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The Deductibility of the Costs of Aircraft Maintenance

Denyse Finn Clancy

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# THE DEDUCTIBILITY OF THE COSTS OF AIRCRAFT MAINTENANCE

Denyse Finn Clancy

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I. INTRODUCTION

IN ITS CONTINUING efforts to expand the reach of section 263\(^1\) of the Internal Revenue Code,\(^2\) the Internal Revenue Service (the Service or the I.R.S.) ruled in Technical Advice Memorandum 96-18-004 (TAM 96-18-004),\(^3\) that the costs incurred by a commercial airline for major, Federal Aviation Administration (FAA) mandated inspections of its aircraft engines are not deductible expenses.\(^4\) The Service in TAM 96-18-004 instead held that these repair expenses must be capitalized pursuant to section 263.\(^5\) Section 263(a)(1) states that: "[n]o deduction shall be allowed for . . . [a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."\(^6\)

The Taxpayer in TAM 96-18-004 owned a fleet consisting of four different types of aircraft labeled A, B, C, and D respectively.\(^7\) New engines for A and B aircraft cost between $750,000 and $810,000, and new engines for C and D aircraft cost between $350,000 and $450,000.\(^8\) The issue before the Service in TAM 96-18-004 was the deductibility of the costs of the "major inspections" of the Taxpayer's aircraft engines, which pursuant to FAA regulations, the Taxpayer conducted "every 6,000 to 7,000 flight hours or approximately every [four] years."\(^9\) In a "major inspection," the Taxpayer typically would compare the status of its aircraft engines to FAA-approved manufacturers' specifications, and make repairs where the engines, because at the passage of flight hours or time, no longer met the required specifications.\(^10\) A major inspection of the Taxpayer's A and B

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\(^1\) I.R.C. § 263 (1997). All section references, unless otherwise noted, are to the Internal Revenue Code of 1986, as amended.
\(^2\) See Meade Emory et al., Costs Incurred for Inspection of Aircraft Must Be Capitalized, 85 J. TAX'N 57 (1996).
\(^5\) Id.
\(^6\) I.R.C. § 263(a)(1).
\(^8\) See id.
\(^9\) Id.
\(^10\) Id. The Taxpayer made two types of inspections to its aircraft—a "hot section inspection" and a "major inspection." Id. A "hot section inspection" was conducted every 3000 to 4000 flight hours, or approximately every one to two years, and consisted of "changing the wearable filters plus inspecting the inlet ducts, exit ducts, combustion liners, diffusers, turbine blades and stators of the engine." Id. The revenue agent did not contest the deductibility of the cost of "hot section inspections." Id. A "major inspection" consists of both the proce-
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Aircraft engines cost approximately $90,000 to $110,000 and for its C and D engines approximately $110,000 to $122,000. With regular, periodic inspection and maintenance, the Taxpayer anticipated that its engines would have a useful service life of more than twenty-two years.

The Service ruled in TAM 96-18-004 that the cost of the FAA-mandated inspections and maintenance of the aircraft engines by the Taxpayer must be capitalized:

Under the facts presented, Taxpayer's expenditures for major inspections of its aircraft engines are not incidental repair costs. Rather, these costs are more in the nature of capital expenditures under section 263 of the Code. Specifically, these expenditures result in substantial improvements to the overall condition of the engine that are not merely incidental and which 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.

Technical advice memoranda issued after October 31, 1976, are "authority for purposes of determining whether there is substantial authority for the tax treatment of an item." Moreover, they may also be used as authority to determine whether the position taken by a Taxpayer's return meets the "realistic possibility standard." Technical advice memoranda are issued pursuant to: (1) the facts specific to a certain Taxpayer; and, more importantly, (2) the facts as that Taxpayer has presented them to the Service. Thus, a Taxpayer who has not carefully marshaled its facts may receive a technical advice memorandum from the Service that may have resulted in a different holding.

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11 See id.
12 See id.
were the facts presented in a light more advantageous to the Taxpayer.\footnote{See id. at 204.} Ken Kempson, former aide to Chief Counsel Brown, explained at a tax symposium in the spring of 1997 that such might have been the case with TAM 96-18-004:\footnote{See id.}

In many cases the actual replacement of parts is a minor part of the inspection costs. Most of the costs could involve taking the engine out of the aircraft, replacing it with a rotatable engine, and then taking apart and putting back together the engine first taken out. Thus on the specific facts presented by another Taxpayer, the TAM’s conclusion of material increase in value through replacement of parts might not be readily replicated.\footnote{A rotatable part, such as a rotatable engine, is a spare part purchased by the airline at the time it purchases the aircraft. In order to prevent down time during inspections, the rotatable parts are inserted into the aircraft while the parts for which they have been substituted are undergoing inspection.}

However, even though TAM 96-18-004 may involve a set of facts that are unique, and therefore does not create precedent,\footnote{See I.R.C. § 6110(j)(3) (1997); see also Letter from Stuart L. Brown, Chief Counsel of the Internal Revenue Service, to Rep. Bill Archer, R-Tex., Chairman of House Ways and Means Committee (Oct. 1, 1996), reprinted in IRS Chief Counsel’s Response to Archer on FAA-Inspection Costs, 96 TAX NOTES TODAY 198-44 (Oct. 9, 1996) [hereinafter Brown Letter] (“Generally, a TAM is intended to provide guidance to a district director or the chief of an appeals office regarding the proper application of the law to a Taxpayer’s specific set of facts. The Code specifically states that a TAM may not be used or cited as precedent.”).} the Service has nonetheless placed such “major inspections” on the “significant issues list,” which advises agents to question their tax treatment during an audit.\footnote{See Lee et al., supra note 16, at 204.}

The airline industry has claimed that capitalizing rather than expensing the cost of its periodic inspections could result in extra costs to the industry of more than one billion dollars by the year 2004.\footnote{See Matthew L. Wald, An I.R.S. Ruling Ruffles Airline Industry Feathers, N.Y. TIMES, Oct. 5, 1996, at 1-38. Air Transport Association lawyer Richard A. Janis explained that the one billion dollar figure consists of the interest that the Service would charge for additional payments from prior years and the higher cost of depreciating rather than deducting the cost of inspections. See id. Janis explained that: “[a] deduction tomorrow is worth less than one today.” Id.} Congress has questioned whether this additional tax burden is consistent with the policy of aircraft safety.\footnote{See Letter from Rep. Bill Archer, R-Tex., Chairman of House Ways and Means Comm., to Margaret Milner Richardson, Comm’r of the Internal Revenue Service (Sept. 19, 1996), reprinted in Archer Letter to Commissioner About FAA-Inspection Costs, 96 TAX NOTES TODAY 198-44 (Oct. 9, 1996).}
House Ways and Means Committee Chair Bill Archer has written former Service Commissioner Margaret Milner Richardson asking that the Service reverse its ruling requiring airlines to capitalize the cost of FAA-mandated aircraft inspections.\textsuperscript{25} In addition to questioning the legal conclusions that the Service made in the TAM,\textsuperscript{26} Representative Archer stressed his concerns about the impact this TAM would have on aviation safety:

At a time when we should be doing everything possible to improve aviation safety, I am concerned that the Internal Revenue Service position represents a new tax burden on critical airline safety inspections and repairs. Moreover, funds potentially available for additional safety efforts could instead be claimed by the Internal Revenue Service. I believe this Internal Revenue Service position is inconsistent with the views recently expressed by Vice President Gore as a result of his commission’s review of airline safety issues and with President Clinton’s even more recent call for increased spending on airline safety.\textsuperscript{27}

Additionally, a bipartisan group of thirty members of the House Ways and Means Committee wrote a letter to Treasury Secretary Robert Rubin asking him to take action to reverse the Service’s position in the TAM.\textsuperscript{28} The group argued that at a time when “we should be doing everything we can to encourage airline safety,” the Service was instead “overstepping its authority in attempting to impose this tax penalty on air safety.”\textsuperscript{29} The lawmakers also maintained that: “[w]e do not believe the Administration intends to increase the cost of ensuring the public safety by making it more expensive to perform routine maintenance and repair of aircraft.”\textsuperscript{30}

