Midland Empire Packing Co. v. Commissioner

14 T.C. 635 (T.C. 1950)

Docket No. 13340.

United States Tax Court.

Promulgated April 19, 1950.

James R. Felt, Esq., for the petitioner.

Wilford H. Payne, Esq., for the respondent.

This case involves deficiencies in declared value excess profits tax in the amount of $321.34 and excess profits tax in the amount of $4,092.72 for the taxable year ended November 30, 1943. The issue presented for decision is whether or not the sum of $4,868.81 expended by the petitioner in oilproofing the basement of its meat-packing plant during the taxable year 1943 is deductible as an ordinary and necessary business expense under section 23 (a) of the Internal Revenue Code, or, in the alternative, as a loss sustained during the year and not compensated for by insurance or otherwise under section 23 (f) of the Internal Revenue Code.

The case has been submitted on a partial stipulation of facts, documentary evidence, and oral testimony.

FINDINGS OF FACT.

The petitioner, herein sometimes referred to as Midland, is a Montana corporation and the owner of a meat-packing plant which is located adjacent to the city of Billings, Yellowstone County, State of Montana. Its returns for the period here involved were filed with the collector of internal revenue for the district of Montana. Its books of account and its tax returns were, during the taxable year and at all other times, kept on the accrual basis of accounting. Petitioner's returns were based on a fiscal year ending November 30.

The basement rooms of petitioner's plant were used by it in its business for the curing of hams and bacon and for the storage of meat and hides. These rooms have been used for such purposes since the plant was constructed in about 1917. The original walls and floors, which were of concrete, were not sealed against water. There had been seepage for many years and this condition became worse around 1943. At certain seasons of the year, when the water in the Yellowstone River was high, the underground water caused increased seepage in the plant. Such water did not interfere with petitioner's use of the basement rooms. They were satisfactory for their purpose until 1943.

The Yale Oil Corporation, sometimes referred to herein as Yale, was the owner of an oil-refining plant and storage area located some 300 yards upgrade from petitioner's meat-packing plant. The oil plant was constructed some years after petitioner had been in business in its present location. Yale expanded its plant and storage from year to year and oil escaping from the plant and storage facilities was carried to the ground surrounding the plant of petitioner. In 1943 petitioner found that oil was seeping into its water wells and into water which came through the concrete walls of the basement of its packing plant. The water would soon drain out through the sump, leaving a thick scum of oil on the basement floor. Such oil gave off a strong odor, which permeated the air of the entire plant. The oil in the basement and fumes therefrom created a fire hazard. The Federal meat inspectors advised petitioner to oilproof the basement and discontinue the use of the water wells or shut down the plant.

As soon as petitioner discovered that oil had begun to seep into its water wells and into the basement of its plant, its officers conferred with the officers of the Yale Oil Corporation and informed Yale that they intended to hold it liable for all damage caused by the oil which had saturated the ground around its packing plant. They informed the officials of Yale that they believed this condition constituted a legal nuisance, which condition they expected would continue to exist for future years, and that they were discontinuing the use of their water wells. The officials of Yale were also informed that the Federal inspectors were requiring petitioner to oilproof the basement.

A. F. Lamey, attorney at law in Billings, Montana, handled nearly all of the negotiations for the settlement of the claims made by Midland against the Yale Oil Corporation for damages resulting from the oil escaping from Yale's refineries to the premises of the packing company. He represented the Yale Corporation and the Maryland Casualty Co., which carried liability insurance with respect to Yale. Early in 1943 he went to the packing plant to inspect the basement and observed the situation as found above. He talked with Chris Shaffer, of the petitioner corporation, and informed him that Yale was not assuming any responsibility and that it was petitioner's duty to take whatever steps were necessary to minimize damages. Prior to that time, petitioner suggested piece-meal settlements, which Yale declined to consider because they felt it would be to their disadvantage to assume responsibility for any damages without a complete release. Lamey wrote to the Maryland Casualty Co., Yale's insurer, in a letter dated March 31, 1943, with reference to this situation, in part as follows:

Past experience indicates that little can be done through a conference with Mr. Shaffer, who is in charge of the plant. His demands are always exorbitant and he has never been willing to make any proposition for a complete and final settlement. He seems to have the idea that the Yale should make monthly payments on the water account, pay damages on hides each year as they are injured, etc. If we ever began making payments on that basis there would be no end to our difficulties. We therefore suggested to the Yale that we do nothing. We feel that we would have a better opportunity to dispose of this claim if the Packing Company obtained the services of a lawyer who could advise them with reference to their rights, and the limits of the Yale's responsibilities.

On June 10, 1943, Lamey again wrote to the Maryland Casualty Co. with respect to the matter of Yale's liability to Midland:

Since our letter of the 5th, we have held two conferences with representatives of the Midland Empire Packing Company. The claimant has employed M. J. Lamb of this city as attorney. At

the conferences, Mr. Frank Jacoby, a contractor, has also been present. It is our understanding that he has some interest in the packing plant. However, we know him very well. He is a competent and honest contractor.

Frank Jacoby was a construction contractor, who also did repair and improvement work at various times for petitioner corporation. He owned one-third of the capital stock of the petitioner throughout the period here involved and later became vice president of the corporation. Jacoby talked with the officers of Yale about the nature of the oil-sealing work to be done on petitioner's plant in order to insure that the work was done to the satisfaction of Yale, inasmuch as petitioner was looking for reimbursement for that amount from Yale. Midland decided to proceed with the work in the basement and Yale agreed that it should be done and that in any litigation or in any settlement that ensued it would accept the testimony of Jacoby as to the reasonableness of the cost of the work done. They also agreed to acknowledge the bills for such work as an element of damages if a settlement was later effected. The Yale officials refused to do the repair work themselves.

The president of Midland continued to refuse to give a complete release covering future damage. The letter of June 10, 1943, recited some of the items claimed by petitioner corporation, including several references to the repairs in petitioner's basement.

With respect to the delay in giving the petitioner a definite answer to the settlement of its liability, the letter stated:

It is rather difficult for the officers of the packing company to understand why we cannot give an immediate definite answer, in view of the fact that the offices of the Yale Petroleum Company are located in Billings. They have no knowledge that there is insurance coverage. We mention this so that you will understand the importance of making some decision with reference to a basis of settlement as soon as possible.

Finally, regarding the legal basis of Yale's liability to the petitioner for the damages caused by the oil, Lamey wrote to the insurance company that it was his opinion that Midland would have little difficulty in establishing liability on the part of the Yale Oil Corporation. He also noted that the item of damage claimed by the packing company could be considered as evidence of damages. The letter then stated that, while the amount needed to settle the claim might be large and the Yale Co. would not be able to get a release for future damages, when the basement repairs were completed there should be little future damage. He recommended that the claim be settled and concluded with a statement that it was to Yale's advantage that Midland was proceeding with repairs to the basement.

The original walls and floor of petitioner's plant were of concrete construction. For the purpose of preventing oil from entering its basement, petitioner added concrete lining to the walls from the floor to a height of about four feet, and also added concrete to the floor of the basement. Since the walls and floor had been thickened, petitioner now had less space in which to operate. Petitioner had this work done by independent contractors, supervised by Jacoby, in the fiscal year ended November 30, 1943, at a cost of $4,868.81. Petitioner paid for this work during that year.

The oilproofing work was effective in sealing out the oil. While it has served the purposes for which it was intended down to the present time, it did not increase the useful life of the building or make the building more valuable for any purpose than it had been before the oil had come into the basement. The primary object of the oilproofing operation was to prevent the seepage of oil into the basement so that the petitioner could use the basement as before in preparing and packing meat for commercial consumption.

