaning up these brownfields so we can create jobs in the city. Again, I tell you, good environmental policy is good for the economy. It creates jobs. It creates a future for America and we have to be prepared to do it.").

¹⁶⁸Note 49 *supra*.

¹⁶⁹For Federal income tax purposes, petitioners depreciate each of their towboats as a single asset under the modified accelerated cost recovery system using the prescribed recovery period of 10 years under the composite 18-year class life. For financial reporting purposes, petitioners depreciate a new or used towboat as a single asset over 35 years." *Ingram Indus.* A vessel, barge, tug, or similar water transportation equipment has a recovery period of 10 years under asset class 00.28 of Rev. Proc. 87-57, 1987-2 C.B. 687. See generally Market Segment Specialization Program, "The Port Project, Training" 3149-123 (Oct. 1995), *Doc 95-9557* (130 pages), 95 *TNT* 205-12. I thank Professor Gene Seago for putting me on the trail to rules here that are not transparent in section 168.

¹⁶³Boris I. Bittker, "Pervasive Judicial Doctrines in the Construction of the Internal Revenue Code," 21 *How. L.J.* 693 (1978); Saul Levmore, "Recharacterizations and the Nature of Theory in Corporate Tax Law," 136 *U. Pa. L. Rev.* 1019 (1988).

¹⁶⁴I am grateful to Anne-Marie Miles for Scenarios A, B, and C, and for this anecdotal evidence learned from her father, an attorney working in environmental law.

¹⁶⁵See note 166 *infra*.

¹⁶⁶These are essentially the facts in TAM 9411002, 94 *TNT* 54-13, which allowed a current deduction for such encapsulation of 25 percent of the pipes in taxpayer's warehouse, but required capitalization of the costs of abatement by removing asbestos-containing materials from taxpayer's boiler house, which was treated for depreciation purposes together with the warehouse as a single asset. The ruling held that

[u]nlike the costs incurred for asbestos removal in the taxpayer's boiler house, the costs incurred by the taxpayer for encapsulation of damaged insulation in its warehouse neither appreciably increased the value of

(Footnote 166 continued in next column.)

rehabilitation doctrine, the court in *Ingram Industries*,¹⁷⁰ in determining whether cyclical maintenance costs (engine “inspection,” replacing 21 percent of the parts, recurring every 3½ years) “materially added to the value of the property,” the towboat, thought it “significant that petitioners [that is, taxpayers] perform the procedures at a time when the engines are completely serviceable and the purpose of performing the procedures is to keep the towboat engines in good operating condition. This is in contrast to the cases relied on by respondent [the Government] where the property was not serviceable and had to be replaced or completely rebuilt or overhauled.”¹⁷¹ As shown below, materiality of the expenditure and regularly recurring are proper rough justice, minimum distortion of income factors, while operable at the time of the expenditure is not. *Ingram Industries* unfortunately failed to clearly articulate the clear-reflection-of-income policy underlying capitalization.¹⁷²

Ingram Industries may have reached the correct result for reasons other than the still operable test that are not inconsistent with minimum distortion of income. The “repair” cycle there was 3½ years rather than 10 years and the Tax Court held that the “repair” cost of inspecting the towboat engine, which amounted to 17 percent of the cost of a reconditioned unit, was insubstantial (“incidental”) compared to the cost of a new or rebuilt engine.¹⁷³ (*Ingram Industries* did not consider in this context the general plan of rehabilitation doctrine.)¹⁷⁴ Current deduction of future benefit costs

¹⁷⁰Note 49 *supra* (\$100,000 cost of inspecting the two engines per towboat not material in comparison to the \$800,000 cost for two rebuilt or overhauled engines).