The lawmakers quoted above dispute the Service’s position with regard to the deductibility of the costs of aircraft safety inspections based on a concern for maintaining aviation safety. In other words, they maintain that the deductibility of inspection costs is supported by FAA safety policy rather than by federal tax policy. This Comment attempts to demonstrate that Congress does not need to create an exception to federal tax policy in

\textsuperscript{25} See id.
\textsuperscript{26} See discussion infra Part IV.
\textsuperscript{27} Archer Letter, supra note 24.
\textsuperscript{28} See Bipartisan Group Says Reverse IRS Decision on Plane Inspections, 96 Tax Notes Today 196-3 (Oct. 7, 1996).
\textsuperscript{29} Id.
\textsuperscript{30} Id.
order for airlines to be able to deduct the cost of FAA-mandated inspections. Instead, this Comment attempts to demonstrate that it is consistent with existing statutory and case law to allow a deduction for the cost of FAA-mandated inspections as well as the cost of the repairs necessitated thereby. Rather than discuss policy arguments or propose new standards for determining whether the cost of an inspection should be capitalized or expensed, this Comment consists of a fact-based analysis of the components of FAA-mandated "major inspections," and then examines how the relevant statutory and case law applies to these facts. Part II discusses the elements of the FAA-required inspection and maintenance program for aircraft. Part III summarizes the statutory and case law applicable in determining whether repairs made to an asset are deductible or must be capitalized. Part IV analyzes and critiques TAM 96-18-004 in its application of law to the facts.

II. FAA-REQUIRED INSPECTION AND MAINTENANCE PROGRAM

In order for an airline to maintain its airworthiness certificate, the FAA requires the airline to develop and maintain an ongoing inspection program for its aircraft. The purpose of the inspection program is to ensure that:

(a) Maintenance, preventive maintenance, and alterations performed by [the airline], or by other persons, are performed in accordance with the certificate holder’s manual;
(b) Competent personnel and adequate facilities and equipment are provided for the proper performance of maintenance, preventive maintenance, and alterations; and
(c) Each aircraft released to service is airworthy and has been properly maintained for operation under this part.

The airline is required to develop a manual that details the programs to be followed in “performing maintenance, preventive maintenance, and alterations of [the] certificate holder’s airplanes, including airframes, aircraft engines, propellers, appliances, emergency equipment, and parts thereof.”

The aircraft maintenance and inspection program is developed by the aircraft manufacturer, documented in a mainte-
When an end-user airline purchases an aircraft, the manufacturer provides the airline with a maintenance planning document which incorporates the maintenance review board document. Any subsequent modifications made to the maintenance planning document by the end-user airline must be approved by the FAA. The majority of inspection and maintenance programs developed since 1968 have used for guidance an Airline/Manufacturer Maintenance Program Development Document, which was written through the joint efforts of the Air Transport Association of America, commercial aircraft manufacturers, domestic and foreign operators, and others, and was approved by the FAA. This document is prepared by a Maintenance Steering Group, and the most recent version is known as “MSG-3.”

MSG-3 outlines the objectives of an efficient airline maintenance program as follows:

(a) To ensure realization of the inherent safety and reliability levels of the equipment;
(b) To restore safety and reliability to their inherent levels when deterioration has occurred;
(c) To obtain the information necessary for design improvement of those items whose inherent reliability proves inadequate; and
(d) To accomplish these goals at a minimum total cost, including maintenance costs and the costs of resulting failures.

MSG-3 “identifies all scheduled tasks and intervals based on the aircraft’s certificated operating capabilities.” MSG-3 recognizes that its maintenance program is to be used as an initial maintenance template and that individual aircraft carriers and manufacturers may need to modify the maintenance programs as outlined in MSG-3 to “address operational and/or environmental conditions unique to the operator.”

MSG-3 specifically recognizes that its maintenance program is not intended to correct inherent safety deficiencies in the air-

35 See Airline/Manufacturer Maintenance Program Development Document MSG-3, Revision 2 (Sept. 12, 1993) [hereinafter MSG-3].
36 See id.
37 Id.
38 Id.
39 Id.
40 Id. at 2.
Rather, the maintenance program is only intended to prevent further deterioration of inherent safety levels. If these inherent safety levels prove to be dissatisfactory, then design modification, and not maintenance, will be necessary to remedy the safety problem. MSG-3 states that: “[a]n efficient program is one which schedules only those tasks necessary to meet the stated objectives. It does not schedule additional tasks which will increase maintenance costs without a corresponding increase in reliability protection.”

MSG-3 designates that the airline’s maintenance program should consist of two groups of tasks: (1) scheduled tasks which are to be performed at designated intervals; and (2) non-scheduled tasks which are deemed necessary from reports of malfunctions or data analysis. Because unexpected repairs are not part of the airlines’ periodic inspections, MSG-3 does not address the implementation of non-scheduled maintenance tasks. MSG-3 breaks down the scheduled tasks into five categories: (1) lubrication/servicing; (2) operation/visual; (3) inspection/functional; (4) restoration; and (5) discard. In order to achieve

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41 Id.
42 See id.
43 See id.
44 Id. at 3.
45 Id.
46 Lubrication/servicing is defined as “[a]ny act of lubrication or servicing for the purpose of maintaining inherent design capabilities.” Id. at 15.
47 An operational check determines whether an item still fulfills its intended purpose. See id. at 16. A visual check is “an observation to determine that an item is fulfilling its intended purpose.” Id.
48 An inspection may consist of a (1) detailed inspection, (2) general visual (surveillance) inspection, or (3) a special detailed inspection. See id. at 17. A detailed inspection involves extensive visual examination of a specific area of the aircraft; normal lighting is supplemented with a direct source of good lighting. Additionally, aids such as mirrors and magnifying glasses may be used, and surface cleaning may be necessary. See id. A general visual inspection entails “[a] visual examination of an interior or exterior area, installation or assembly to detect obvious damage, failure or irregularity.” Id. This type of inspection is made under normal lighting conditions; ladders or platforms may be necessary to gain access to the area being checked. See id. A special detailed inspection is an intensive examination at a specific item or assembly to detect damage or failure. See id. This type of inspection will probably necessitate special equipment and intensive cleaning, substantial access, or disassembly. See id. A functional check “is a quantitative check to determine if one or more functions of an item performs within specified limits.” Id.
49 Restoration is intended to restore the item in question to a specific safety standard; it may range from cleaning the item to repair or replacement of a part. See id.
the MSG-3's objectives of ensuring aircraft safety while at the same time minimizing cost of repair, MSG-3 employs a "decision logic diagram," which places each of the scheduled maintenance tasks into a hierarchical succession.\textsuperscript{51} First, the significant systems and components of the aircraft are identified.\textsuperscript{52} Then those significant systems and components are assigned a maintenance task that will most effectively maintain the safety and reliability of the system or component.\textsuperscript{53} Thus, for example, if mere lubrication/servicing will be effective in maintaining the safety, reliability, and economic efficiency of the item, then there is no need for an operational/visual check, inspection/functional check, restoration, or discard.\textsuperscript{54} Restoration or discard will only be considered if lubrication/servicing, operational visual/check, and a functional check would not be effective in maintaining the designated item at its inherent level of safety and reliability.\textsuperscript{55} Redesign of an aircraft item is only mandatory if none of the scheduled servicing tasks will be applicable and effective in maintaining the safety and reliability of the part or system.\textsuperscript{56}

Once the scheduled maintenance tasks are identified, they are then divided into intervals for performance.\textsuperscript{57} In general, the airline industry has divided the scheduled maintenance tasks into a series of four different checks, "A," "B," "C," and "D."\textsuperscript{58} The more frequently necessitated tasks are generally per-

\textsuperscript{50} See id. at 3. Discard is defined as the "removal from service of an item at a specified life limit." Id. at 19. It is normally required for single celled parts, such as "cartridges, canisters, cylinders, engine disks, [and] safe-life structural members." Id.

