

LIFE IN ALL ITS FULLNESS: A DISCUSSION OF CAPITALIZATION V. DEDUCTION

INTRODUCTION*

Every year, billions of dollars ride on the issue of capitalizing versus deducting repair expenses under Internal Revenue Code (the "Code" or "IRC") section 162.¹ Capitalization/deduction issues are the biggest issues on audit, making section 162 the single Code section generating the most dollar value controversy for business taxpayers.² Indeed, classifying repair expenses is a major tax planning issue for many American businesses. But to say that capitalization/deduction issues are financially important is only the beginning of an interesting inquiry.

More controversial is the evidence suggesting that the Internal Revenue Service (the "Service" or the "IRS") is making unfair, inconsistent decisions that ignore well-established policy considerations and cost businesses a considerable amount of money.³ Based on such evidence, this Note argues that the Service, Congress or both should do *something* to improve the current method for deciding capitaliza-

* This Note's title derives from *Welch v. Helvering*, 290 U.S. 111, 115 (1933). Judge Cardozo wrote the following regarding the distinction between a currently deductible expense and an expense that must be capitalized: "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." *Id.*

¹ For example, in a recent article in the *New York Times*, a spokesperson from the Air Transport Association stated that if the capitalization/deduction ruling in Technical Advice Memorandum 96-18-004 (May 3, 1996) were applied nationally, it could cost the airline industry more than one billion dollars between now and 2004. Matthew L. Wald, *An I.R.S. Ruling Ruffles Airline Industry Feathers*, N.Y. TIMES, Oct. 5, 1996, at 5A. The spokesperson went on to say that the one billion dollars was a combination of interest charges that would become due for overdue payments in past years and the higher cost of depreciating the expenditures over longer periods, instead of being able to take a current, lump sum deduction. *See id.*

Issues regarding capitalization versus deduction under Code § 162 are referred to herein as "capitalization/deduction" issues. *See* I.R.C. § 162 (1994). In general, to make this Note accessible to a broad audience, I have given terms of art simple definitions.

² *See* Wald, *supra* note 1; *see also* John Lee, *Professor Says IRS Shouldn't Change Position on Capitalizing Costs of Airplane Engine Overhauls*, IRS TAX CORRESPONDENCE, Oct. 18, 1996, available in WESTLAW, 96 TNT 204-11.

³ *See infra* notes 168-256 and accompanying text. *See, e.g.*, *Illinois Merchants Trust Co., Executor of the Estate of William R. Manierre*, 4 B.T.A. 103, 103 (1926); *see also* Alan Gunn, *The Requirement That a Capital Expenditure Create or Enhance an Asset*, 15 B.C. INDUS. & COM. L. REV. 443, 458 (1974).

tion/deduction issues.⁴ The status quo is unacceptable and the time is ripe for change.⁵

This Note discusses this controversy using a recent Technical Advice Memorandum (the "TAM" or "96-18-004") as a point of reference.⁶ When the IRS asked for comments on 96-18-004, numerous industrial leaders and congressional members replied, criticizing the TAM's outcome and offering alternative analyses.⁷ This suggests that business taxpayers from numerous areas realized that the TAM was further evidence of how the Service is raising revenues by making suspect decisions.⁸ The TAM's reasoning also illustrates numerous flaws in the Service's current capitalization/deduction approach.⁹ For these reasons, the TAM is a useful reference point for discussion.¹⁰

Section I of this Note provides background on the sources of law underlying capitalization/deduction issues and is divided into subsections on both statutory and case law.¹¹ This Section also illustrates how matching revenues with expenses incurred to earn those revenues impacts capitalization/deduction decisions.¹² Section II briefly examines the TAM in light of the background material in Section I.¹³ Section

⁴ See *infra* notes 168-256 and accompanying text.

⁵ See *infra* notes 168-256 and accompanying text.

⁶ See generally *Tech. Adv. Mem. 96-18-004*. The Service issues letter rulings called Technical Advice Memoranda which advise taxpayers on the proper application of tax laws to a taxpayer's return or refund. See Melissa D. Ingalls, *Indopco, Inc. v. Commissioner: Determining the Taxable Nature of a Target Corporation's Takeover Expenses*, 43 DEPAUL L. REV. 1165, 1166 n.12 (1994).

⁷ See David Field, *IRS Rule Change Upsets Airlines, Repair Deduction a Safety "Penalty,"* USA TODAY, Oct. 8, 1996, at 6B; see also Stephan G. Dollinger, *API Says Cost of Complying with Regs Should Be Currently Deductible*, IRS TAX CORRESPONDENCE, July 25, 1996, available in WESTLAW, 96 TNT 145-55 (American Petroleum Institute writing to IRS to say that costs of inspections should have been currently deductible).

⁸ See *supra* note 7 and accompanying text. The numerous reactions to the TAM also support the assertion that it is an important indicator, even though under I.R.C. § 6110, TAMs can only be cited in limited circumstances as precedent. I.R.C. § 6110 (1994). Section 6110 reads in pertinent part: "For the purposes of this section . . . [t]he term 'written determination' means a ruling, determination letter, or technical advice memorandum. . . . Unless the Secretary otherwise establishes by regulations, a written determination may not be used or cited as precedent." *Id.* In fact, the Secretary of the Treasury has limited the scope of § 6110(j)(3) by regulations. See Treas. Reg. § 1.6662-4(d)(3)(iii) (1997). The regulations state in pertinent part: "[O]nly the following are authority for purposes of determining whether there is substantial authority for the tax treatment of an item: . . . technical advice memoranda issued after October 31, 1976: . . ." *Id.* (applies to an accuracy-related penalty). Treasury Regulation § 1.6694-2 states that TAMs may also be used to determine if a policy on a tax return satisfies the realistic possibility standard. Treas. Reg. § 1.6694-2 (1997); see also *Costs Incurred for Inspection of Aircraft Must be Capitalized*, 85 J. TAX'N 57, 57 (Meade Emory et al. eds., 1996) [hereinafter *Costs*].

⁹ See *infra* notes 168-256 and accompanying text.

¹⁰ See *Costs*, *supra* note 8 and accompanying text.

¹¹ See *infra* notes 16-133 and accompanying text.

¹² See *infra* notes 27-30 and accompanying text.

¹³ See *infra* notes 134-67 and accompanying text.