¹⁷¹*Id.*

¹⁷²Finally, the parties address the role, if any, that *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 117 L. Ed. 2d 226, 112 S. Ct. 1039 (1992) (*INDOPCO*) should play in our consideration of this issue. Respondent references *INDOPCO* along with section 1.162-4, Income Tax Regs., for the following position:

In order to be entitled to a deduction for the engine overhaul, petitioners must clearly show that it is an incidental repair that does not appreciably prolong the property’s useful life, but keeps it in an ordinarily efficient operating condition. ***

Accordingly, respondent’s use of *INDOPCO* does not vary from the standards set forth earlier in this opinion. There is no unique aspect or requirement in the Supreme Court’s *INDOPCO* opinion that pertains specifically to the issue we consider. Likewise, petitioners confirm that the *INDOPCO* holding did nothing to change the standards established by the pre-*INDOPCO* body of law that deals with repair and maintenance expenses. Accordingly, it is not necessary to analyze further the *INDOPCO* holding in the context of this case.

Ingram Indus., note 49 *supra*. Unfortunately, the Service apparently did not argue that *INDOPCO* required that clear reflection of income and future benefits should be taken into account as, for example, in *Wolfsen Land & Cattle*, note 61 *supra*.

¹⁷³*Ingram Industries*, note 49 *supra*.

¹⁷⁴Burgess J.W. Raby and William L. Raby, “When Push Comes to Shove on Engine Maintenance Expenses,” *Tax Notes*, Oct. 30, 2000, p. 655 at 658.

does not distort the taxpayer’s income where those costs are insubstantial or steady-state recurring.¹⁷⁵ The Seventh Circuit recently reaffirmed the concept that the regularity of expenses with future benefit supports their current deduction.¹⁷⁶

In TAM 9618004¹⁷⁷ the Commissioner allowed a current deduction for repairs done on a one- to two-year cycle and costing between \$25,000 and \$80,000. In contrast, this TAM capitalized the costs of “major engine inspections” of aircraft engines (also called off-wing inspections since the engines are removed for inspection) recurring every three to five years and costing between \$90,000 and \$120,000 because they were “not merely incidental and . . . have the effect of adding materially to the then value of the engine while at the same time prolonging the engine’s useful life. Furthermore, these expenditures generate significant future benefits to Taxpayer, not the least of which is the fact that without them, the FAA would not permit Taxpayer to continue to operate its aircraft. Finally, in the case of engines owned by Taxpayer, the major inspection costs restore exhaustion for which an allowance has been made.”¹⁷⁸ While *Ingram Industries*’s four-year cycle might be considered closer to the two-year cycle than the five-year cycle in *Wolfsen Land & Cattle*¹⁷⁹ discussed in Section V.C. below, it is the same as the four-year cycle for major engine inspections that the TAM capitalized.

Revenue Ruling 2001-4, the Service’s restatement of the general plan of rehabilitation doctrine, restates the still-operable rule in holding the doctrine inapplicable where “the plan primarily involved repair and maintenance items or the work was performed merely to keep the property in ordinarily efficient operating condition.”¹⁸⁰ This extension of *Ingram Industries* in Revenue Ruling 2001-4 to an eight-year cycle roughly equivalent to the recovery period under section 168¹⁸¹ clearly exposes, however, the weakness in the reasoning in *Ingram Industries* — that the asset was not yet inoperable. Revenue Ruling 2001-4 permitted current deduction of a \$2 million “heavy maintenance visit” (consisting of disassembling the aircraft down to the frame and then lubricating, inspecting, and replacing minor parts and repainting and repairing the removed

¹⁷⁵See notes 101 and 103 *supra*; Lee, Start-Up Costs, note 27 *supra* at 15-20; Lee, Capitalization Rules, note 36 *supra* at 679-80; Lee, *et al.*, Rough Justice II, note 5 *supra* at 1523-48.

¹⁷⁶*U.S. Freightways Corp.*, note 5 *supra*.

¹⁷⁷*Doc 96-13304 (14 pages)*, 96 TNT 89-13.

¹⁷⁸*Id.*; see generally Lee, Walberg, and Whitesell, Cyclical Aircraft Maintenance Costs, note 39 *supra* at 163-4, 202-03, and 210-12.

¹⁷⁹*Wolfsen Land & Cattle*, note 61 *supra* at 18 (called for treatment of recurring costs of maintaining irrigation system as freestanding amortizable intangibles with “appropriate useful lives, i.e., 5 years for field checks, 10 years for ditches, and 30 years for large levees and canals,” corresponding with the dredging cycle necessary to avoid complete dysfunction. *Id.* at 8).

