

**Norwest Corp. v. Commissioner**  
108 T.C. 265 (1997)

JACOBS, *Judge*: . . . .

The issues for decisions are: 1 (1) Whether petitioner is entitled to deduct the costs of removing asbestos-containing materials from its Douglas Street bank building . . . .

GENERAL FINDINGS

One of petitioner's subsidiaries, Norwest Bank Nebraska, N.A. (Norwest Nebraska), owns a building at 1919 Douglas Street in Omaha, Nebraska (the Douglas Street building or building). The Douglas Street building is a three-story commercial office building that occupies half a square block and has a lower level parking garage. Norwest Nebraska constructed the building in 1969 at a \$ 4,883,232 cost. During all relevant periods, Norwest Nebraska used the Douglas Street building as an operations center as well as a branch for serving customers.

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In 1985 and 1986, Norwest Nebraska consolidated its "back room" operations at the Douglas Street building. Pursuant to that process, Norwest Nebraska undertook to determine the most efficient means for providing more space to accommodate the additional operations personnel within the building. The planning process indicated that the building needed a major remodeling. (The building had not been remodeled since its construction; Norwest Nebraska usually remodels its banks every 10 to 15 years.) Thus, by the end of 1986, petitioner and Norwest Nebraska had decided to completely remodel the Douglas Street building. In December 1986, both petitioner and Norwest Nebraska approved a preliminary budget of \$ 2,738,000 for carpet, furniture, and improvements.

The Douglas Street building was constructed with asbestos-containing materials as its main fire-retardant material. (The local fire code required that buildings contain fireproofing material.) Asbestos-containing materials were sprayed on all columns, steel I-beams, and decking between floors. The health dangers of asbestos were not widely known when the Douglas Street building was constructed in 1969, and asbestos-containing materials were generally used in building construction in Omaha, Nebraska.

A commercial office building's ventilation system removes existing air from a room through a return air plenum as new air is introduced. The returned air is subsequently recycled through the building. The area between the decking and the suspended ceiling in the Douglas Street building functioned as the return air plenum. The top part of the return air plenum, the decking, was one of the components of the building where asbestos-containing materials had been sprayed during construction.

Over time, the decking, suspended ceiling tiles, and light fixtures throughout the building became contaminated. This contamination occurred because the asbestos-containing fireproofing had begun to delaminate, and pieces of this material reached the top of the suspended ceiling.

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## DISCUSSION

At issue is whether petitioner's costs of removing the asbestos-containing materials are currently deductible pursuant to section 162 or must be capitalized pursuant to section 263 or as part of a general plan of rehabilitation. . . .

The total cost of renovating the Douglas Street building was close to \$ 7 million, comprising nearly \$ 4,998,749 in remodeling costs and approximately \$ 1.9 million 6 in asbestos removal costs. Petitioner considered the cost of all demolition done by the asbestos removal contractors (including the cost of removing the asbestos tiles) as a removal cost for both book and tax purposes. Petitioner considered the cost of any demolition done by the general contractor or one of the subcontractors a remodeling cost for both book and tax purposes. . . .

At issue is whether petitioner's costs of removing the asbestos-containing materials are currently deductible pursuant to section 162 or must be capitalized pursuant to section 263 or as part of a general plan of rehabilitation. . . .

Section 263 requires taxpayers to capitalize costs incurred for permanent improvements, betterments, or restorations to property. In general, these costs include expenditures that add to the value or substantially prolong the life of the property or adapt such property to a new or different use. In contrast, section 162 permits taxpayers to currently deduct the costs of ordinary and necessary expenses (including incidental repairs) that neither materially add to the value of property nor appreciably prolong its life but keep the property in an ordinarily efficient operating condition. See sec. 1.162-4, Income Tax Regs. . . .

In *Illinois Merchants Trust Co. v. Commissioner*, 4 B.T.A. 103, 106 (1926), which involved the cost of shoring up a wall and repairing a foundation needed to prevent a building from collapsing, the Board of Tax Appeals drew the following distinctions:

To repair is to restore to a sound state or to mend, while a replacement connotes a substitution. A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. \* \* \* Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. The one is a maintenance charge, while the others are additions to capital investment which should not be applied against current earnings. \* \* \*

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Expenses incurred as part of a plan of rehabilitation or improvement must be capitalized even though the same expenses if incurred separately would be deductible as ordinary and necessary. Unanticipated expenses that would be deductible as business expenses if incurred in isolation must be capitalized when incurred pursuant to a plan of rehabilitation. Whether a plan of capital improvement exists is a factual question "based upon a realistic appraisal of all the surrounding facts and circumstances, including, but not limited to, the purpose, nature, extent, and value of the work done".