III, building on this examination, analyzes the Service's current position on capitalization/deduction issues and highlights major criticisms of that position.¹⁴ This Section then discusses briefly the implications of these arguments and possible future courses of action.¹⁵

I. BACKGROUND

A. *Conceptual Background*

This Section introduces some basic tax concepts. It includes working definitions of taxable income, capital expenditure and current expense. In addition, this Section discusses the principle of matching revenues with expenses, that principle's importance in classifying costs and its importance in an accurate tax assessment. The advanced technicalities of these principles are beyond the scope of this Note. Here, it is sufficient to say that matching revenues with the costs incurred to earn those revenues is a material issue.¹⁶

1. Taxable Income Definition

For the purposes of this Note, as the examples below are greatly simplified, the concept of taxable income is straightforward.¹⁷ Businesses are allowed to deduct the ordinary and necessary costs from their total revenues to calculate their taxable income.¹⁸ Thus, one may think of taxable income as a figure determined by calculating how much money a business has taken in during the year and subtracting how much the business has paid out to earn that revenue (Revenues - Costs = Taxable Income).¹⁹

For example, assume Corporation earned \$100 in revenue during year one, but it paid \$50 in costs to earn that revenue. This made its taxable income \$50 (\$100 in revenue less \$50 in costs). Corporation's taxable income would then be multiplied by its applicable tax rate to find its tax liability for year one. Thus, if we assume Corporation's applicable tax rate was 10%, Corporation owed \$5 at the end of year one ($\$50 * 10\% = \5). With this in mind, if Corporation's taxable income was lower, its ultimate tax liability would have also decreased.

¹⁴ See *infra* notes 168-256 and accompanying text.

¹⁵ See *infra* notes 247-56 and accompanying text.

¹⁶ See *Indopco, Inc. v. Commissioner*, 503 U.S. 71, 84 (1992).

¹⁷ This Note considers taxable income only in the context of businesses.

¹⁸ See I.R.C. § 162 (1994).

¹⁹ See *id.*

2. Principle of Matching Income and Expenses

A discussion of the importance of matching a particular year's revenues with the expenses incurred to earn those revenues is also appropriate. Assume the same facts as above and also assume that Corporation's income for year two was \$125. Further assume that Corporation made Improvements to a loader at the beginning of year one. Those Improvements lasted for two years. In other words, the Improvements helped Corporation earn income during year one *and* during year two. Corporation paid for the Improvements in full at the time it made them and the Improvement costs were \$90. The \$90 Improvement costs were the only costs Corporation incurred during the two years the Improvements lasted. Also assume that the Improvements were worth \$50 at the end of year one and were totally worthless at the end of year two.

In this simplified example, taxable income is revenue received less the costs of earning that revenue.²⁰ With this in mind, if Corporation could deduct all \$90 of its Improvement costs in year one, that would distort Corporation's taxable income for both year one and year two.²¹ After all, the Improvements helped Corporation earn revenues in year one *and* in year two. If Corporation could deduct all \$90 of its Improvement costs in year one, there would be no costs to account for the \$125 in year two revenues. Thus, Corporation should have to divide the Improvement costs between years one and two in a manner that reflects how much Corporation paid to use the Improvements during those years. This division should match the Improvement costs for each year with the revenues earned from expending those costs.²²

One way to make such a division would be to treat the Improvements' \$40 decline in value during year one as the costs for earning the \$100 in year one revenues.²³ Likewise, the Improvements' \$50

²⁰ See *id.*

²¹ Considering future benefits of an expenditure is important to the classification of expenses because future benefits indicate that the expense incurred probably generates current income as well as future income. Thus, where one objective of the Code is to match expenses with the income they generate, expenses generating future benefits should be matched with future income.

Of course, nearly all expenditures will have benefits beyond the year in which they are incurred. This reality can make it hard to classify any expense as a current deduction, if the expense creates benefits beyond the current taxable year. Some commentators have suggested that, although highly unlikely, if the matching principle were carried to its extreme, no expense would be deductible. See PAUL R. McDANIEL ET AL., *FEDERAL INCOME TAXATION, CASES AND MATERIALS* 427 (3d ed. 1994); see also *infra* notes 80-82.

²² See *Indopco*, 503 U.S. at 87.

²³ This method is taken from Code § 167. See I.R.C. § 167. Section 167 reads in pertinent

decline in value during year two would be treated as the cost to earn \$125 during year two. In other words, the costs the Corporation "paid" to earn its revenues were the decline in value of the Improvements. Using this calculation, Corporation's taxable income for year one would be \$100 less the \$40 decline in the Improvement's value, yielding \$60 in taxable income. In year two, Corporation had to "pay" the remaining \$50 of the Improvements' value to earn \$125 in revenues. This made Corporation's year two taxable income \$75.

Note, these calculations attempt to "match" each year's Improvement costs with Corporation's revenues from that year.²⁴ Even though Corporation actually paid for its Improvements in year one, the matching principle distributes those costs over the years those Improvements helped Corporation earn revenue.²⁵ Because the Improvement costs helped Corporation during both years one and two, the Improvement costs must be distributed over both of those years.²⁶

3. Matching Principle as Used to Determine if Costs are Capital Expenditures or Currently Deductible

A small extension of this example illustrates how the matching concept relates to distinguishing current expenses from capital expenditures. Assume that costs that can be matched to revenues from a single year are current expenditures, while costs which can be matched to revenues from multiple years are capital expenditures (the "one year" rule of thumb).²⁷ Considering only this rule as a basis for analysis, assume that Corporation spent \$5 for Office Supplies that it exhausted in year one. Therefore, the Office Supplies only helped Corporation earn revenue during year one and should thus be matched with Corporation's \$100 year one revenues. Under the "one year" rule of thumb, the Office Supply costs would be a current expense that could properly be deducted from its \$100 year one revenues.²⁸ If the Office Supply costs were Corporation's only costs for year one, this would make Corporation's year one taxable income \$95 (\$100 in revenues - \$5 in Office Supply costs = \$95 in taxable income).

part: "There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—(1) of property used in the trade or business, or (2) of property held for the production of income." *Id.*

²⁴ See *Indopco*, 503 U.S. at 87.

²⁵ See *id.*

²⁶ See *id.*

²⁷ See *United States v. Wherli*, 400 F.2d 686, 689 (10th Cir. 1968) (using a similar "one year" rule of thumb). See generally I.R.C. §§ 162, 263; Treas. Reg. §§ 1.162-3, 1.162-4 (1997).

²⁸ See *Wherli*, 400 F.2d at 689. See generally I.R.C. §§ 162, 263; Treas. Reg. §§ 1.162-3, 1.162-4.

The Office Supply costs are different from the Improvement costs discussed above because the Office Supplies only produced revenue in year one, while the Improvements produced revenue in years one and two. The Office Supply costs are currently deductible expenses, but the Improvement costs must be capitalized over two years (deducted in installments over years one and two). Thus, under the "one year" rule of thumb described above, the Improvement costs for years one and two would be considered capital expenditures and the Improvements would be capital assets.²⁹

B. Statutory Provisions

Numerous Code provisions dictate how expenses affect taxable income.³⁰ Code sections 162 and 263 provide for an accurate calculation of taxable income by matching income with the costs incurred to produce that income.³¹ Section 162, with its attendant regulations, generally provides that businesses can deduct from taxable income the costs of producing that income.³² Section 263, with its own host of regulations, supplements section 162 by indicating that expenses for

²⁹ See *Wherli*, 400 F.2d at 689. See generally I.R.C. §§ 162, 263; Treas. Reg. §§ 1.162-3, 1.162-4.

³⁰ See, e.g., I.R.C. §§ 162, 167, 263. A lengthy discussion on the nuances of these various sections is beyond the scope of this Note. The sections quoted below are those which are most applicable to the subject matter considered herein.