\textsuperscript{51} Id. at 3-14.

\textsuperscript{52} See id. at 6.

\textsuperscript{53} See id. at 7. Each system or component is identified as significant based on, from an engineering perspective, what might be the anticipated consequences of failure. See id. Maintenance Significant Items (MSI's) are those items whose failure: "a) could affect safety (on ground or in flight)[,] and/or, b) could be undetectable or are not likely to be detected during operations[,] and/or, c) could have significant operational impact[,] and/or d) could have significant economic impact." Id.

\textsuperscript{54} See id. at 3-14.

\textsuperscript{55} See id.

\textsuperscript{56} See id.

\textsuperscript{57} See International Air Transport Association, Airline Accounting Guideline No. 5: Accounting for Maintenance Costs (Oct. 1997) [hereinafter Airline Accounting Guideline].

\textsuperscript{58} See id. at 3.

Fleet maintenance requirements typically involve short cycle engineering checks, component checks "A", monthly checks, annual
formed in the "A" checks.\textsuperscript{59} The heaviest and most extensive checks are performed during the less frequently scheduled "D" checks.\textsuperscript{60}

III. DISCUSSION OF AUTHORITIES—STATUTORY AND CASE LAW APPLICABLE IN DETERMINING WHETHER REPAIRS MADE TO AN ASSET ARE DEDUCTIBLE OR MUST BE CAPITALIZED

A. DEDUCTION OF "ORDINARY AND NECESSARY" EXPENSES

A Taxpayer is allowed to deduct all "ordinary and necessary expenses" paid or incurred during the taxable year in carrying on a trade or business.\textsuperscript{61} There is no bright line test for what is ordinary and necessary, and the scope of these terms remains uncertain despite their inclusion in the tax law since the Revenue Act of 1913.\textsuperscript{62} The United States Supreme Court defined "necessary" in the context of section 162 as "appropriate and helpful."\textsuperscript{63} The Supreme Court left us with this nebulous criteria for what is "ordinary."

Here, indeed, as so often in other branches of the law, the decisive distinctions are those of degree and not of kind. One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.\textsuperscript{64}

For an expense to be "ordinary," it does not have to be habitual or recurring:

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. A lawsuit affecting the safety of a busi-

\textsuperscript{59} See id.
\textsuperscript{60} See id.
\textsuperscript{61} I.R.C. § 162(a) (1997). Section 162(a) states: "[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Id.
\textsuperscript{63} Welch v. Helvering, 290 U.S. 111, 113 (1933).
\textsuperscript{64} Id. at 114-15.
ness may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less [sic], 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 . . . . 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.65

The use of the terms ordinary and necessary in order to classify costs of repair as either deductible expenses or capital expenditures has declined in recent years, as more specific statutory and case law criteria have developed.66

B. INCIDENTAL REPAIRS CONTRASTED WITH REPAIRS IN THE NATURE OF REPLACEMENTS: DOES THE REPAIR ADD TO THE VALUE, SUBSTANTIALLY PROLONG THE USEFUL LIFE, OR ADAPT THE PROPERTY TO A NEW OR DIFFERENT USE?

The cost of incidental repairs that keep the property in efficient operating condition may be deducted as an ordinary and necessary business expense as long as such repairs neither (1) materially add to the value of the property nor (2) appreciably prolong its life.67 For tax purposes, the cost of a repair is treated differently from the cost of a replacement:

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 an expense. . . . Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall . . . be capitalized . . . .68

Deductions are not allowed for amounts paid for “permanent improvements or betterments made to increase the value of any property or estate” or an amount “expended in restoring property or in making good the exhaustion thereof.”69 These types of capital improvements generally include those that (1) add to the value, (2) substantially prolong the useful life, or (3) adapt the property to a new or different use.70 The burden lies on the

65 Id. at 114 (citation omitted).
66 See BITTKER, supra note 62, § 20.3.1.
68 Id.
70 See Treas. Reg. § 1.263(a)-1(b).
Taxpayer to prove that repair costs are deductible expenses rather than capital expenditures.\textsuperscript{71}

\textit{Illinois Merchants Trust Co. v. Commissioner}\textsuperscript{72} illustrates the criteria used Service to determine whether a repair (1) adds to the value, (2) substantially prolongs the useful life, or (3) adapts the property to a new or different use. In \textit{Illinois Merchants}, the Taxpayer owned a seven-story brick building which rested on a “floating foundation” of wooden piles.\textsuperscript{73} The wooden piles remained submerged under the Chicago River until an unexpected lowering of the water level in 1919 caused the piles to become exposed to air.\textsuperscript{74} The exposed portions became prey to dry rot, and the side of the building that abutted the river threatened to collapse.\textsuperscript{75} The Taxpayer attempted to correct this situation and salvage the building by removing the rotted piles and replacing them with concrete supports.\textsuperscript{76} This work entailed replacing a large portion of the ground floor of the building and shoring up the “partially collapsed wall.”\textsuperscript{77} The court held that such replacement of the wooden piles with concrete supports “did not prolong the original estimated life of the building, nor did it increase its value.”\textsuperscript{78} In language that has become oft-quoted,\textsuperscript{79} the court explained:

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

\textsuperscript{71} See Hudlow v. Commissioner, 30 T.C.M. (CCH) 894, 922 (1971); see also IN-DOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992) (“[A]n income tax deduction is a matter of legislative grace and . . . the burden of clearly showing the right to the claimed deduction is on the Taxpayer.”) (quoting Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593 (1943)).

\textsuperscript{72} 4 B.T.A. 103 (1926).

\textsuperscript{73} Id. at 104.

\textsuperscript{74} See id.

\textsuperscript{75} See id.

\textsuperscript{76} See id.

\textsuperscript{77} Id.

\textsuperscript{78} Id.

uses for which it was acquired. Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements or additions that 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.  

Applying these principles, the court in *Illinois Merchants* held that the work done to the building merely kept the building in operating condition.  

Second, the court held that even though the life of the building was prolonged from what it would have been had the repairs not been made, these repairs were merely keeping the property in operating condition for the building's expected, useful life, rather than putting the building into a new state with a longer than originally expected lifespan. The court reasoned:

There is no question but that by this expenditure the life of the building was prolonged over what it would have been after the sudden lowering of the water level in the river, but any repair increases the useful life of property over what it would have had without the repair, and hence the Commissioner's construction would prohibit the deduction of any such expenditure. The evidence is clear that the normal, useful, expected life of this building was not increased.  

The court in *Illinois Merchants* set forth the test to be used in determining whether expenditures have prolonged the useful life or increased the value of an asset. The court held that: "[t]he evidence shows that these expenditures did not add to the value or prolong the expected life of the property over what they were before the event which made the repairs necessary occurred." A later tax court decision, *Plainfield-Union Worker Co. v. Commissioner* reaffirmed the use of this test in ruling that a Taxpayer was allowed to deduct the cost of repairs made to a system of cast-iron pipes. The *Plainfield-Union* test, as it has come to be known, compares the status of the asset after the repair has been made to the status of the asset before the condi-

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80 *Illinois Merchants*, 4 B.T.A. at 106.
81 See id. at 107.
82 See id.
83 Id.
84 Id. at 108.
tion necessitating the repair. If the repair work merely restores the asset to its status prior to the occurrence of the condition that made the repair necessary, then the cost of such repair work is a deductible expense.

Finally, the court in *Illinois Merchants* noted that the insertion of the concrete supports did not adapt the building to a new or different use; this repair merely kept the building in operational condition and therefore the cost of such repair was a deductible expense.

C. The Plan of Rehabilitation Doctrine

In addition to the authority provided by the Internal Revenue Code and its attendant Regulations, the courts have created a doctrine called the “plan of rehabilitation.” The plan of rehabilitation doctrine is an “overriding precept” that if an expenditure is part of a general plan of rehabilitation, that expenditure must be capitalized, even though if viewed separately, that expenditure would constitute an ordinary, deductible business expense. Thus, a minor repair, such as fixing a door, which would ordinarily be treated as an expense, is instead treated as a capital expenditure when part of a plan of rehabilitation. When repairs made to an asset are not part of a larger plan of rehabilitation, repair expenditures must be analyzed on an individual, item-by-item basis.