¹⁸⁰Note 1 *supra* at 298.

¹⁸¹Section 168(e)(3)(C).

components, but not materially upgrading or adding to the airframe or any substantial structural part) yielding future benefits for eight years as in the ruling surely distorts the taxpayer's income. In Revenue Ruling 2001-4 the cost, while perhaps not substantial in comparison to the original cost of the aircraft,¹⁸² 13.3 percent of the original cost 15 years earlier, was so large per se¹⁸³ (\$2 million) that it hardly appears insubstantial.¹⁸⁴

Revenue Ruling 2001-4 contained two other fact patterns: (2) in addition to the heavy maintenance visit, all of the skin panels on the fuselage were replaced, which materially added to the value of the aircraft (in addition new cabin fire and smoke detection and suppression system, ground proximity warning, and air phone system were installed), and (3) similarly many structural, exterior, and interior modifications were made, for example, new belly skin panels, metal supports under the lavatories and galleys, new wiring systems in the wings, replacing frame rivets, upgrading cockpit avionics and equipment, replacing all seats, windows, and carpeting, and installing new cabin fire and smoke detection and suppression system, ground proximity warning, and air phone system; all of this materially increased the value of the airframe and substantially prolonged its life. The ruling concluded that the replacement of skin panels and installation of new systems in (2) had to be capitalized, but the costs of the heavy maintenance visit were still currently deductible because all of the expenditures did not rehabilitate the entire aircraft "restoring it to a 'like new' condition." In the third scenario, "the effect of all the work performed on aircraft 3, including the inspection, repair, and maintenance items, is to materially increase the value of the airframe and substantially prolong its useful life."¹⁸⁵ Thus the general plan of rehabilitation doctrine applied. Clearly the rule of tax parity would require capitalization of all of the expenditures as to the third aircraft and under *Moss* the doctrine would not apply (as to the replacement of the skin panels and

installation of new systems). However, the amount of the expenditure and long intervals between the repair cycles suggest that the expenditures still should be capitalized.

I understand informally that few heavy maintenance visit repairs fall into the first category. Nevertheless, a refund suit filed by FedEx disclosed that after the ruling the Service conceded the deductibility of the airframe heavy maintenance visits, but still disallowed current deduction of off-wing engine inspections.¹⁸⁶ As a practical matter, the Service has advised area counsel to guide examiners to focus only on the third or later heavy maintenance visit as to a particular aircraft.¹⁸⁷

B. Depreciation Over Longer Recovery Period

The Service in TAM 9618004¹⁸⁸ capitalized the shorter-term recurring maintenance costs (four-year cycle) that extended the life of aircraft engines and aluminum reduction cells, respectively, over the longer 7½-year recovery period under section 168 for the rehabilitated asset, producing in my opinion distortion of income. Such depreciation over a longer period than the benefit of the expenditure distorts the taxpayer's income. Treating the cost as a freestanding asset depreciable over four years in the case of the aircraft engine maintenance in TAM 9618004, or three to four years in the case of engine inspections in *Ingram Indus.*, discussed above,¹⁸⁹ on a straight-line basis under section 167 minimizes the income distortion that occurs by (a) depreciating the maintenance as a reconditioned

¹⁸²The heavy maintenance costs as to the airframe amounted to \$2 million in comparison to the \$15 million acquisition cost or 13.3 percent. Rev. Rul. 2001-4, note 1 *supra* at 296. In *Ingram Indus.* the comparable percentage was 1.6 percent, but the Tax Court correctly thought that the "more telling" comparison was between the costs at issue and the cost of a completely overhauled engine, or 17 percent. Revenue Ruling 2001-4 followed the *Ingram Indus.* approach of treating cyclical expenditures as merely keeping the asset in ordinarily efficient operating condition over its anticipated useful life and thus "did not include the type of substantial capital improvements necessary to trigger the plan of rehabilitation doctrine." Rev. Rul. 2001-4, note 1 *supra* at 299.