³¹ See I.R.C. §§ 162, 263. Section 162 states in pertinent part: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the year in carrying on any trade or business . . ." I.R.C. § 162. The "necessary" element of this language is very easy to fulfill, as it has been defined as anything which is "appropriate and helpful" for a business. See, e.g., *Indopco, Inc. v. Commissioner*, 503 U.S. 71, 85 (1992); *Commissioner v. Tellier*, 383 U.S. 687, 689 (1966). The great ambiguity of the "ordinary" element is not readily apparent; this single word of § 162 is largely responsible for the litigation filed under this section. See *Indopco*, 503 U.S. at 85-86.

Section 263 states in pertinent part: "(a) General Rule.—No deduction shall be allowed for—(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. . . . (2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made." I.R.C. § 263. Of course, if taxpayers had to capitalize all expenses that added value to their assets, then nothing would be currently deductible—some courts have been cognizant of this and do not read the language of § 263 so literally. See, e.g., *Encyclopedia Britannica v. Commissioner*, 685 F.2d 212, 217 (7th Cir. 1982). On the other hand, as discussed below, the current trend in the Service's reasoning appears to go in just the opposite direction. See *infra* notes 197-218 and accompanying text.

³² See I.R.C. § 162. The attendant regulations state the following:

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

permanent improvements that increase the value of property must be capitalized.³³

IRC section 161 gives guidance on how to read sections 162 and 263 in conjunction.³⁴ In general terms, section 161 states that where section 263 dictates that an expense must be capitalized, such a characterization controls over a determination made under section 162.³⁵ In other words, section 161 says that where sections 162 and 263 give conflicting results, section 263 will control.³⁶

When an expense is paid to acquire a capital asset, section 167 tells a taxpayer the length of that asset's "life" for the purposes of Code sections 162 and 263.³⁷ The asset's "life" is then used to determine how quickly the taxpayer can recover the cost of the asset via deductions from taxable income.³⁸ Just as with sections 162 and 263, the policy behind this section is one of matching expenses with the income they generate.³⁹ A capital asset will be consumed as it produces income over a period of years, thus the cost of a capital asset should be recovered incrementally over the years it produces income.⁴⁰

with section 167 or charged against the depreciation reserve if such an account is kept.

Treas. Reg. § 1.162-4 (1997). As is obvious from the broad language of the statute, any exact definition of repair is not to be found therein. See *Indopco*, 503 U.S. at 86; *Welch v. Helvering*, 290 U.S. 111, 114, 116 (1933).

³³ See I.R.C. § 263; see also Treas. Reg. § 1.263(a)-1(b). The regulations state:

In general, the amounts referred to in paragraph (a) of this section include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. Amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures within the meaning of subparagraphs (1) and (2) of this paragraph.

Treas. Reg. § 1.263(a)-1(b); see I.R.C. § 162; Treas. Reg. § 1.162-4.

³⁴ I.R.C. § 161. The Code states in pertinent part: "In computing taxable income under section 63, there shall be allowed as deductions the items specified in this part, subject to the exceptions provided in part IX (section 261 and following, relating to items not deductible)." *Id.*

³⁵ See *id.*; Tech. Adv. Mem. 96-38-001 (Sept. 20, 1996).

³⁶ See Tech. Adv. Mem. 96-38-001.

³⁷ See I.R.C. § 167.

³⁸ See *id.* For example, the pertinent sections for calculating the useful life of the engines in the TAM are Treasury Regulations §§ 1.167(a)-12(d)(3)(ii), which state in pertinent part: "For the purpose of sections 162 and 263 and the regulations thereunder, whether an expenditure prolongs the life of an asset shall be determined by reference to the expected period of use of the asset in the taxpayer's business without regard to paragraph (a)(5)(ii) of this section." Treas. Reg. §§ 1.167(a)-12(d)(3)(ii). In the case of the aircraft engines in the TAM, their "expected period of use" was more than 22 years. See TAM 96-18-004; Burgess, J.W. Raby & William L. Raby, *Capitalizing the Costs of Aircraft Engine Overhauls*, SPECIAL REPORTS, May 23, 1996, available in WESTLAW, 96 TNT 102-67.

³⁹ See *Indopco, Inc. v. Commissioner*, 503 U.S. 71, 84 (1992).

⁴⁰ See *id.*

C. Financial Analysis Discussion

Another aspect of the capitalization/deduction area is the financial difference between deducting and capitalizing a given cost. The basic difference between the two is a function of the "time value of money."⁴¹ Due to the time value of money, a current deduction is worth more than capitalizing deductions incrementally and reducing future tax liabilities.⁴²

D. Capitalization/Deduction Issues in Repairs Cases

Cases in the capitalization/deduction area are difficult to harmonize.⁴³ Two factors contribute to this difficulty. First, decisions in the capitalization/deduction area are highly fact specific, making distinctions between current expenses and capital expenditures "those of degree and not of kind."⁴⁴ Second, cases in this area are usually little more than a description of the expenditure in question and a conclusion that it is, or is not, a capital expenditure.⁴⁵ Where the decision-maker does provide some substantive analysis, it sometimes directly conflicts with reasoning used in other decisions.⁴⁶

This section is broken into three parts. To provide some context, the first part is a discussion of *Indopco, Inc. v. Commissioner of Internal*

⁴¹ The time value of money can be defined in simple terms as the difference between the value of readily available funds and the right to receive funds at sometime in the future. See Ingalls, *supra* note 6, at 1170 n.32.

For example: If the taxpayer keeps \$1,000 now and puts it in the bank at 7% interest, at the end of one year the \$1,000 is worth \$1,070. Therefore, \$1,000 at the end of one year is not worth the same as \$1,000 today; it is \$70 less than what it could be. Of course this disparity grows over time. It should become clear that it is more advantageous to immediately deduct money from current taxable income than it is to receive the same amount of money in the future through depreciation.

Id.

⁴² See *id.*

⁴³ See Gunn, *supra* note 3, at 443. Although Professor Gunn's assertion is a bit dated, the cases it refers to are still good law, so it remains true today. See *id.*

While the results of these cases are conflicting, they do typically share some procedural attributes. Parties usually stipulate to the pertinent facts, except the determination as to whether a given expense was a capital expenditure or a deductible repair. See, e.g., *Plainfield Union Water Co. v. Commissioner*, 39 T.C. 333, 344 (1962); *In re Illinois Merchants Trust Co.*, 4 B.T.A. 103, 103 (1926). In addition, in every case, the burden is on the taxpayer to prove that a deduction should be allowed. See *Indopco*, 503 U.S. at 84.

⁴⁴ *Indopco*, 503 U.S. at 86 (quoting *Welch v. Helvering*, 290 U.S. 111, 114 (1933)). In *Stoelzing v. Commissioner*, the Third Circuit made a similar observation. See 266 F.2d 374, 376 (3d Cir. 1959) ("The line of demarcation between deductible repairs and additions to capital is, of course, obscure.").

⁴⁵ See Gunn, *supra* note 3, at 458.