After the oilproofing was completed and prior to the close of the petitioner's taxable year ended November 30, 1943, negotiations for settlement were again conducted between representatives of petitioner and the Yale Oil Corporation, at which time Yale offered to pay petitioner in cash the sum of approximately $7,500 in satisfaction of all claims asserted by Midland against Yale, provided Midland would execute a general release to Yale. Because Midland was unwilling and refused to give such release for the payment offered, no amount was in fact paid to petitioner by Yale in that year. Petitioner continued to maintain that it was entitled to a much larger amount for the general damage done to the plant by this nuisance. Negotiations had reached this point in the fiscal year ended November 30, 1943.

The petitioner thereafter filed suit against Yale, on April 22, 1944, in a cause of action sounding in tort and on November 30, 1944, joined as a defendant in such action Yale's successor, the Carter Oil Co., which had acquired the properties of Yale Oil Corporation. This action was to recover damages for the nuisance created by the oil seepage. In those proceedings the defendants demurred to the joinder of parties in the petitioner's complaint. On appeal, the Montana Supreme Court sustained the demurrer.

Petitioner subsequently settled its cause of action against Yale for $11,659.49 and gave Yale a complete release from all liability. This release was dated October 23, 1946. The recovery of the cost of the waterproofing only was reported in its excess profits and income tax returns for the year ended November 30, 1946.

The petitioner is still making claim upon the Carter Oil Co. and is endeavoring to settle that claim without suit.

Midland charged the $4,868.81 to repair expense on its regular books and deducted that amount on its tax returns as an ordinary and necessary business expense for the fiscal year 1943. The Commissioner, in his notice of deficiency, determined that the cost of oilproofing was not deductible, either as an ordinary and necessary expense or as a loss in 1943.

OPINION.

ARUNDELL, Judge:

The issue in this case is whether an expenditure for a concrete lining in petitioner's basement to oilproof it against an oil nuisance created by a neighboring refinery is deductible as an ordinary and necessary expense under section 23 (a) of the Internal Revenue Code, on the theory it was an expenditure for a repair, or, in the alternative, whether the expenditure may be treated as the measure of the loss sustained during the taxable year and not compensated for by insurance or otherwise within the meaning of section 23 (f) of the Internal Revenue Code.

The respondent has contended, in part, that the expenditure is for a capital improvement and should be recovered through depreciation charges and is, therefore, not deductible as an ordinary and necessary business expense or as a loss.

It is none too easy to determine on which side of the line certain expenditures fall so that they may be accorded their proper treatment for tax purposes. Treasury Regulations 111,[1] from which we quote in the margin, is helpful in distinguishing between an expenditure to be classed as a repair and one to be treated as a capital outlay. In Illinois Merchants Trust Co., Executor, 4 B. T. A. 103, at page 106, we discussed this subject in some detail and in our opinion said:

It will be noted that the first sentence of the article [now Regulations 111, sec. 29.23 (a)-4] relates to repairs, while the second sentence deals in effect with replacements. In determining whether an expenditure is a capital one or is chargeable against operating income, it is necessary to bear in mind the purpose for which the expenditure was made. 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. It does not add to the value of the property, nor does it appreciably prolong its life. It merely keeps the property in an operating condition over its probable useful life for the uses for which it was acquired. 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.

It will be seen from our findings of fact that for some 25 years prior to the taxable year petitioner had used the basement rooms of its plant as a place for the curing of hams and bacon and for the storage of meat and hides. The basement had been entirely satisfactory for this purpose over the entire period in spite of the fact that there was some seepage of water into the rooms from time to time. In the taxable year it was found that not only water, but oil, was seeping through the concrete walls of the basement of the packing plant and, while the water would soon drain out, the oil would not, and there was left on the basement floor a thick scum of oil which gave off a strong odor that permeated the air of the entire plant, and the fumes from the oil created a fire hazard. It appears that the oil which came from a nearby refinery had also gotten into the water wells which served to furnish water for petitioner's plant, and as a result of this whole condition the Federal meat inspectors advised petitioner that it must discontinue the use of the water from the wells and oilproof the basement, or else shut down its plant.