¹⁸³Section 42 defines "substantial rehabilitation" as at least 10 percent of unadjusted cost. Fifty percent clearly is substantial. "IRS Releases MSSP Audit Guide to Grain Farmers," *Doc 95-10876* (279 pages), 95 TNT 237-21.

¹⁸⁴*Compare Wolfson Land & Cattle* and TAM 9424002, 94 TNT 118-12, with Rev. Rul. 2001-4 and TAM 9315004, note 74 *supra*; see generally Lee, *et al.*, *Rough Justice II*, note 5 *supra* at 1527 n. 179.

¹⁸⁵Rev. Rul. 2001-4.

¹⁸⁶"FedEx Argues Off-Wing Maintenance of Engines Is Ordinary Business Expense," *Doc 2001-12228* (25 original pages), 2001 TNT 98-85; see also *Petition of CNF Transportation Inc. v. Commissioner* (June 27, 2000), *Doc 2000-19093* (64 original pages), 2000 TNT 151-23 (deductibility of payments to third party for periodic inspection and maintenance of taxpayer's commercial aircraft amounting to \$29 million and \$54 million in 1989 and 1990, respectively).

¹⁸⁷FSA 200202026, note 1 *supra*.

¹⁸⁸Note 177 *supra*; see generally Lee, Walberg, and Whitesell, *Cyclical Aircraft Maintenance Costs*, note 39 *supra* at 202-04; Pavano, note 24 *supra* at 279 (argues that the Service's conclusion that cyclical maintenance gives the engine four more years of operational life is erroneous); Clancy, note 60 *supra* at 559 (same), 561 (applies restoration principle), 568 (reads *Norwest Corp.* as not limiting general plan of rehabilitation doctrine to assets not in operative condition as *dicta*), and 572 (adopts notion that better matching is with past income rather than future income). See also Deborah A. Geier, "The Myth of the Matching Principle as a Tax Value," 15 *Am. J. Tax Pol'y* 17, 42-5 (1998) (future benefit expenses generally should not be currently deductible under income tax system because such treatment is the hallmark of a consumption tax regime); Coolidge, note 127 *supra* at 790 ("The matching principle remains a restricted proposition — it only reaches income generated by a business's expenses. It guards the line between costs that affect present income and those that affect future income. Current costs cannot, in any world, produce past income. . . . [The prior] pollution may have produced the need for the current cleanup expenses, but the expenses themselves remained a later choice within [an entity's] discretion.").

¹⁸⁹See notes 169-71 *supra* and accompanying text.

engine purchase under section 168 over 10 years,¹⁹⁰ or (b) currently deducting the cost. Alternatively, if the recurrence period is short enough and the expenditure relatively small enough, under a balancing test a current deduction could be appropriate. But these factors should be expressly relied on rather than an overly broad “still in operating condition” rubric as in *Ingram Indus.*

In *Moss v. Commissioner*¹⁹¹ the Service sought to capitalize the expenditures for repainting and wallpapering motel rooms, which were done on a two- to three-year cycle, to the cost of the motel building, itself recoverable then over an almost 30-year period, while the capitalized costs of longer-lived beds and furniture were recoverable over a 7½-year period using a front-loaded accelerated depreciation rate.¹⁹² The review court in *Moss* likely was pushed in part toward its current deduction holding by the Service’s inequitably seeking capitalization and recovery over a much longer period than the repair cycle. Before *INDOPCO*, a similar inequitable Service litigating posture lead some courts (and Congress at times in committee reports)¹⁹³ to favor the, since discredited by *INDOPCO*, creation of a separate asset prerequisite to capitalization.¹⁹⁴ The Fourth Circuit described the Commissioner’s position in one of the bank credit card expansion costs taxpayer victories decided under that rubric as “an attempted overreaching by the tax collector. If he failed, he had less basis for protest than if he had confined his demands to those which were properly Caesar’s”).¹⁹⁵

C. Depreciation as a Freestanding Intangible

In *Wolfsen Land & Cattle v. Commissioner*,¹⁹⁶ the taxpayer incurred substantial costs in dredging irrigation

ditches every 10 years when it became dysfunctional in lieu of performing annual maintenance. The parties presented the court with two income-distorting options: either allow a current deduction of the substantial costs or capitalize the costs to the nondepreciable basis of the land with an indefinite useful life. *Wolfsen Land & Cattle* properly viewed *both* of the opposing choices — currently deducting (in the 10th year) or capitalizing the costs to the irrigation system, which was nondepreciable since it was of indefinite life — as distorting the taxpayer’s income.