⁴⁶ Compare *Plainfield Union*, 39 T.C. at 338 (using taxpayer's original expectations to measure

Revenue.⁴⁷ The second part deals with the current alternatives for measuring how much a given expense increases the value or prolongs the life of property.⁴⁸ The third part briefly discusses two doctrines that can transform otherwise deductible expenses into capital expenditures: (1) the rehabilitation doctrine⁴⁹ and (2) the government regulation doctrine.⁵⁰

1. *Indopco v. Commissioner*

Indopco's after effects were quite dramatic.⁵¹ One commentator found that after the decision came down, "IRS field agents were running wild, using the ruling to deny all manner of deductions."⁵² What stirred all this activity? An extension of the example discussed above will illustrate the answer.

In the example above, the rule for classifying expenditures dictated that a capital expenditure was any expense that helped Corporation earn revenues during more than one year. This rule was tied to the principle that revenues from a given year should match the expenses incurred to generate those revenues. For the sake of simplicity, the example also stated that Corporation exhausted its Office Supplies during one year and that the Office Supplies only helped Corporation earn revenues in that year. Thus, Corporation could match the Office Supply costs to the revenues from that year and deduct those costs currently.

In fact, this is only one interpretation of the Corporation's expenditure for the Office Supplies. The Office Supplies helped Corporation earn revenues during one year. On a more basic level, however, they allowed the Corporation to stay in business during that year. In turn, Corporation could earn revenues in future years. Thus, one could say that because the Office Supplies kept Corporation in business, the

increase in value), and *Illinois*, 4 B.T.A. at 107 (using taxpayer's original expectations to measure increase in value), with Rev. Rul. 88-57, 1988-2 C.B. 36, 37 (comparing asset value just before repair with asset value just after repair to measure increase in value).

⁴⁷ See *infra* notes 51-69 and accompanying text.

⁴⁸ See *infra* notes 70-89 and accompanying text.

⁴⁹ See *infra* notes 90-119 and accompanying text.

⁵⁰ See *infra* notes 120-33 and accompanying text.

⁵¹ See John W. Lee, *Doping Out the Capitalization Rules After INDOPCO*, SPECIAL REPORTS, Nov. 9, 1992, available in WESTLAW, 92 TNT 225-86.

⁵² This is true simply because the cases dealing with repairs have always looked to the future benefit of the repair as an indicator of whether an expense should be capitalized. See John Paul LeBlanc, *The Supreme Court Attempts to "Iron Out" the Wrinkles in National Starch*, 54 LA. L. REV. 437, 459 (1993); Sarah R. Lyke, *Indopco, Inc. v. Commissioner: National Starch Decision Adds Wrinkles to Capital Expenditure Issue*, 88 NW. U. L. REV. 1239, 1267-68 (1994).

Office Supplies also allowed Corporation to earn future revenues during subsequent years. Using the "one year" rule of thumb for classifying expenses, the Office Supply expenses would be capital expenditures, as they helped Corporation earn revenues from multiple years.

At first glance this result seems incorrect. After all, Corporation exhausted its Office Supplies during one year. In the following years, Corporation probably bought more office supplies to replace those that it had exhausted. It does not seem correct to attribute the revenues from subsequent years to the Office Supplies that Corporation exhausted long before. If the Service could classify the Office Supply costs as capital expenditures using this reasoning, then any expense could conceivably be deemed a capital expenditure. As a result, taxpayers would lose considerable money because they would have to capitalize all of their costs.

The *Indopco* Court's opinion suggested that expenses generating any future benefits should be capitalized, and the fear of this possible treatment for expenditures scared many taxpayers. In fact, *Indopco*'s emphasis on future benefits did not fundamentally change the analysis in repairs capitalization/deduction cases, but *Indopco* did highlight future benefits as a main factor for deciding capitalization/deduction cases.⁵³ As the extensive commentary on *Indopco* suggests, this was enough to make taxpayers look very closely at the Court's opinion.

In 1992, in *Indopco, Inc. v. Commissioner of Internal Revenue*, the Supreme Court held that professional services expenses incurred as part of a corporate merger should be capitalized.⁵⁴ In support of this holding, the Supreme Court emphasized three aspects of its pertinent precedents: 1) expenses need not create or enhance a separate capital asset in order to be capital expenditures; 2) deductions from income for expenses are exceptions to the norm of capitalization; 3) where the benefits from an expenditure extend into future years, such an expenditure is more likely to be matched appropriately to future income via capitalization or amortization.⁵⁵

In *Indopco*, the taxpayer was a corporation that had paid acquisition-related expenses, including legal expenses, in connection with a merger.⁵⁶ The taxpayer asserted that these expenses were deductible against current income pursuant to section 162 of the Code and filed a return consistent with that position in 1978.⁵⁷ The IRS then audited

⁵³ See LeBlanc, *supra* note 52, at 459; Lyke, *supra* note 52, at 1267-68.

⁵⁴ *Indopco*, 503 U.S. at 90.

⁵⁵ See *id.* at 84, 87.

⁵⁶ See *id.* at 82.

⁵⁷ See *id.*

the taxpayer and disallowed the deductions.⁵⁸ Both the Tax Court and the United States Court of Appeals for the Third Circuit affirmed the Service's findings.⁵⁹

The *Indopco* Court began its analysis by reviewing Code sections 162 and 263 and pointing out that the policy objective behind these sections is to match the expenses and revenues of a taxable period, to yield an accurate calculation of net income.⁶⁰ In commenting on the typical operation of these sections, the Court pointed out that deductions under section 162 are exceptions to the norm of capitalization for two primary reasons.⁶¹ First, pertinent Supreme Court precedent puts the burden on the taxpayer to show the right to a claimed deduction.⁶² Second, while capital expenditures are not specifically enumerated in the Code, current deductions are so enumerated, subjecting deductions to disallowance in favor of capitalization.⁶³ Notwithstanding these reasons, the Court also stated that making distinctions between current expenses and capital expenditures is a matter of degree; each case turns on special factual distinctions, making these cases appear difficult to harmonize.⁶⁴ Next, the Court stated that where an expense results in benefits continuing beyond the year in which the expenditure is incurred, that fact is "undeniably important" in determining whether immediate deduction or capitalization is appropriate.⁶⁵

The Court then applied this reasoning to the facts of the case.⁶⁶ The Court affirmed the Court of Appeals's finding that the taxpayer would realize benefits from the merger well beyond the taxable year when it paid the professional fees.⁶⁷ In addition, the Court looked to precedent for the "well-established rule" that expenses incurred in mergers are not deductible under section 162.⁶⁸ With these principles as a basis, the Court held that the professional fees were capital expenses.⁶⁹

⁵⁸ See *id.*

⁵⁹ See *Indopco*, 503 U.S. at 82.

⁶⁰ See *id.* at 84.

⁶¹ See *id.*

⁶² See *id.*

⁶³ See *id.*

⁶⁴ See *Indopco*, 503 U.S. at 86.

⁶⁵ See *id.*; see also McDANIEL, *supra* note 21 and accompanying text.

⁶⁶ See *Indopco*, 503 U.S. at 88-90.

⁶⁷ See *id.* at 88.

