RECEIVED
DEC 14 1992

F asbestos

PATRIC KINS

FACSIMILE TRANSMISSION COVER SHEET

FROM: Laura Rippey x2597

PITTSBURGH INDUSTRIAL HYGIENE, SAFETY AND PRODUCT RELIABILITY

FAX NO.: (412) 553-3835, OR

225-3835 (ALCOA PHONE NETWORK)

PLAINTIFF'S
EXHIBIT
AL-1319

TO: S. McKinney, Tennessee / S. Anderson, Massena

FAX NO.: 8-246-2617 / 8-240-4203

DATE 9 Dec. 1992

NO. PAGES 3 (INCLUDING COVER SHEET)

Subject: asbestos Capitol Expense – Yes / No ?

A number of weeks ago a bullet was in the Friday report about an IRS "advice memorandum" that treated asbestos removal as a Capitol expense. This was not a ruling by the IRS. There has been no change in the

ALUMINUM COMPANY OF AMERICA

ALCOA BUILDING

PITTSBURGH, PENNSYLVANIA 15219

ALCOA

cc: RM James
C. F. DiMascio / Penny Bober (Newsletter)
P. R. Atkins, 19
Asbestos file

HQ 014439

tax code. Pittsburgh accounting says that neither asbestos removal nor the replacement with an alternative insulating material is a capitol expense. However in cases where <u>improvements</u> are made the costs are capitol.

Attached for your information is the original clipping from financial times which resulted in the item in the Friday Report.

IRS Position May Boost Cost Of Environmental Work

Agency Appears To Be Restricting Deductions For Other Expenses, Too

By Vineeta Anand
In Washington

The cost of doing business in America may have ratcheted up again, thanks to a recent pronouncement by the Internal Revenue Service.

In a technical advice memorandum not yet released publicly, the IRS said an unidentified company could not treat the cost of removing asbestos insulation from machinery and replacing it with new insulation as an

Finance

"ordinary and necessary" business expense to be deducted in the year in which it occurred.

The memo appears to be the first piece of evidence that the IRS is extending the reasoning of a Supreme Court ruling earlier this year to deny tax deductions for a wide range of business expenses.

In February, the Supreme Court ruled in Indopco Inc. vs. Commissioner that companies could no longer deduct the costs of friendly takeovers as "ordinary and necessary" business expenses because friendly acquisitions result in economies of scale, synergies, market power and other long-term benefits to shareholders that last beyond one year.

The IRS is also expected shortly to publish a second memo regarding the deductibility of asbestos removal and Superfund cleanup costs.

In addition, *Investor's Business Daily* has learned of another instance in which the IRS blocked a company from deducting as an ordinary business expense the fees paid to a management consulting firm for a study of the company's data processing and management information systems.

The company was represented by D. Royce Powell, a partner in the Raleigh, N.C., law firm of Maupin Taylor Ellis & Adams, a source said. Powell did not return numerous phone calls.

The IRS has issued another memo to a utility regarding whether it could deduct the legal and accounting expenses for conducting a "prudency audit" needed to justify rates. In this instance, however, the company was allowed to deduct the expenses, according to Mary Lou Fahey of the Tax Executives Institute.

In its still-unpublished memo, the IRS argued that asbestos removal could not be treated as a tax-deductible repair because it produced long-term benefits to the company by reducing health risks to workers and making the equipment more marketable. The agency said these costs must be treated as capital expenditures instead.

The memo was first cited by the newsletter Tax Notes Today Aug. 20.

The company had argued that the removal of asbestos insulation was similar to other routine repairs and maintenance work performed on machinery. Moreover, the company noted that because the new insulation material is about 10% less effective in blocking heat than asbestos insulation, it will not accrue long-term benefits from reduced energy costs or increased equipment life.

Finally, the company said the removal of asbestos simply restored the original value of the equipment and did not enhance its value in any way.

But the IRS contended that the removal of asbestos insulation should be capitalized rather than treated as an ordinary business expense because it pre-emptively lowered the company's exposure to health and safety liabilities. It also said the asbestos' effectiveness as insulation had not diminished in any way.

Cabell Chinnis, a tax attorney in Latham & Watkins' Washington office, said the IRS' argument that the expenses should be capitalized because they produce long-term benefits is a specious one because all repairs enhance value.

"A repair, if properly performed, will increase the value of the property relative to its value before the repair, so this test here that says the removal increases the value of the property does not help us at all," he said.

Capital expenditures associated with tangible assets must generally be amortized over the life of those assets. Capital expenditures not associated with any specific assets may end up never being deducted.

Although the IRS did not specify the length of time over which the cost of replacing the asbestos insulation must be amortized, it could presumably be deducted over the life of the equipment in question.

"Think of it. How many companies have asbestos problems? Many, many, many," observed Lester W. Droller, tax partner in the law firm of Jones, Day, Reavis & Pogue.

Droller, who expects the company in question to dispute the IRS memo in court, anticipates IRS agents will extend the application of this memo to various other environmental cleanups — of PCBs and other carcinogenic substances, ground and water contaminations, and cleanups of Superfund sites.

The memo also raises the troublesome question of whether companies can deduct the costs of cleaning up land or dump sites that they do not own.

Most importantly, experts say the IRS memo could have a profound effect on the way American companies do business by making it harder for them to deduct not only the costs of environmental cleanups and repairs but also product advertising, employee training, fees for lawyers, investment bankers, accountants and other consultants, and a host of other activities currently treated as tax-deductible business expenses.

"I think anything that has a future benefit associated with it is subject to capitalization by agents in the field, which is what we were worried about when Indopco was decided," observed Richard J. Heigel, a partner with the law firm of Cravath, Swaine & Moore.

By denying companies the ability to take tax deductions for such expenses as environmental cleanups, which frequently run into millions of dollars, the IRS memo could affect corporate cash flow and Wall Street's perception of companies.

Companies with large environmental liabilities that could be hit hard include those in industries such as petroleum, natural resources, chemicals, heavy manufacturing and utility companies, according to Robert Willens, senior vice president at Lehman Brothers Inc. and a tax specialist.

HQ 014441