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86 *Id.* at 338.
87 *See id.* at 337.
88 *See id.*
89 United States v. Wehrli, 400 F.2d 686, 689 (10th Cir. 1968).
90 *Id.*
91 *See* I.M. Cowell v. Commissioner, 18 B.T.A. 997, 1002 (1930). In *Cowell*, the Board of Tax Appeals explained how improvements made to a hotel might be deductible expenditures when made separately, yet when part of a plan of rehabilitation must be capitalized:

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.*
92 *See* Wehrli, 400 F.2d at 690.
Finally, no discussion of the deductibility of the costs of repair is complete without examining the Supreme Court’s decision in *INDOPCO*. When the Court handed down *INDOPCO* in 1992, it created increased controversy and uncertainty as to which expenditures are deductible and which must be capitalized: “The *INDOPCO* decision has . . . significantly decreased Taxpayers’ comfort regarding the deductibility of many of their expenditures and significantly increased controversy between Taxpayers and the Service regarding the deductibility of various types of expenditures.” In *INDOPCO*, the Supreme Court addressed the issue of whether investment banking fees and expenses incurred by a target corporation in a friendly acquisition could be deducted by the target corporation as ordinary and necessary business expenses under section 162 of the Internal Revenue Code. The Taxpayer in *INDOPCO* argued that because the investment banking fees and expenses did not give rise to a continuing benefit or separate and distinct asset, they should not be capitalized. The Supreme Court rejected the Taxpayer’s argument and held that such expenses must be capitalized.

In *INDOPCO*, the Supreme Court noted that “an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the Taxpayer.” In order to determine whether the cost of an asset should be capitalized or expensed, the Supreme Court focused on the timing of the revenues accrued and the expenses incurred:

The primary effect of characterizing a payment as either a business expense or a capital expenditure concerns the timing of the Taxpayer’s cost recovery: While business expenses are currently deductible, a capital expenditure usually is amortized and depreciated over the life of the relevant asset, or, where no specific asset or useful life can be ascertained, is deducted upon dissolu-

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95 *INDOPCO*, 503 U.S. at 89.
96 *Id.* at 82.
97 See *id.* at 90.
98 *Id.* at 84. (quoting Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593 (1943)).
tion of the enterprise . . . the Code endeavors to match expenses with the revenues of the taxable period to which they properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes.99

*INDOPCO* is significant because it suggests that the test as to whether a cost must be capitalized depends on whether it provides a continuing benefit: “Although the mere presence of an incidental future benefit—'some future aspect'—may not warrant capitalization, a Taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization.”100 Therefore, one reading of *INDOPCO* is that expenditures do not need to create a separately identifiable asset in order to be classified as capital expenditures; if the expenditures merely give rise to a continuing benefit that extends beyond the current year, then such expenditures “bear the indicia of capital expenditures and are to be treated as such.”101

Shortly after the Supreme Court handed down the *INDOPCO* decision, the Service issued a revenue ruling qualifying the impact of *INDOPCO* on the treatment of repair costs.102 The Service held that “[a]mounts paid or incurred for incidental repairs are generally deductible as business expenses under . . . section [162] even though they may have some future benefit.”103

The Indopco[sic] decision clarifies that the creation or enhancement of a separate and distinct asset is not a prerequisite to capitalization. That clarification does not, however, change the

99 Id. at 83-84 (citations omitted). The Treasury Regulations also address the issue of matching income and deductions:

It is recognized that no uniform method of accounting can be prescribed for all Taxpayers. Each Taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.


100 *INDOPCO*, 503 U.S. at 87.

101 Id. at 90.

102 See Rev. Rul. 94-12, 1994-1 C.B. 36.

103 Id.
fundamental legal principles for determining whether a particular expenditure can be deducted or must be capitalized. With respect to expenditures that produce benefits both in the current year and in future years, the determination of whether such expenditures must be capitalized requires a careful examination of all the facts.104

However, the Service continues to use the concept of matching expenses with income in order to determine whether the cost of an expenditure may be expensed, most notably for our purposes in the TAM addressed by this Comment.105

IV. AN ANALYSIS OF TECHNICAL ADVICE MEMORANDUM 96-18-004

The Service ruled in TAM 96-18-004 that a "major inspection" adds to the value and prolongs the useful life of the Taxpayer's aircraft engine.106 Moreover, the Service held that such inspections provide repairs to the aircraft engine in the nature of replacements, and as such must be capitalized.107 Additionally, the Service asserted that the repairs made to the engines during the "major inspections" constituted a plan of rehabilitation.108 Finally, the Service stated that "it is appropriate to require [the] Taxpayer to capitalize" the inspection and repair costs, because this would best "match expenses with the income that these expenditures helped generate."109 Each of these assertions is discussed in turn below.

A. WHETHER MAJOR INSPECTIONS SUBSTANTIALLY PROLONG THE USEFUL LIFE OF THE AIRCRAFT ENGINES

The Service stated in TAM 96-18-004 that the life of the Taxpayer's aircraft engines are substantially prolonged by the major inspections:

Under the FAA requirements, after a predetermined number of hours or cycles of operation, Taxpayer must perform a major inspection on its aircraft engines in order to maintain the aircraft's

104 Id.
105 See Tech. Adv. Mem. 96-18-004 (May 3, 1996) ("Because section 263 is designed to match expenses with the income that these expenditures helped generate . . . it is appropriate to require [the] Taxpayer to capitalize these expenditures.").
106 Id.
107 See id.
108 See id.
109 Id.
Airworthiness certificate. In Taxpayer’s case, these major inspections are performed every 6000 to 7000 flight hours or approximately every [four] years. Without this engine inspection, Taxpayer is not permitted to operate its aircraft. Thus, in effect, the anticipated service life of the Taxpayer’s engines, without such inspections, is no more than [four] years. After the inspection, the engine has new service life of up to [four] additional years until the next inspection is required. With continuous inspections, the aircraft and the engines may have an aggregate service life of [twenty-two] years or more. Accordingly, these inspections extend the service life of the engines, and with repeated inspections, allow the engines to have a service life significantly beyond the useful life anticipated for such engines without such major inspections.\textsuperscript{110}

\textit{Illinois Merchants v. Commissioner} is instructive as to the criteria that should be used to establish whether the life of a property has been extended by repairs made to the property.\textsuperscript{111} In \textit{Illinois Merchants}, the Commissioner argued that the useful life of the building had been prolonged after the Taxpayer replaced rotting wooden piles in the foundation of a building with concrete supports.\textsuperscript{112} The court disagreed with the Commissioner, pointing out that the Commissioner’s reasoning would prohibit the cost of any repair from being deductible: “any repair increases the useful life of property over what it would have had without the repair, and hence the Commissioner’s construction would prohibit the deduction of any such expenditure.”\textsuperscript{113} Instead, the court in \textit{Illinois Merchants} stated that in determining whether a repair increased the useful life of a property, the proper consideration to make is whether the repair increased the “normal, useful, expected life” of such property.\textsuperscript{114} The court stated: “The life of the property . . . relates to its probable, normal, useful life for the purpose of the allowance for the return of the capital investment.”\textsuperscript{115}

\begin{footnotes}
\textsuperscript{110} Id.
\textsuperscript{111} 4 B.T.A. 103 (1926).
\textsuperscript{112} Id. at 106. The Commissioner relied on the predecessor to Treas. Reg. § 1.162-4 (1997), which also stated that “[r]epairs 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.” Id.
\textsuperscript{113} Id. at 107.
\textsuperscript{114} Id.
\textsuperscript{115} Id.
\end{footnotes}
Prior to 1962, the depreciable life and useful life of an asset were tied together. A Taxpayer would determine the length of the asset's useful life, and the amount of depreciation taken by the Taxpayer per year would be dependent upon the length of the useful life. Whether an expenditure made with respect to such asset was a repair expense or capital expenditure was determined by when in the life of the asset the Taxpayer made repairs to the asset:

If a Taxpayer determined an asset had a short useful life to him, purportedly consistent with his retirement or replacement practices, he normally would not have many repair expenses but nevertheless would be allowed as repair expenses those amounts necessary to keep the asset in normal efficient operating condition during that short useful life. If the Taxpayer retained the asset beyond the end of that useful life, expenditures that in the early period of its use were viewed as repair expenses would, in the later period of its use, constitute capital expenditures since they resulted in extending the useful life of the property.