[W]e are faced with something of a conundrum, how do we treat a maintenance-type expense substantial in amount, which only restores its subject to its original operating condition, yet need be repeated only on the average of every 10 years and is performed on a subject of indefinite life.

To permit a current deduction of such a large expenditure with a beneficial effect lasting on the average of 10 years would surely distort that year’s income. Yet to deny even an amortization deduction for an expenditure with a specific demonstrable beneficial life on the grounds that its deductibility is contaminated by its relationship to an asset of indefinite life, i.e., the land, would similarly require an uneven reporting of income.¹⁹⁷

The Tax Court resolved this conundrum and effected clear reflection of income by giving “independent status to those expenditures on the basis that they create a free-standing intangible asset with an amortizable 10-year life.”¹⁹⁸ (Similarly gates in the irrigation system that were replaced every 5 years were held depreciable over a 5-year period.) True, in *Wolfsen Land & Cattle* the “repaired” asset was almost dysfunctional while in *Ingram Industries* it was not; however, had the taxpayer in *Wolfsen Land & Cattle* carried out the re-dredging in the ninth year when the irrigation ditch was not yet dysfunctional,¹⁹⁹ the *Ingram Industries* test would have been met, but under *Wolfsen Land & Cattle* distortion of income still would have resulted from currently deducting a expenditure with a nine-year future benefit. An even more striking example is TAM 9424002²⁰⁰ where offshore pumping stations were originally 30 meters above sea level and after subsidence of three meters (first detected in 1977, confirmed in 1984) were raised 6 meters at a cost of \$471 million (completed in 1987). If the subsidence had been corrected (back to 30 meters) while the pumping stations were still operable (say in 1977 or when subsidence was only 2 meters), under *Ingram Indus.* the huge expenditure would be currently deductible. The substantial tax savings from a current deduction could

¹⁹⁰Section 168(c).

¹⁹¹Note 18 *supra* at 839-40.

¹⁹²Sections 168(c) and (d)(1) and (4)(A); Lee, Capitalization Rules, note 36 *supra* at 677-78.

¹⁹³H.R. Rep. No. 96-1278, 96th Cong., 2d Sess. 11 (1980), S. Rep. No. 99-313, 99th Cong., 2d Sess. 141 and n. 38 (1986); H. R. Rep. No. 103-66, 103rd Cong., 1st Sess. 760-61 (1993) (discussions as to costs of self-created intangible assets being deductible under current law implicitly relying on separate asset prerequisite to capitalization). This legislative history, being long subsequent to enactment of section 162 and its predecessors, cannot control a doctrine based on section 162 under the rubric that “the views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one.” *United States v. Price*, 361 U.S. 304, 313 (1960); *United States v. Vogel Fertilizer Co.*, 455 U.S. 16, 33 n.14 (1982); *Sierra Club, Inc. v. Commissioner*, 86 F.3d 1526, 1534, *Doc 96-18450* (24 pages), 96 TNT 124-13 (9th Cir. 1996).

¹⁹⁴Lee, Start-Up Costs, note 27 *supra* at 9-10; Lee, *et al.*, Rough Justice I, note 5 *supra* at 638-42 and n. 18 (Service authorities reluctantly adopted separate asset doctrine). This subsequent legislative history should not broaden deductibility of business expansion costs under section 162, see note 193 *supra*, despite the arguments of many. *E.g.*, “Comments of Tax Executives Institute, Inc. on Notice 96-7 Request for Comments on Further Capitalization Guidance Submitted to the Internal Revenue Service March 20, 1996,” *Doc 96-9048* (23 pages), 96 TNT 60-19, paras. 39, 42.