⁶⁸ See *id.* at 89.

⁶⁹ See *id.* at 90. Once its reasoning was applied to the facts of *Indopco*, the Court relied almost exclusively on the future benefit doctrine to find that the expenses should be capitalized. See *id.* at 88-90.

2. Two Alternatives for Measuring Increase in Value and Prolonged Life

Currently, in deciding capitalization/deduction issues, the Service has two choices for measuring the amount a given expense increases the value or prolongs the life of any property involved. Under both methods, where an expense results in an increase in value or substantially prolongs the useful life of property, such an expense will be considered a capital expenditure. These choices are straightforward in their application, but often lead to conflicting results.

The first option is the "original expectations" valuation.⁷⁰ This analysis measures how much incurring a cost increases an asset's value or prolongs its life as follows: (1) it determines the value and lifespan the taxpayer expected the asset to have at the time the cost was incurred, (2) it determines the value of the asset and its expected lifespan after the cost was incurred, and (3) it compares these two valuations.⁷¹ If the asset has increased in value or gained years on its expected life based on that comparison, the original expectations analysis would classify the cost as a capital expenditure.⁷² Thus, if a cost allows a taxpayer to repair some heavy equipment, and as a result the equipment will last one year longer than expected, such a cost would be considered a capital expenditure.⁷³ On the other hand, if the heavy

⁷⁰ See generally *Schroeder v. Commissioner*, 72 T.C.M. (CCH) 185 (1996) (distinguishing capital expenses from current expenditures using original expectations analysis); *Frank v. Commissioner*, 71 T.C.M. (CCH) 2748 (1996) (distinguishing installation of new capital from currently deductible painting expenses); Tech. Adv. Mem. 96-45-002 (Nov. 8, 1996) (finding training costs to be current expenditures).

⁷¹ See *Plainfield Union Water Co. v. Commissioner*, 39 T.C. 333, 338 (1962). Accord *Jacks v. Commissioner*, 55 T.C.M. (CCH) 960 (1988). See generally *LaSalle Trucking Co. v. Commissioner*, 22 T.C.M. (CCH) 1375 (1963).

Jacks illustrates what courts sometimes perceive as the difference between a capital expenditure and a currently deductible repair. See generally 55 T.C.M. (CCH) at 960. In *Jacks*, the taxpayer replaced two major components on its loader. See *id.* at 969. First, the taxpayer replaced the loader's transmission with a used transmission. See *id.* Second, the taxpayer overhauled the loader's engine. See *id.* The court then applied the "original expectations" analysis to both repairs. See *id.* at 969-70. The court found that the used transmission simply allowed the loader to live out its originally expected life; thus, the taxpayer could deduct the transmission replacement cost currently. See *id.* On the other hand, the court found that rebuilding the engine allowed the loader to outlive its originally expected life span. See *id.* With this, the court held that the costs for rebuilding the engine had to be capitalized. See *id.*

For another similar case, consider *LaSalle Trucking Co. v. Commissioner*, 22 T.C.M. (CCH) 1375 (1963). In *LaSalle*, the taxpayer would rotate worn truck engines with overhauled engines to minimize downtime on trucks needing repair. See *id.* at 1380-81. The costs of repairs in *LaSalle* were almost half the cost of a new truck. See *id.* The court found that the engine repair expenditures should be capitalized. See *id.* at 1383.

⁷² See *LaSalle*, 22 T.C.M. at 1383.

⁷³ See *supra* note 71 and accompanying text.

equipment will only live out its expected operational life, even with the repair costs, then there has been no increase in value under the original expectations analysis.⁷⁴

The following discussion details how this analysis typically operates. In 1962, in *Plainfield-Union Water Co. v. Commissioner*, the Tax Court of the United States decided that the taxpayer in question, a public utility, did not have to capitalize the costs of repairing its pipelines.⁷⁵ The court pointed out that the proper measure of increased value is not yielded by comparing the asset's value at the time just before the repair to the asset's value just after the repair.⁷⁶ Under such an analysis, the court reasoned, any proper repair would increase value.⁷⁷ The proper comparison, the court stated, was between the asset's value at the time of the repair and the asset's value before the condition necessitating the expenditure (the "original expectation").⁷⁸ Using this test, the court made four critical findings regarding the pipe repairs: 1) they restored the pipes to their original carrying capacity, 2) they were not part of an overall plan of rehabilitation, 3) they did not increase the useful life, value or strength of the pipes, and 4) they did not adopt the pipes to a new or different use.⁷⁹

The original expectations analysis works from the premise that, if taken literally, the language in sections 162 and 263 would unduly prohibit the deduction of certain expenditures.⁸⁰ More specifically, the analysis takes into account the fact that where taxpayers incur repair costs, those costs will increase the value of property over what the property's value would have been without the repair.⁸¹ If taxpayers were forced to compare the value of their property immediately before and after any repairs to measure increase in value, a literal reading of sections 162 and 263 would treat nearly all repair costs as capital expenditures.⁸²

There is another valuation method that takes this rather harsh approach, and in so doing, sometimes conflicts with the original expectations analysis.⁸³ Under this alternative method, as expressed in *Revenue Ruling 88-57* (the "Rev. Rul." or "88-57"), the increase in

⁷⁴ See *id.*

⁷⁵ 39 T.C. at 338.

⁷⁶ See *id.*

⁷⁷ See *id.* This clearly echoes the reasoning put forth in *In re Illinois Merchants Trust*. See 4 B.T.A. 103, 107 (1926).

⁷⁸ See *Plainfield Union*, 39 T.C. at 338.

⁷⁹ See *id.* at 337.

⁸⁰ See *Illinois*, 4 B.T.A. at 107.

⁸¹ See *id.*

⁸² See *id.*; see also *Plainfield Union*, 39 T.C. at 338.

⁸³ See Rev. Rul. 88-57, 1988-2 C.B. 36, 37.

value resulting from any repair expense should be measured as follows: the Service will compare the value of the property just before the repair with the value of the property just after the repair.⁸⁴ Under the 88-57 reasoning, if a taxpayer performs a repair properly, then such a repair almost inevitably will result in an increase in value.⁸⁵ In turn, since any increase in value can trigger capitalization treatment under section 263, most repair expenses thus will be considered capital expenditures.⁸⁶

Note the clear possibility for conflicting results between the original expectations and 88-57 methods. The original expectations method classifies costs as capital expenditures only where they prolong the life of property beyond what the taxpayer expected at the time of purchase.⁸⁷ In contrast, the 88-57 method treats nearly all repair costs as capital expenditures.⁸⁸ Thus, the 88-57 method could classify costs as capital expenditures while the original expectations method would treat the same costs as currently deductible.⁸⁹

3. Doctrines Which Can Change How an Expense Is Classified

a. *Doctrine of Rehabilitation*

Repair costs that would normally be considered deductible can be classified as capital expenditures under the doctrine of rehabilitation.⁹⁰ This doctrine relates to both the matching principle and the options for measuring increase in value and prolonged life.⁹¹ After a taxpayer rehabilitates an asset, the costs for that work will help the taxpayer earn

⁸⁴ *Id.* *Rev. Rul. 88-57* states that the original expectations method should only be used where a sudden and unexpected event forces a taxpayer to repair property. *See id.* This synthesis of the case law ignores the holding in *Plainfield Union*, as the taxpayer there could use the original expectations analysis despite the fact that there was no sudden and unanticipated damage to the repaired asset. *See generally Plainfield Union*, 39 T.C. at 338. Thus, this Note rejects *Rev. Rul. 88-57's* synthesis of the case law and assumes that either test is applicable to a range of situations.