Thus, Taxpayers who had estimated a short, useful life for an asset would have higher depreciation deductions yet fewer deductible repair expenses than those Taxpayers who used longer useful lives for depreciation purposes. This resulted in a "balancing mechanism" in which the Taxpayer "using a shorter useful life would receive approximately the same total in deductions as the Taxpayer using a longer useful life." This balance gave the Service less incentive to challenge a Taxpayer who claimed that the repairs made to a property did not extend the useful life of the property, because if the Taxpayer claimed that the property had a long expected useful life, then the Taxpayer was taking smaller depreciation deductions than if the property were being depreciated according to a relatively shorter useful life. Therefore, a Taxpayer who claimed a useful life of thirty years might have been able to claim more repair expenses, but his depreciation deductions would have been spread out over a longer period of time:

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118 Id.
119 See id.
120 Id. See also Gen. Couns. Mem. 39,743 (Feb. 2, 1988) ("So long as Taxpayers used their declared useful life for depreciation purposes, the long-term result of the two systems was approximately the same.").
The assumption was that Taxpayers would end up in the same position whether they depreciated freight-train cars over a thirty year life and expensed all rehabilitations, or depreciated the cars over a ten year life and capitalized the rehabilitations. So long as Taxpayers used their declared useful life for depreciation purposes, the long-term result of the two systems was approximately the same. Thus, there was less incentive for the Service to challenge a claimed useful life of thirty years.\(^{122}\)

In 1962, the Service published guidelines for depreciation that differentiated the periods used for depreciation of an asset from an asset’s actual period of use.\(^{123}\) When the asset depreciation range (ADR) system was adopted in 1971, “the break between depreciable lives and useful lives was final.”\(^{124}\) Finally, in 1981, Congress created much shorter recovery periods for depreciable assets in order to “provide the investment stimulus that is essential for economic expansion.”\(^{125}\) This had the effect of creating an even greater distinction between an asset’s depreciable life and its useful life.\(^{126}\)

The Service’s job has been made more difficult for purposes of determining an asset’s probable, useful life once the link was broken between depreciable lives and physical useful lives. The Regulations state that for purposes of determining whether an expenditure prolongs the life of an asset, the proper measurement of the expected useful life of the asset is to be made “without regard to the [ADR] asset depreciation period for such asset.”\(^{127}\) Thus, a Taxpayer who asserts that his property has a service life of thirty years for purposes of determining whether a repair has prolonged the useful life of the asset will nonetheless get to depreciate the same asset on a much shorter recovery period. This elimination of the tie between the depreciable life of an asset and the actual useful life of the asset has thus eliminated the “balancing mechanism” that gave the Service less incentive to question the purported useful life of an asset.

\(^{122}\) Id.


\(^{126}\) Assets used in the commercial carrying of passengers by air have a recovery period of seven years. See Rev. Proc. 87-56, 1987-2 C.B. 674. They have an estimated useful life of approximately twenty years. See William L. Raby & Burgess J.W. Raby, Capitalizing the Costs of Aircraft Engine Overhauls, 71 Tax Notes Today 1221, 1222 (May 23, 1996).

\(^{127}\) Treas. Reg. § 1.167(a)-11(g)(1)(ii)(b) (1997).
Now that the depreciable life of an asset is no longer the criterion used to establish an asset’s useful life, determining the useful life of an asset is a fact-based question resolved only through a consideration of a number of factors:

The estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the Taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progression of the art, economic changes, inventions, and current developments within the industry and the Taxpayer’s trade or business, (3) the climatic and other local conditions peculiar to the Taxpayer’s trade or business, and (4) the Taxpayer’s policy as to repairs, renewals, and replacements.\(^{128}\)

Thus, in determining the useful life of an aircraft engine, the commercial airline’s scheduled maintenance and repair must be taken into consideration.\(^{129}\) Therefore, if a commercial airline plans to keep an aircraft engine in service for twenty-five years through the use of periodic inspections and repairs, such inspections and repairs do not extend the useful life of the aircraft engine for purposes of section 162 and section 263.

Moreover, the fact that repairs or inspections are mandated by the government does not mean that they extend the useful life of the asset for tax purposes and thereby affect the deductibility of the repair costs.\(^{130}\) In *Midland Empire Packing Co. v. Commissioner*, the Taxpayer owned a meat-packing plant and used the basement of the plant for storage purposes and to cure hams and bacon.\(^{131}\) From the time of the plant’s construction in 1917 until 1943, water from the nearby Yellowstone River had seeped into the walls and floors of the basement.\(^{132}\) Such water

\(^{128}\) Treas. Reg. § 1.167(a)-1(b) (1997) (emphasis added).
\(^{129}\) *See id.*
\(^{130}\) *See Midland Empire Packing Co. v. Commissioner*, 14 T.C. 635 (1950); *see also* Rev. Rul. 94-38, 1994-1 C.B. 35 (holding that the Taxpayer could deduct under section 162 the costs of cleaning up land and treating groundwater even though such expenditures upon the land were made “in order to comply with presently applicable and reasonably anticipated federal, state, and local environmental requirements.”).
\(^{131}\) 14 T.C. 635, 636 (1950).
\(^{132}\) *See id.*
Seepage did not interfere with the Taxpayer’s intended use of the basement. In 1943, the Yale Oil Corporation constructed an oil-refining plant approximately 300 yards up the river from the meat-packing plant. Soon thereafter, the Taxpayer discovered that oil from the oil-refining plant was seeping into the basement along with the water. As a result, the Federal meat inspectors “advised [the Taxpayer] to oilproof the basement and discontinue the use of the water wells or shut down the plant.” The Taxpayer added concrete lining to the walls and ceiling of the basement at a cost of $4,868.81 in order to prevent further seepage. The court held that such repair to the walls of the basement did not increase the useful life of the building even though such repair was mandated by the federal government:

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.

The timing of periodic FAA-mandated inspections of an aircraft engine is generally determined by the number of flight hours that an aircraft engine has been used in flight or by the passage of a certain defined calendar time. As discussed in Part II of this Comment, even the “major inspections” are merely intended to check the aircraft engine for deterioration and maintain the aircraft engine at inherent safety levels. In other words, the inspections are intended to ensure that the designated parts or systems of an aircraft engine are in a serviceable condition, and that they will remain in such serviceable condition until the next scheduled inspection. Just as in Midland Empire Packing, in which the oilproofing operation was intended

133 See id.
134 See id.
135 See id.
136 Id. at 637.
137 See id. at 638-39.
138 Id. at 639.
139 See supra text accompanying note 9.
140 See supra text accompanying notes 41-56.
merely to restore the building to its intended use by acting in compliance with federal meat packing requirements, the aircraft owners are merely maintaining the aircraft engine in a serviceable condition by complying with FAA safety requirements. Thus, under the existing statutory and case law, FAA-mandated inspections do not increase the useful life of the aircraft engine.