¹⁹⁵*NCNB I*, note 100 *supra* at 959-60.

¹⁹⁶Note 61 *supra* at 8.

¹⁹⁷*Id.* at 26-7.

¹⁹⁸*Id.* at 27.

¹⁹⁹The canals in question only became dysfunctional at the end of 10 years when the hydraulic capacity of the ditches became so reduced that they could no longer irrigate the fields. *Id.* at 15, 25.

²⁰⁰Note 184 *supra*.

offset the additional economic costs of repeating the raising earlier this time and the next time.

In *Vanalco, Inc. v. Commissioner*²⁰¹ the government and the taxpayer “stipulated” that cell linings of aluminum reduction cells have an average useful life of three years. The Tax Court held that the cost of removing and replacing the exhausted cell lining was around \$23,000, or about 22 percent of the cost of the rehabilitated reduction cell. “Thus, the cell lining has a life that is independent of the cell unit as a whole.”²⁰² The Tax Court found “that replacing the cell linings cannot be classified as an incidental repair, and the cost must therefore be capitalized.”²⁰³ Presumably the Service and the Tax Court allowed recovery of the annual costs of replacing cell linings (which were quite substantial in the aggregate)²⁰⁴ over that three-year period. The technical problem is that section 198 does not work that way; it prohibits composite depreciation and apparently even if the cell lining were treated as a separate asset would place it into the catch-all seven-year recovery period category.²⁰⁵ The more conceptually accurate approach would be to treat the cell-lining replacement cost as a freestanding amortizable intangible, depreciable straight-line over a three-year period.

The common sense freestanding depreciable intangible solution is equally applicable to cyclical engine maintenance and the re-bricking of the aluminum reduction cell costs. Unfortunately, the Service to date generally has refused to adopt the depreciation of a freestanding intangible asset approach to recurring costs.²⁰⁶ Consequently, it often strains to find an appropriate depreciable asset that could have the recurring costs tied to it. For example, in the case of employee training costs, the Service initially permitted depreciation of capitalized new nuclear power plant employee training costs over the life of the building in which the workforce was employed.²⁰⁷ Contemporaneously, the Service capitalized training costs as start-up costs of a new plant in an existing lumber business as a depreciable intangible asset — “an operational fiberboard plant.”²⁰⁸ Subsequently, during the period the Service followed the separate asset doctrine,

it allowed a current deduction for the costs of training a work force in connection with the establishment of a new manufacturing facility by a taxpayer with similar existing operational plants in other locations.²⁰⁹ Later, the Service amortized employee training costs over the life of a plant’s 40-year Nuclear Regulatory Commission license.²¹⁰ The PCP remediation cost TAM similarly capitalized the soil remediation costs to the taxpayer’s natural gas piping, its chief operating asset.²¹¹ This awkward progression strongly indicates that the Service should recognize generally the approach of capitalizing costs as freestanding assets depreciated over their own useful lives,²¹² rather than fudging in litigation by stipulating to the recurrence cycle as the useful life of the replacement without regard to section 168. (How is this “stipulation” approach applicable to other taxpayers?) Otherwise as in *Moss* it runs the risk that a court may find a current deduction less income distorting than overly long depreciation.²¹³ This may have underlain in part the result in *Ingram Indus.* In Revenue Ruling 2001-4 the Service itself appears to have given up the fight and allowed a current deduction of substantial costs benefitting an eight-year period.²¹⁴ Administratively, Examination is going even further and simply allowing the costs of the first two heavy maintenance visits to be currently deductible.²¹⁵

VI. Conclusion

The article reveals that all of the recent authorities considering cyclical expenses or toxic substance remediation, to which the general plan of rehabilitation doctrine has been applied at least sporadically,²¹⁶ are at least partially incorrect in reasoning or result, creating distortion of the taxpayer’s income. For instance, the Tax Court in *Ingram Indus.* conceptualized expenditures recurring every 3 years as maintaining a 40-year asset by maintenance at 3-year intervals.