⁸⁵ *See Rev. Rul. 88-57*, 1988-2 C.B. at 37; *see also Illinois*, 4 B.T.A. at 107.

⁸⁶ *See Illinois*, 4 B.T.A. at 107; *Rev. Rul. 88-57*, 1988-2 C.B. at 37; *see also I.R.C. § 263* (1994).

⁸⁷ *See supra* notes 71-73.

⁸⁸ *See supra* notes 80-82.

⁸⁹ *See supra* notes 70-88.

⁹⁰ *See United States v. Wherli*, 400 F.2d 686, 698 (10th Cir. 1968). *See generally Hotel Kingkade v. Commissioner*, 180 F.2d 310 (10th Cir. 1950); 88-57, 1988-2 C.B. at 36. Further decisions regarding the doctrine of rehabilitation are available. *See, e.g., Mountain Fuel Supply Co. v. United States*, 449 F.2d 816, 821-22 (10th Cir. 1971) (finding that partly because project was "well defined in scope," a plan of rehabilitation was present); *Bank of Houston v. Commissioner*, 19 T.C.M. (CCH) 589, 592 (1960) (illustrating that the component parts of a rehabilitation project, which would normally be repairs if done alone, must be capitalized when part of larger plan of rehabilitation; explicitly rejecting approach of considering repairs individually).

⁹¹ *See supra* notes 20-26, 70-88.

income in multiple years, as the improvements will typically last for more than a single year.⁹² In addition, the asset is worth more than what the taxpayer expected the asset to be worth at that point in its operational life.⁹³ Likewise, the asset will have a longer operational life as a result of the rehabilitation.⁹⁴ Therefore, where a taxpayer rehabilitates property, the costs for that rehabilitation should be capital expenditures under either the matching principle or the valuation options described above.⁹⁵

The intricacies of this doctrine are not as simple. A number of small expenses usually make up the costs for a given plan of rehabilitation, and some of those expenses would conceivably be treated as current expenses if incurred independently.⁹⁶ Because the rehabilitation costs help the taxpayer to earn revenues in multiple years, however, all of those costs should be treated as capital expenditures.⁹⁷ Therefore, where individual expenses are part of a larger plan of rehabilitation, the Service will group those expenses together and treat them all as capital costs.⁹⁸ This is true even though some of those expenses would be currently deductible if incurred on their own.⁹⁹

The key question thus becomes: when will this doctrine impact how a given expense should be classified? Whether a plan of rehabilitation exists, and whether a particular item is part of it, are usually questions of fact to be determined by the fact finder based on the totality of circumstances.¹⁰⁰ The factors in such a determination might include the purpose, nature and extent of the work done, as well as any resulting increase in value.¹⁰¹ Examining the purpose might include discerning whether the work was done for an incoming tenant or to adapt the property to a new or different use.¹⁰²

To illustrate some of these concepts, consider *Revenue Ruling 88-57*.¹⁰³ In 88-57, the IRS published its determination that where a railroad rehabilitates its freight-train cars as part of a cyclical rehabili-

⁹² See, e.g., 88-57, 1988-2 C.B. at 37.

⁹³ See *id.* at 36-37.

⁹⁴ See *id.* at 37.

⁹⁵ See *id.* at 36-37.

⁹⁶ See *id.*

⁹⁷ See 88-57, 1988-2 C.B. at 36-37.

⁹⁸ See *id.*

⁹⁹ See *id.*

¹⁰⁰ See *United States v. Wherli*, 400 F.2d 686, 690 (10th Cir. 1968).

¹⁰¹ See *id.*

¹⁰² See *id.*

¹⁰³ 1988-2 C.B. at 37. For a similar case, see generally, *Wolfsen Land & Cattle Co. v. Commissioner*, 72 T.C. 1 (1979).

tation plan, and the value of the cars materially increases as a result, such rehabilitations are capital expenditures.¹⁰⁴ In the *Rev. Rul.*, the taxpayer in question was a railroad.¹⁰⁵ The railroad established a program for rehabilitating its freight-train cars, which included the following: complete disassembly, inspection and reconditioning and/or replacement of components of the suspension and draft systems, trailer hitches and other special equipment.¹⁰⁶ Rehabilitation would usually occur after eight to ten years of use, at a time when the car typically had a value of \$8000; after a rehabilitation the car would be worth approximately \$30,000 and would have a further service life of twelve to fourteen years.¹⁰⁷ If the railroad did not rehabilitate the cars, they would have a service life of twelve to fourteen years from the date of their first use. With regular rehabilitations, however, the cars could last in excess of thirty years.¹⁰⁸ The railroad depreciated the cars' costs over a seven-year period.¹⁰⁹

The *Rev. Rul.* discussed the state of the applicable law and stated that three tests could be used to determine whether an expense should be capitalized or deducted currently.¹¹⁰ According to the Service, a taxpayer should examine all three tests before determining that an expense is deductible, and if any of the three tests are met, an expense should be capitalized.¹¹¹ The first two tests were straightforward: an expense should be capitalized where it appreciably prolongs the useful life of the property or where the expenditure materially adds to the value of the property.¹¹² The third test stated that where an expenditure is made for an item as part of a general plan of rehabilitation, improvement or modernization, the expense must be capitalized, even though standing alone, portions of the expense may have been classified as currently deductible repairs.¹¹³

The Service determined that the railroad's expenses met the first test, as the rehabilitation program increased the cars' lives from twelve or fourteen years to thirty years, an appreciable increase.¹¹⁴ Next, the Service determined that the rehabilitation expenses added materially

¹⁰⁴ See 88-57, 1988-2 C.B. at 36.

¹⁰⁵ See *id.*

¹⁰⁶ See *id.*

¹⁰⁷ See *id.*

¹⁰⁸ See *id.*

¹⁰⁹ See 88-57, 1988-2 C.B. at 36.

¹¹⁰ See *id.* at 37.