B. WHETHER MAJOR INSPECTIONS INCREASE THE VALUE OF THE AIRCRAFT ENGINES

In TAM 96-18-004 the Service stated that for the Taxpayer in question, the major inspections increase the value of the aircraft engines:

We believe that an inspected engine containing many new or reconditioned parts is materially more valuable than an engine that has not been inspected. Similarly, an aircraft with an engine that has been inspected and meets FAA airworthiness requirements is more valuable to Taxpayer than an aircraft with an engine that has not been inspected, and as a result, cannot be operated in its business.141

In contrast, David Fuscus, a spokesman for the Air Transport Association, argued that inspections of an aircraft and its engine do not add to the aircraft's value: "You bring an airworthy aircraft into the maintenance bay, and you go out with an airworthy aircraft."142

The courts have recognized that almost any repair will necessarily increase the value of the asset; however, such increase in value does not necessarily render the repair a capital expenditure.143 Plainfield-Union Water Co. v. Commissioner144 sets forth the "restoration principle," which is used to analyze whether the repairs made to an asset increase its value.145 Under Plainfield-Union, the proper test as to whether a repair materially enhances the value or substantially prolongs the useful life of the asset (and thus is a capital expenditure) is a comparison of the status of the asset after the repair has been made to the status of the asset before the condition necessitating the repair.146 If the re-

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142 Wald, supra note 23, at 38.
143 See id.
144 39 T.C. 333 (1962).
146 Plainfield-Union, 39 T.C. at 338.
pair work merely restores the asset to its status prior to the occurrence of the condition which made the repair necessary, then the cost of such repair work is a deductible expense.147

In Plainfield-Union, the Taxpayer was a public utility that installed a system of cast-iron pipes in order to transport water to its customers.148 After fifty years of use, the cast-iron pipes had become clogged with tuberculation after an additional water source containing “undiluted aggressive” water was introduced.149 In order to restore the carrying capacity of the pipes, the Taxpayer cleaned them and installed cement lining to prevent future tuberculation.150 The court in Plainfield-Union held that “[t]he useful life, strength, value, and capacity of the cleaned and lined water pipes were not increased by the expenditure . . . .” for cleaning and cement-lining.151 Therefore, the Taxpayer was allowed to deduct the cost of the repairs made to the pipes under section 162(a).152 The court acknowledged that “any properly performed repair adds value as compared with the situation existing immediately prior to that repair.”153 However, the test to be applied 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.”154

In contrast to the law as stated by the Service in TAM 96-18-004, the occurrence of a condition that damages an asset does not have to be “outside of normal wear and tear attributable to the use” of the asset;155 the Service has stated that the Plainfield-Union test may apply in situations other than ones in which there is “sudden and unanticipated damage to an asset.”156 Thus, the value of an asset after repair must be compared to the value of the asset before the condition necessitating the repair, even if the necessity of the repair was caused by gradual deterio-

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147 See id. at 337
148 Id. at 334.
149 Id. at 335.
150 See id. at 336.
151 Id. at 341.
152 See id.
153 Id. at 338.
154 Id.
156 Rev. Rul. 94-38, 1994-1 C.B. 35 (holding that costs incurred to clean up land and groundwater contaminated by hazardous waste are deductible as ordinary and necessary business expenses under section 162 of the Internal Revenue Code).
Applying these standards to the facts present under FAA-mandated inspections of aircraft engines, the Plainfield-Union test dictates that the comparison should be made between the status of the aircraft engine prior to the condition necessitating the inspection (the accrual of a certain number of flight hours or the passage of a specified amount of calendar time) and the status of the aircraft engine immediately after undergoing an inspection.

One outstanding issue under the Plainfield-Union test is at what point the condition necessitating an inspection should be deemed to have occurred. That is, if an aircraft engine is due to be inspected every 6000 flight hours, for purpose of the Plainfield-Union test, should the "before" status of the engine be the engine once it has flown 5999 flight hours, or the status of the engine before it has commenced even one of the flight hours? The tax treatment of the environmental costs to clean up land and to treat groundwater provides a useful analogy from which to consider the tax treatment of the FAA-mandated aircraft engine checks. On June 20, 1994, the Service issued Revenue Ruling 94-38, holding that (1) the costs incurred by a Taxpayer to clean up land and to treat groundwater that had been contaminated by the Taxpayer with hazardous waste are deductible as ordinary and necessary business expenses under section 162; and (2) costs incurred by the Taxpayer in constructing groundwater treatment facilities are capital expenditures under section 263. The Taxpayer owned and operated a manufacturing plant, which he had built on land purchased in 1970. The plant discharged hazardous waste, which the Taxpayer buried in the land on which the plant was built. In 1993, in order to comply with "presently applicable and reasonably anticipated federal, state, and local environmental requirements (the environmental requirements')," the Taxpayer decided to (1) remediate the contaminated groundwater and soil, and (2) construct a system to monitor the groundwater to ensure that the remediation had removed all hazardous waste. Accordingly, the Taxpayer excavated the contaminated soil, transported it to waste disposal facilities, and filled the decontaminated areas with fresh soil. The soil remediation continued from 1993 to 1995. In addition,

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157 See id.
158 1994-1 C.B. 35.
159 Id.
the Taxpayer constructed groundwater treatment facilities to extract, treat, and monitor contaminated groundwater.

The soil remediation and groundwater treatment had the effect of restoring the Taxpayer's land to the condition it was in before the contamination occurred. The Taxpayer planned to dispose of future waste in appropriate waste disposal facilities.

The Service held that because the groundwater treatment facilities both constituted production within the meaning of section 263A(g)(1) and had a useful life beyond the taxable year in which they were constructed, they must be capitalized. However, with regard to the soil remediation expenditures, the Service applied the Plainfield-Union test and determined that the "soil remediation and ongoing groundwater treatment expenditures do not result in improvements that increase the value of [the Taxpayer's] property because [the Taxpayer] has merely restored its soil and groundwater to their approximate condition before they were contaminated by [the Taxpayer's] manufacturing operations."160

The facts of Revenue Ruling 94-38 are analogous to the facts presented by TAM 96-18-004 in that the conditions necessitating repairs for both the Taxpayer in Revenue Ruling 94-38 and the commercial airlines are government regulations. Moreover, in both cases, the damage to the asset occurs not instantaneously, but rather over an accumulated period of time. Both the remediation of the soil and the repairs to the aircraft are necessitated the moment that any "damage" to either the soil or the aircraft engines occurs. It would be inconsistent with government regulations to allow either the soil to be contaminated or the aircraft engine to be in a state of disrepair, however slightly. The fact that the clean-up occurs some time after the environmental damage has occurred does not mean that the clean-up was not necessitated from the moment of contamination. Similarly, the fact that a certain number of hours or the passage of a defined period of time will "trigger" the need for an aircraft engine inspection does not mean that the inspection was not necessary and imminent from the moment that the first hour of flight occurred. Therefore, for purposes of the Plainfield-Union test, the status of the aircraft engine prior to its first hour of the requisite number of flight hours before inspection or prior to the passage of the first minute of the defined period of time is the status to which the "post-inspection" aircraft engine must be
compared, just as the soil immediately prior to the contamination is the soil to which the "post-decontaminated" soil is compared. Accordingly, a "post-inspection" aircraft engine shows no increase in value when compared to its state prior to logging any flight hours; indeed, if anything, there has been a decrease in value since an inspection can never make an aircraft engine like new. It can never correct the wear and degradation caused by the stresses of flight and exposure to the atmosphere or the increased physical age of the engine.