The toxic materials remediation cases are equally irreconcilable and wrong (for different reasons). *Norwest Corp.* appears to have applied the *Plainfield Union* restoration principle by comparing the value of the remediated property after clean-up with the value before the toxicity was discovered (but incorrectly applied the general plan of rehabilitation by violating the reverse rule of parity basis for the latter doctrine). In contrast *United Dairy Farmers* did not so apply the res-

²⁰¹Note 1 *supra* (The Ninth Circuit in affirming the Tax Court on this issue did not discuss the general plan of rehabilitation yet it did as to another issue).

²⁰²*Id.*

²⁰³*Id.*

²⁰⁴*Vanalco* reported a repair expense of \$4.4 million for replacing 206 cell linings in 1992 and \$4.2 million for the cost of replacing 192 cells in 1993. Brief for Appellee, *Vanalco, Inc. v. Commissioner*, On Appeal to the Ninth Circuit (Nov. 14, 2001), *Doc 2001-29480* (52 original pages), 2001 TNT 241-24, para. 15.

²⁰⁵Section 168(e)(3)(C)(2).

²⁰⁶*But cf.* TAM 9424002, note 184 *supra* (using the period of recurrence as the useful life to depreciate the costs incurred to raise a sinking seawall).

²⁰⁷See TAM 7509099440A (Sept. 9, 1975).

²⁰⁸See TAM 7504281070A (Apr. 28, 1975); *cf.* GCM 37,500 (Apr. 5, 1978) (suggesting, but not ruling, that pre-opening costs like training should be capitalized and amortized over the life of the facility).

²⁰⁹See TAM 8303012 (Oct. 7, 1982), *modifying* TAM 8204061 (Oct. 28, 1981).

²¹⁰See TAM 9430003, 94 TNT 149-31 (Apr. 22, 1994).

²¹¹See note 111 *supra*.

²¹²Lee, Walberg, and Whitesell, Cyclical Aircraft Maintenance Costs, note 39 *supra* at 205, 215-19.

²¹³Lee, Capitalization Rules, note 36 *supra* at 677.

²¹⁴The Service is reported to have negotiated an industry-wide resolution of aircraft maintenance costs with the airline industry. Amy Hamilton, “IRS Negotiating Resolution of IN-DOPCO-type Issues With Two Industries,” *Tax Notes*, Feb. 5, 2001, p. 728.

²¹⁵See note 187 *supra* and accompanying text.

²¹⁶Compare *Vanalco* with *Ingram Indus.* and Rev. Rul. 2001-4.

toration principle, overlooking the acquisition cost doctrine, which would turn on whether the remediation was anticipated at the time of purchase.

The fundamental error in all cases was reliance on tests, or better talismans,²¹⁷ all originating before the development of determining capitalization versus a current deduction on the basis of which would produce less or no distortion of income. Had the courts and the Service considered these capitalization versus expensing/repair versus improvement cases in light of minimum distortion of income (for example, substantial future benefits mandates capitalization unless the benefit is relatively short term or depreciation is unavailable or the recovery period extends over a period substantially longer than the period benefited) and realized that the general plan of rehabilitation doctrine is but a manifestation of the policy that neither a taxpayer purchasing nor a taxpayer creating or enhancing her asset should be tax advantaged or disadvantaged compared to the other, this Serbonian Bog of conflicting, erroneous authorities would not have been created. The guidance as to repair costs now under consideration offers a perfect opportunity to drain this Serbonian Bog and not fix it in concrete.

²¹⁷Courts use "talisman" as metaphor for a "magical power" that wards off the scrutiny of the trier of fact, blinding her to other relevant factors and, thus, dictates the tax consequences of the transaction. *In re Lane*, 742 F.2d 1311, 1315 (11th Cir. 1984); *United States v. Winters*, 174 F.3d 478, 482 (5th Cir. 1999); *Smith v. Commissioner*, 65 F.2d 37 (5th Cir. 1995). See generally *Commissioner v. Duberstein*, 363 U.S. 278, 284-85 (1960).