¹¹¹ See *id.*

¹¹² See *id.*

¹¹³ See *id.*

¹¹⁴ See 88-57, 1988-2 C.B. at 36, 37. The Service stated Treasury Regulation sections

to the value of the property.¹¹⁵ According to the Service, this increase was properly measured as follows: since sudden and unanticipated damage did not occur, the appropriate comparison of value was the value of the cars immediately prior to the rehabilitation with the value of the cars immediately after the rehabilitation.¹¹⁶ Before rehabilitation, the cars were typically worth \$8000, but after rehabilitation, their value jumped to approximately \$30,000, making the \$22,000 change in value material.¹¹⁷ Third, the Service determined that the car rehabilitations were made pursuant to a plan of rehabilitation, modernization and improvement, making the rehabilitation costs capital expenditures.¹¹⁸ Thus, under all three tests, the service found that the expenses at issue in the *Rev. Rul.* were capital expenses.¹¹⁹

b. Government Regulation Doctrine

In most cases where a repair is made solely because of government regulations, courts will find that such a repair increases the value of the capital asset involved.¹²⁰ In this way, just as with the rehabilitation doctrine above, the government regulations doctrine can change how an expense will be classified.¹²¹ An expense that would otherwise have been considered currently deductible might be considered a capital expenditure, simply because it brings a piece of property into compliance with government regulations.¹²² In fact, courts often concede that any material increase in value can be attributed exclusively to bringing

1.167(a)-11(g)(1)(ii)(b) and section 1.167(a)-12(d)(3)(ii). *See id.* The Service stated that whether a rehabilitation prolonged the life of an asset was to be determined using the anticipated life from the time the asset was first placed in service, where the taxpayer was a corporation using the asset depreciation range or class life system. *See id.*

¹¹⁵ *See id.*

¹¹⁶ *See id.*

¹¹⁷ *See id.* at 36-37. *But see* American Bemberg Corp. v. Commissioner, 10 T.C. 361, 378 (1948) (holding that although company's expenditures to remedy structural problems were significant, they did not materially increase the value of the property from the time it was first built and therefore were currently deductible).

¹¹⁸ *See* 88-57, 1988-2 C.B. at 36, 37.

¹¹⁹ *See id.* at 37.

¹²⁰ *See* *Swig Inv. Co. v. United States*, No. 95-5051, 1996 WL 580320, at *4 (Fed. Cir. Oct. 10, 1996); *Teitelbaum v. Commissioner*, 294 F.2d 541, 544 (7th Cir. 1961); *Cerda v. United States*, No. 82 C 3852, 1984 WL 2803, at *5 (N.D. Ill. Apr. 30, 1984); *Blue Creek Coal v. Commissioner*, 48 T.C.M. (CCH) 1504, 1508 (1984); *Hotel Sulgrave, Inc. v. Commissioner*, 21 T.C. 619, 622 (1954).

¹²¹ *See* *Swig*, 1996 WL 580320, at *4; *Teitelbaum*, 294 F.2d at 544; *Cerda*, 1984 WL 2803, at *5; *Blue Creek Coal*, 48 T.C.M. (CCH) at 1508; *Hotel Sulgrave*, 21 T.C. at 622.

¹²² *See* *Swig*, 1996 WL 580320, at *4; *Teitelbaum*, 294 F.2d at 544; *Cerda*, 1984 WL 2803, at *5; *Blue Creek Coal*, 48 T.C.M. (CCH) at 1508; *Hotel Sulgrave*, 21 T.C. at 622.

a piece of property in line with government regulations.¹²³ In other words, an asset which meets government regulations is deemed to be worth materially more than an asset which does not, thereby making the costs incurred for the work performed on the former asset capital expenditures.¹²⁴

For example, consider *Teitelbaum v. Commissioner*.¹²⁵ In 1961, in *Teitelbaum*, the United States Court of Appeals for the Seventh Circuit held that the taxpayer in question had to capitalize the costs of rewiring his building.¹²⁶ The taxpayer rewired his building from DC to AC power to comply with the local building code.¹²⁷ The court stated that merely because the rewiring was done involuntarily, pursuant to a city ordinance, did not mean the expense was currently deductible.¹²⁸ The court reasoned that even though the electrical work may not have improved the property by increasing its attractive appearance or efficiency, or prolonging its life, such modifications did render the property more valuable for the taxpayer's use by bringing it into compliance with the applicable regulation.¹²⁹ With this reasoning, the court concluded that the rewiring expenses were not currently deductible.¹³⁰

The *Teitelbaum* dissent would have held the rewiring expenses currently deductible.¹³¹ In evaluating the expenses, the dissent used language that closely mirrored the applicable sections of the Code.¹³² Judge Major stated that the expenses did not increase the value, prolong the life or change the use of the property, thereby concluding that the expenses should have been currently deductible.¹³³

¹²³ See *Swig*, 1996 WL 580320, at *4; *Teitelbaum*, 294 F.2d at 544; *Cerda*, 1984 WL 2803, at *5; *Blue Creek Coal*, 48 T.C.M. (CCH) at 1508; *Hotel Sulgrave*, 21 T.C. at 622.

¹²⁴ See *Cerda*, 1984 WL 2803, at *4-5 (mentioning only meeting Chicago's building code as increase in value); *Hotel Sulgrave*, 21 T.C. at 620-21.

¹²⁵ 294 F.2d at 544.

¹²⁶ See *id.*

¹²⁷ See *id.*

¹²⁸ See *id.*

¹²⁹ See *id.*

¹³⁰ See *Teitelbaum*, 294 F.2d at 544, 547.

¹³¹ See *id.* at 548 (Major, J., concurring in part and dissenting in part).

¹³² See *id.* (Major, J., concurring in part and dissenting in part).

¹³³ See *id.* at 548-49 (Major, J., concurring in part and dissenting in part). In fact, the dissent implied that even if a buyer would pay more for a building with proper wiring, such a fact would not dictate that the wiring expenses should be capitalized. See *id.* (Major, J., concurring in part and dissenting in part). The dissent's reasoning is analogous to the "original expectations" analysis discussed above. See generally *supra* notes 70-82 and accompanying text.

II. TAM 96-18-004

In 1996, the IRS issued TAM 96-18-004, which stated that expenditures for major inspections performed on aircraft engines, as required by the FAA, must be capitalized under section 263 of the Code.¹³⁴ The issue at the heart of the TAM was the treatment of certain repair expenses of an unnamed airline (the "Airline").¹³⁵ The IRS decided that the Airline had to capitalize the expenses, i.e. the Airline could only deduct the repair expenses incrementally from its taxable income over time.¹³⁶ Thus, the Airline could not deduct the expenses entirely from its taxable income during the year it incurred them.¹³⁷ As discussed below, this resulted in the Airline suffering negative financial effects and suggested that other airlines could succumb to a similar fate.¹³⁸

The FAA required the Airline to perform two types of inspections on its aircraft engines: (1) a "hot section inspection" about every two years and (2) a "major inspection" about every four years.¹³⁹ A "hot section inspection" included checking specific parts of the engine and would cost between \$25,000 and \$80,000.¹⁴⁰ On the other hand, a "major inspection" involved a repeat of the "hot" inspection, but also included a check on every component of the engine, as well as the replacement of many of the component parts.¹⁴¹ In performing the inspection, the engine was normally taken off the wing and replaced with an engine that had already been inspected.¹⁴² With proper inspections and other maintenance, the Airline's engines could be expected to last more than twenty-two years.¹⁴³ A "major inspection" for the Airline's A and B type aircraft would cost between \$90,000 and \$110,000, while a major inspection performed on C and D types would cost around \$110,000.¹⁴⁴

¹³⁴ TAM 96-18-004 (Jan. 23, 1996).