To meet this situation, petitioner during the taxable year undertook steps to oilproof the basement by adding a concrete lining to the walls from the floor to a height of about four feet and also added concrete to the floor of the basement. It is the cost of this work which it seeks to deduct as a repair. The basement was not enlarged by this work, nor did the oilproofing serve to make it more desirable for the purpose for which it had been used through the years prior to the time that the oil nuisance had occurred. The evidence is that the expenditure did not add to the value or prolong the expected life of the property over what they were before the event occurred

[1] SEC. 29.23 (a)-4. REPAIRS.—The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as expense, provided the plant or property account is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, should be charged against the depreciation reserve if such account is kept. (See sections 29.23 (l)-1 to 29.23 (l)-10, inclusive.)

which made the repairs necessary. It is true that after the work was done the seepage of water, as well as oil, was stopped, but, as already stated, the presence of the water had never been found objectionable. The repairs merely served to keep the property in an operating condition over its probable useful life for the purpose for which it was used.

While it is conceded on brief that the expenditure was "necessary," respondent contends that the encroachment of the oil nuisance on petitioner's property was not an "ordinary" expense in petitioner's particular business. But the fact that petitioner had not theretofore been called upon to make a similar expenditure to prevent damage and disaster to its property does not remove that expense from the classification of "ordinary" for, as stated in Welch v. Helvering, 290 U. S. 111, "ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. * * * the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack. Cf. Kornhauser v. United States, 276 U. S. 145. The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part." Steps to protect a business building from the seepage of oil from a nearby refinery, which had been erected long subsequent to the time petitioner started to operate its plant, would seem to us to be a normal thing to do, and in certain sections of the country it must be a common experience to protect one's property from the seepage of oil. Expenditures to accomplish this result are likewise normal.

In American Bemberg Corporation, 10 T. C. 361, we allowed as deductions, on the ground that they were ordinary and necessary expenses, extensive expenditures made to prevent disaster, although the repairs were of a type which had never been needed before and were unlikely to recur. In that case the taxpayer, to stop cave-ins of soil which were threatening destruction of its manufacturing plant, hired an engineering firm which drilled to the bedrock and injected grout to fill the cavities where practicable, and made incidental replacements and repairs, including tightening of the fluid carriers. In two successive years the taxpayer expended $734,316.76 and $199,154.33, respectively, for such drilling and grouting and $153,474.20 and $79,687.29, respectively, for capital replacements. We found that the cost (other than replacement) of this program did not make good the depreciation previously allowed, and stated in our opinion:

In connection with the purpose of the work, the Proctor program was intended to avert a plant-wide disaster and avoid forced abandonment of the plant. The purpose was not to improve, better, extend, or increase the original plant, nor to prolong its original useful life. Its continued operation was endangered; the purpose of the expenditures was to enable petitioner to continue the plant in operation not on any new or better scale, but on the same scale and, so far as possible, as efficiently as it had operated before. The purpose was not to rebuild or replace the plant in whole or in part, but to keep the same plant as it was and where it was.

The petitioner here made the repairs in question in order that it might continue to operate its plant. Not only was there danger of fire from the oil and fumes, but the presence of the oil led the Federal meat inspectors to declare the basement an unsuitable place for the purpose for which it had been used for a quarter of a century. After the expenditures were made, the plant did not operate on a changed or larger scale, nor was it thereafter suitable for new or additional uses. The expenditure served only to permit petitioner to continue the use of the plant, and particularly the basement for its normal operations.

In our opinion, the expenditure of $4,868.81 for lining the basement walls and floor was essentially a repair and, as such, it is deductible as an ordinary and necessary business expense. This holding makes unnecessary a consideration of petitioner's alternative contention that the expenditure is deductible as a business loss, nor need we heed the respondent's argument that any loss suffered was compensated for by "insurance or otherwise."

Decision will be entered under Rule 50.