C. Repairs in the Nature of Replacements

In TAM 96-18-004, the Service argued that because the major inspection results in the replacement of parts of the aircraft’s engine, the cost of such inspection must be capitalized: “[b]oth the courts and the service have required Taxpayers to capitalize the costs of replacing the small parts of larger equipment where such expenditures have the effect of increasing the value or prolonging the useful life of the Taxpayer’s equipment.”161 One of the cases that the Service cites in support of this position is Hudlow v. Commissioner.162 In Hudlow, the court held that the $12,599.84 incurred by the Taxpayer to repair three electric forklifts was a capital expenditure.163

The court held that the extensive repairs made by the Taxpayer to three of his electric forklift trucks prolonged their useful lives and increased their value.164 The Taxpayer had experienced recurrent breakdowns with respect to its forklift trucks that frequently rendered them unserviceable, in turn causing disruptions to the Taxpayer’s business.165 The Taxpayer finally decided that he would either have to determine what was causing the breakdowns and have the trucks repaired or purchase different forklift trucks.166 Toward this end, he contracted with the dealer of the forklifts to “go over them and perform the work necessary so that they would no longer break down frequently.”167 The Taxpayer incurred repair expenses of

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162 30 T.C.M. (CCH) 894 (1971).
163 Id. at 923.
164 See id. at 923.
165 See id. at 922.
166 See id. at 921.
167 Id.
$12,599.84 with respect to the three trucks that cost approximately $14,000 each when new.168

In holding the repairs to be capital expenditures, the court stated that:

The facts as we have found them leave us with the unmistakable impression that the machines were substantially worn out, and that the work done by Industrial Trucks, Inc., was in the nature of an overhaul, which served to prolong the life of the machines and to increase their value. The cost of the work performed on the trucks to get them operating again each time they broke down might have qualified as repair expenses; but the amount involved here represented the replacement of major parts, not just to repair a breakdown, but to put the machines into such condition that they would no longer be unduly susceptible to breakdowns.169

Thus, the forklifts were not restored to the condition that they were in prior to the breakdown, but rather were transformed such that breakdowns would no longer be inherent in their nature. In addition, the court noted that the Taxpayer testified that the work done to the forklift trucks increased their value (although no facts were presented in order to make the value and useful life comparisons required by Plainfield-Union Water Co. v. Commissioner170).171 The court also noted as significant the fact that "[t]he cost of [the repair] work was financed over a period of years, with the title to the machines given as security . . . ," which the court found similar to the financing used when purchasing a new machine.172

Contrary to the statements of the Service in TAM 96-18-004, the Hudlow decision does not provide precedent for TAM 96-18-004's position that repairs made to aircraft engines must be capitalized. Rather, Hudlow is a fact-specific situation in which the court considered a number of factors before concluding that the repairs to the forklifts were capital expenditures.173 Factors of particular importance to the court were: (1) whether the repairs changed the very nature of the property (in terms of its susceptibility to future breakdowns); (2) whether only those repairs necessary to restore the property to an efficient operating

168 See id.
169 Id. at 923.
170 39 T.C. 333 (1962); see supra text accompanying notes 144-47.
171 See Hudlow, 30 T.C.M. at 923.
172 Id.
173 Id.
COSTS OF AIRCRAFT MAINTENANCE

condition were made; (3) whether the repairs materially increased the value and prolonged the useful life of the property; and (4) the method of financing used to defray the repair costs.  

The court in *Hudlow* recognized that not all repairs made in the event of a breakdown are necessarily capital expenditures, but rather explicitly stated that “*t*[he cost of the work performed on the [forklifts] to get them operating again each time they broke down might have qualified as repair expenses . . .” However, the court found that the repairs to the forklifts were capital expenditures because, in addition to the other factors listed above, the repairs substantially changed the very nature of the forklifts themselves—in particular, the forklifts were overhauled such that they would no longer be prone to breakdowns. Thus, the forklifts were not restored merely to the condition that they were in prior to the breakdown; instead, the forklifts were changed from their former state to that in which breakdowns would no longer be inherent in their nature. Because repairs to aircraft engines in an inspection merely restore the engines to the condition that they were in prior to the occurrence of the condition that necessitated the inspection, according to the *Plainfield-Union* test, such repairs are probably deductible expenses. Only if the repairs changed the condition of the engines to a state different from that which existed immediately prior to the occurrence of the event or condition that necessitated the inspection would the repairs be capital expenditures.

D. **The Plan of Rehabilitation Doctrine**

TAM 96-18-004 goes beyond asserting that the repairs made during a major inspection prolong the life and increase the value of the Taxpayer’s aircraft and aircraft engine; TAM 96-18-004 asserts that the inspection is part of a general plan of rehabilitation: “Taxpayer’s inspection activities, which involve inspecting, replacing and restoring a large portion of engine parts every predetermined number of flight hours, would comprise a general plan of rehabilitation of such engines. Accordingly, all

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174 See id. at 921-22.
175 Id. at 923.
176 See id.
177 See id.
costs incurred pursuant to that plan of rehabilitation must be capitalized.”

Traditionally, the tax court has found a plan of rehabilitation to apply only when the property in question is not in an operative condition or generally suitable for its intended use. A recent tax court decision, Norwest v. Commissioner, at first appears to contradict this precedent in that the court states: “[a]n asset need not be completely out of service or in total disrepair for the general plan of rehabilitation doctrine to apply.” In Norwest, the Norwest Bank Nebraska (the Bank) constructed a commercial office building (the Building) in 1969 at a cost of $4,883,232 for use as an operations center and as a branch for serving customers in Omaha, Nebraska. In 1985 and 1986, the Bank consolidated its “back room” operations, and in doing so developed a plan to remodel the Building such that it would be (1) modernized and (2) able to accommodate the additional personnel. The Building needed a “major remodeling;” it had not been remodeled in sixteen years and the Bank’s practice was to remodel its buildings every ten to fifteen years.

The Building had been constructed with asbestos-containing fire-proofing materials (the “asbestos-containing materials”), that were sprayed on all columns, steel I-beams, and decking between floors. Over time, the asbestos-containing materials had begun to delaminate, and the decking, suspended ceiling tiles, and light fixtures of the Building had become contaminated. The airborne asbestos fiber concentration in the

180 See Schroeder v. Commissioner, 72 T.C.M. (CCH) 185, 189 (1996) (declining to apply the rehabilitation doctrine to repairs made to two barns and a granary that were suitable for use in the Taxpayer’s farming and breeding businesses); Keller Street Dev. Co. v. Commissioner, 37 T.C. 559 (1961), aff’d in relevant part, 323 F.2d 166 (9th Cir. 1963) (holding that there was no plan of rehabilitation for repairs made to a brewery because “the brewery was in operating condition and use during the taxable years in question and had been for several years before”); Kaonis v. Commissioner, 37 T.C.M. (CCH) 792, 796 (1978), aff’d without published opinion, 639 F.2d 788 (9th Cir. 1981) (holding that the plan of rehabilitation doctrine does not apply to repairs made to a home used for production of rental income where “the property was tenantable and generally suitable for its use in the trade or business”).
182 Id. at 270.
183 See id.
184 See id.
185 See id. at 271.
186 See id.
Building at the time of the remodeling did not exceed either EPA or OSHA guidelines; however, Norwest decided to remove the asbestos-containing materials from the Building at the time of remodeling because (1) performing the remodeling would further disturb the asbestos-containing materials and cause more contamination; (2) removing the asbestos-containing materials from the Building at the same time as the remodeling was more cost efficient; (3) coordinating the removal of the asbestos-containing materials and the remodeling would minimize the inconvenience to the employees of the Building; and (4) removing the asbestos-containing materials would create a safer work environment for the employees and thereby minimize liability issues for the Bank.\textsuperscript{187} The cost of renovating the Building was $4,998,749, and the cost of removing the asbestos-containing materials was $1,900,000.\textsuperscript{188} It was stipulated by both the Bank and the Service that the removal of the asbestos-containing materials did not extend the Building's useful life.\textsuperscript{189}

The issue before the court in \textit{Norwest} was whether the cost of removing the asbestos-containing materials was deductible pursuant to section 162,\textsuperscript{190} or whether such cost must be capitalized pursuant to section 263\textsuperscript{191} or as part of a general plan of rehabilitation.\textsuperscript{192} The Bank contended, \textit{inter alia}, that (1) the removal of the asbestos-containing materials "did not increase the value of the [Building] when compared to its value before it was known to contain a hazardous substance;"\textsuperscript{193} and (2) although the removal of the asbestos-containing materials and remodeling were performed concurrently, the cost of removing the asbestos-containing materials was not part of a general plan of rehabilitation, because the remodeling and the removal of the asbestos-containing materials "were separate and distinct projects, conceived of independently, undertaken for different purposes, and performed by separate contractors."\textsuperscript{194} Significantly, the Bank conceded that the remodeling was part of a plan of rehabilitation and argued that the removal of the asbestos-containing materials was a separate project from the remod-