An asset need not be completely out of service or in total disrepair for the general plan of rehabilitation doctrine to apply. For example, in *Bank of Houston v. Commissioner*, T.C. Memo. 1960-110, the taxpayer's 50-year-old building was in "a general state of disrepair" but still serviceable for the purposes used (before, during, and after the work) and was in good structural condition. The taxpayer hired a contractor to perform the renovation (which included nonstructural repairs to flooring, electrical wiring, plaster, window frames, patched brick, and paint, as well as plumbing repairs, demolition, and cleanup). Temporary barriers and closures were erected during work in progress. The Court recognized that each phase of the remodeling project, removed in time and context, might be considered a repair item, but stated that "The Code, however, does not envision the fragmentation of an over-all project for deduction or capitalization purposes." The Court held that the expenditures were not made for incidental repairs but were part of an overall plan of rehabilitation, restoration, and improvement of the building.

Petitioner contends that the costs of removing the asbestos-containing materials are deductible as ordinary and necessary business expenses because: (1) The asbestos removal constitutes "repairs" within the meaning of section 1.162-4, Income Tax Regs.; (2) the asbestos removal did not increase the value of the Douglas Street building when compared to its value before it was known to contain a hazardous substance--a hazard was essentially removed and the building's value was restored to the value existing prior to the discovery of the concealed hazard; (3) although performed concurrently, the asbestos removal and remodeling were not part of a general plan of rehabilitation because they were separate and distinct projects, conceived of independently, undertaken for different purposes, and performed by separate contractors; and (4) using the principles of section 213 (which allows individuals to deduct certain personal medical expenses that are capital in nature) and section 1.162-10, Income Tax Regs. (which allows a trade or business to deduct medical expenses paid to employees on account of sickness), the cost of removing a health hazard is deductible under section 162.

Respondent, on the other hand, contends that the costs of removing the asbestos-containing materials must be capitalized because: (1) The removal was neither incidental nor a repair; (2) petitioner made permanent improvements that increased the value of the property by removing a major building component and replacing it with a new and safer component, thereby improving the original condition of the building; (3) petitioner permanently eliminated the asbestos hazard that was present when it built the building, creating safer and more efficient operating conditions and reducing the risk of future asbestos-related damage claims and potentially higher insurance premiums; (4) the asbestos removal and the remodeling were part of a single project to rehabilitate and improve the building; (5) the purpose of the expenditure was not to keep the property in ordinarily efficient operating condition, but

to effect a general restoration of the property as part of the remodeling; and (6) section 213 and section 1.162-10, Income Tax Regs., are not analogous to the present case. . . .

We believe that petitioner decided to remove the asbestos-containing materials from the Douglas Street building beginning in 1987 primarily because their removal was essential before the remodeling work could begin. The extent of the asbestos-containing materials in the building or the concentration of airborne asbestos fibers was not discovered until after petitioner decided to remodel the building and a budget for the remodeling had been approved. Because petitioner's extensive remodeling work would, of necessity, disturb the asbestos fireproofing, petitioner had no practical alternative but to remove the fireproofing. Performing the asbestos removal in connection with the remodeling was more cost effective than performing the same work as two separate projects at different times. (Had petitioner remodeled without removing the asbestos first, the remodeling would have been damaged by subsequent asbestos removal, thereby creating additional costs to petitioner.) We believe that petitioner's separation of the removal and remodeling work is artificial and does not properly reflect the record before us.

The parties have stipulated that the asbestos removal did not increase the useful life of the Douglas Street building. We recognize (as did petitioner) that removal of the asbestos did increase the value of the building compared to its value when it was known to contain a hazard. However, we do not find, as respondent advocates, that the expenditures for asbestos removal materially increased the value of the building so as to require them to be capitalized. We find, however, that had there been no remodeling, the asbestos would have remained in place and would not have been removed until a later date. In other words, but for the remodeling, the asbestos removal would not have occurred.

The asbestos removal and remodeling were part of one intertwined project, entailing a full-blown general plan of rehabilitation, linked by logistical and economic concerns. "A remodeling project, taken as a whole, is but the result of various steps and stages." *Bank of Houston v. Commissioner*, T.C. Memo. 1960-110. In fact, removal of the asbestos fireproofing in the Douglas Street building was "part of the preparations for the remodeling project." See *id.* Before remodeling could begin, nearly every ceiling light fixture in the building was ripped down and crews removed all the asbestos-containing materials that had been sprayed on the columns, I-beams, and decking between floors, as well as the floor tiles in the customer lobbies. Only then could the remodeling contractor perform its work. As described above, the entire project required close coordination of the asbestos removal and remodeling work.

Clearly, the purpose of removing the asbestos-containing materials was first and foremost to effectuate the remodeling and renovation of the building. Secondly, petitioner intended to eliminate health risks posed by the presence of asbestos and to minimize the potential liability for damages arising from injuries to employees and customers.

In sum, based on our analysis of all the facts and circumstances, we hold that the costs of removing the asbestos-containing materials must be capitalized because they were part of a general plan of rehabilitation and renovation that improved the Douglas Street building.

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