\textsuperscript{187} See id. at 273-76.
\textsuperscript{188} See id. at 277.
\textsuperscript{189} See id. at 284.
\textsuperscript{190} I.R.C. § 162 (1997).
\textsuperscript{191} I.R.C. § 263 (1997).
\textsuperscript{192} See \textit{Norwest}, 108 T.C. at 278.
\textsuperscript{193} \textit{Id.} at 281.
\textsuperscript{194} \textit{Id.}
The Service contended, \textit{inter alia}, that (1) by removing the asbestos-containing materials the Bank made permanent improvements that increased the value of the building, and (2) the removal of the asbestos-containing materials and the remodeling were part of a single plan of rehabilitation.\footnote{See id.}

The Service may have won the battle but lost the war in \textit{Norwest}; although the court held that the cost of removing the asbestos-containing materials must be capitalized, the court so held only because this cost was intertwined with an undisputed plan of rehabilitation, and not because it fell within the criteria set forth in section 263.\footnote{See id. at 282.} In this context, the court stated that:

\begin{quote}
We recognize . . . 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 . . . that the expenditures for asbestos removal materially increased the value of the building so as to require them to be capitalized.\footnote{Id. at 285.}
\end{quote}

With regard to the applicability of the plan of rehabilitation doctrine, the court stated that: \textquoteleft\textquoteleft[I]n 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.\textquoteright\textquoteright\footnote{Id. at 285.} This holding might appear broad at first in that it implies the applicability of the general plan of rehabilitation doctrine. However, the court's holding was actually narrow; the court held only that the removal of the asbestos-containing materials was part of the plan of rehabilitation, not whether it was appropriate to apply the plan of rehabilitation in the first instance.\footnote{Id. at 284-85}

The court reasoned that absent the remodeling of the Building, the removal of the asbestos-containing materials was neither necessary nor required by a governmental authority.\footnote{See id.} On the other hand, the court found that the remodeling could not commence without the removal of the asbestos-containing materials. Therefore, the court held that because the removal of the asbestos-containing materials and the remodeling were \textquoteleft\textquoteleftpart of one intertwined project, entailing a full-blown general
plan of rehabilitation, linked by logistical and economic concerns," the removal of the asbestos-containing materials was part of the preparations for the plan of rehabilitation and therefore must be capitalized.\textsuperscript{202} The court’s statement that "[a]n asset need not be completely out of service or in total disrepair for the general plan of rehabilitation to apply"\textsuperscript{203} is dicta; the statement does not go to the court’s holding that a plan of rehabilitation is a step-by-step process, and those steps that are integral to the plan of rehabilitation must be capitalized.\textsuperscript{204} The court specifically did not address the question of whether it was appropriate to apply the plan of rehabilitation doctrine to capital expenditures and repairs made to an asset in a serviceable condition.

Therefore, given that the rehabilitation doctrine still applies only when an asset is completely out of service or in total disrepair, the Service’s position in the TAM 96-18-004 does not appear tenable. The major inspections occur not when an aircraft engine is in a state of disrepair, but rather when the aircraft engine has flown a certain number of flight hours or a specified amount of calendar time has passed.\textsuperscript{205}

\section*{E. Matching Expenses with Income}

The Service in TAM 96-18-004 asserts that the benefits that the Taxpayer enjoys as a result of its “major inspections” will accrue to the Taxpayer in future years, and thus the cost of the inspections must be capitalized in order to match future revenue with expenses. Citing INDOPCO,\textsuperscript{206} the Service states:

\[\text{sections 162 and 263 of the Code are generally designed to provide a more accurate calculation of net income for tax purposes by matching expenses with the revenues of the taxable period to which the expenses are properly attributable. . . . Because section 263 is designed to match expenses with the income that these expenditures helped generate . . . it is appropriate to require Taxpayer to capitalize these expenditures.}\textsuperscript{207}

First, as discussed in Part III.D. of this Comment, the Service in TAM 96-18-004 appears to ignore that the Service has previ-

\textsuperscript{202} Id. at 285.
\textsuperscript{203} Id. at 280; see supra note 181.
\textsuperscript{204} See id. at 285.
\textsuperscript{206} See supra text accompanying notes 93-105.
ously stated in Revenue Ruling 94-12\textsuperscript{208} that: "[a]mounts paid or incurred for incidental repairs are generally deductible as business expenses under . . . section [162] even though they may have some future benefit."\textsuperscript{209} Second, the Service in TAM 96-18-004 assumes that the repairs made to the aircraft engine will provide future benefits. In fact, the most accurate matching of expenses to revenues would "set up a reserve out of income over the four years preceding each major engine inspection," because the deterioration causing the need for repair gave rise to revenue prior to the inspection.\textsuperscript{210} Two commentators asserted in Tax Notes that:

The aircraft engine TAM is wrong. Overhaul every four years or so does not extend the engine's ultimate life beyond what the Taxpayer might reasonably have estimated for the simple reason that any useful life estimate, by the nature of the commercial aircraft industry, has to reflect that there will be periodic engine overhauls. The revenue to which the overhaul relates is not the revenue to be derived from operation of the engines during future years. Rather, it is the revenue that has already been derived from operation of the aircraft during the prior four years.\textsuperscript{211}

Thus, under this logic, a proper "matching" of expenses to revenues would allow the deduction of the anticipated cost of repair at the time that the need for repair arises. In other words, the anticipated cost of repair could be deducted gradually according to each flight hour which has passed, until the cost has been fully deducted by the time the need arises for the "major inspection." However, section 461(h) precludes the deduction of an anticipated cost of repair prior to the actual providing of the repair services to the Taxpayer, because under section 461(h) the all events test has not been satisfied until the repairs have been performed. Therefore, given the limitations imposed by section 461(h), the next best manner in which to clearly match revenues with expenses is to deduct the costs of the "major inspection" against current income. To capitalize the expenditures made for the "major inspections" and reduce future income, as the Service in TAM 96-18-004 would have the Taxpayer do, would mean that revenues from the wrong period have been reduced. The costs arising from a "major inspection" relate to revenues earned prior to the time of the inspection;

\textsuperscript{208} 1994-1 C.B. 36.
\textsuperscript{209} Id.
\textsuperscript{210} Raby & Raby, supra note 122, at 1222.
\textsuperscript{211} Id. at 1223.
thus, the costs of the “major inspection” should be deducted immediately in order that they might be most closely matched with the revenues generated prior to the occurrence of the “major inspection.”

Finally, TAM 96-18-004 asserts that “in the case of engines owned by the Taxpayer, the major inspection costs restore exhaustion for which an allowance has been made.” Presumably, the Service means to say that this is in conflict with section 263, which states that no deduction shall be allowed for “[a]ny amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.” However, it seems that section 263 is prohibiting the taking of double deductions for the same asset; one may not depreciate and expense the cost of the same asset. In the case of the “major inspection” of an aircraft engine, the cost of such inspection has not already been taken as a deduction, therefore it is incorrect to state, as does the Service in TAM 96-18-004, that an allowance has already been made and taken for the costs of such “major inspection.”

V. CONCLUSION

The legal reasoning of the Service in TAM 96-18-004 is not supported by statute, case law, or principles of accounting. Deductions may be a matter of legislative grace, but in the area of aircraft engine inspections, this appears to be an area where grace has been granted by both statute and legal precedent.

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212 A comparison may be made between the costs associated with aircraft inspection and those associated with remedial environmental cleanup activities: [T]he costs associated with remedial cleanup activities generally are attributable to past rather than future income. For example, if, in the production of widgets, X Corporation creates a hazardous byproduct that is stockpiled on its property rather than properly disposed of, the net income for X Corporation is overstated. The reason for the overstatement of income is that disposing of the hazardous waste is an expense associated with the production of widgets already manufactured, but this expense has not yet been recognized. Rather than capitalize subsequent expenditures for environmental cleanup and reduce future income, a more accurate matching of revenues with expenses would require the costs to be deducted to offset current income.


214 I.R.C. § 263(a) (2).