¹³⁵ See *id.*

¹³⁶ See *id.*

¹³⁷ See *id.*

¹³⁸ See *id.*; *Costs*, *supra* note 8; *Field*, *supra* note 8 and accompanying text.

¹³⁹ See TAM 96-18-004.

¹⁴⁰ See *id.*

¹⁴¹ See *id.*

¹⁴² See *id.*

¹⁴³ See *id.*

¹⁴⁴ See TAM 96-18-004. A spokesperson for the Air Transport Association estimated recently that airlines spend around \$3 billion, or one third of their inspections and maintenance costs, on "major inspections" each year. See Wald, *supra* note 1, at A5.

The Service first reviewed the applicable law under sections 162 and 263 of the Code and cited *Indopco* for the policy objective that those sections were designed to achieve—namely, the proper matching of expenses with the income they generate during a taxable period.¹⁴⁵ As part of this matching process, the Service stated, it is important to consider the duration and extent of any benefits the taxpayer realizes.¹⁴⁶ The Service emphasized the *Indopco* interpretations of the Code which state that deductions are a matter of legislative grace and that the taxpayer has the burden of showing the right to a claimed deduction.¹⁴⁷ Before moving into the analysis of the Airline's case, the Service also stated that distinctions between current expenditures and capital investments required a careful examination of the facts.¹⁴⁸

The Service began its analysis by stating that the major inspection costs materially increased the value of the Airline's engines under section 263(a)(1) of the Code.¹⁴⁹ The Service bolstered this statement with several supporting factual findings.¹⁵⁰ An engine with many new or reconditioned parts, the Service found, is worth materially more than an engine equipped with older or more worn components.¹⁵¹ Next, the Service looked to the FAA requirements to measure how much the inspections resulted in increased value and prolonged life.¹⁵² Accordingly, the Service reasoned that once an engine is inspected, it may once again be used for flights under the FAA requirements, making the engine more valuable in that respect.¹⁵³ The Service said that, in effect, the inspections give each engine a new service life of up to four years until the next inspection is required.¹⁵⁴

The Service then compared and contrasted the Airline's inspections to previous decisions.¹⁵⁵ First, the Service reasoned that the inspections were substantially similar to the costs considered in *Rev. Rul. 88-57* and that therefore the inspection costs should be capitalized.¹⁵⁶ Then, the Service distinguished *Plainfield Union* from the inspections

¹⁴⁵ See TAM 96-18-004. For a discussion of *Indopco*, see *supra* notes 51-69 and accompanying text.

¹⁴⁶ See TAM 96-18-004.

¹⁴⁷ See *id.*

¹⁴⁸ See *id.*

¹⁴⁹ See *id.*

¹⁵⁰ See *id.*

¹⁵¹ See TAM 96-18-004.

¹⁵² See *id.*

¹⁵³ See *id.*

¹⁵⁴ See *id.*

¹⁵⁵ See *id.*

¹⁵⁶ See TAM 96-18-004. For a discussion of *Rev. Rul. 88-57*, see *supra* notes 103-19 and accompanying text.

performed in the TAM on several grounds.¹⁵⁷ While the public utility repaired the pipes in *Plainfield Union* because of a sudden change in water source, the Airline inspected its engines to reverse the effects of gradual wear and tear.¹⁵⁸ Also, the Service stated that in *Plainfield Union*, the pipe repairs did not increase the value, useful life or structural strength of the pipes; on the other hand, the same could not be said for the inspections in the TAM.¹⁵⁹

The TAM then compared the Airline's inspection costs to cases where taxpayers had to capitalize the costs of replacing major components on their capital assets.¹⁶⁰ For example, the Service found that the Airline's expenditures were similar to those of *LaSalle v. Commissioner*.¹⁶¹ In comparing *LaSalle* to the Airline's costs, the Service answered various arguments of the Airline.¹⁶² The Airline tried to distinguish *LaSalle* by looking to the ratio of the cost of repair to the cost of a new piece of equipment.¹⁶³ In *LaSalle*, the engine overhauls were half the cost of a new truck.¹⁶⁴ On the other hand, the Airline asserted, the engine repairs were only between 3% and 10% of the costs of a new airplane.¹⁶⁵ This argument did not persuade the Service; it pointed out that taxpayers can be required to capitalize the costs of replacing minor components of capital assets where replacing those components results in prolonged life or increased value.¹⁶⁶ After disposing of some further issues, the Service found that the costs of the inspections should be capitalized.¹⁶⁷

III. ANALYSIS

The time is right for a new standard to decide capitalization/deduction issues.¹⁶⁸ The current method, which relies primarily on ambiguous case law and Code language, is unpredictable.¹⁶⁹ TAM 96-18-

¹⁵⁷ See TAM 96-18-004. For a discussion of *Plainfield Union*, see *supra* notes 75-79.

¹⁵⁸ See TAM 96-18-004.

¹⁵⁹ See *id.*

¹⁶⁰ See *id.*

¹⁶¹ See *id.* For a discussion of *LaSalle*, see *supra* note 71.

¹⁶² See TAM 96-18-004.

¹⁶³ See *id.*; see also *supra* note 106 and accompanying text.

¹⁶⁴ See TAM 96-18-004.

¹⁶⁵ See *id.*

¹⁶⁶ See *id.*

¹⁶⁷ See *id.*

¹⁶⁸ LeBlanc, *supra* note 52 (commenting that taxpayers should have a bright line test to ensure conservative, reasonable positions on tax returns); see Lee, *supra* note 51.

¹⁶⁹ Some have suggested that prayer and fasting may be just as effective as any other method for solving capitalization/deduction problems. See Gunn, *supra* note 3, at 443.

004 is further evidence of this unpredictability—the Service's reasoning therein is suspect and it was a clear departure from pertinent precedents.¹⁷⁰ In addition, the IRS is clearly expanding the applicability of section 263, and the TAM is recent evidence of this expansion.¹⁷¹ A more predictable standard would allow taxpayers to plan more effectively for future tax liabilities and would reduce administrative burdens on the Service and taxpayers alike.¹⁷²

Below, this Note takes issue with the Service's analysis in several areas.¹⁷³ Next, it offers some bright line tests for determining when expenses should be capitalized as alternatives to the method used in the TAM.¹⁷⁴ Finally, this Note suggests a conservative approach for practitioners advising clients on capitalization/deduction issues.¹⁷⁵

The Service's future decisions can take a number of directions and still be consistent with the current case law.¹⁷⁶ If the TAM is any indication, the Service will further expand the application of section 263.¹⁷⁷ In turn, this will result in greater revenues for the United States Treasury Department.¹⁷⁸ This increase in revenues was likely the incentive for using questionable reasoning in the TAM to reach a finding of capitalization.¹⁷⁹

In the TAM, the Service misapplied the doctrine of rehabilitation in several ways.¹⁸⁰ The doctrine of rehabilitation is usually applied in

¹⁷⁰ See *infra* notes 173–254 and accompanying text.

¹⁷¹ See *Costs*, *supra* note 8, at 57.

¹⁷² See *infra* notes 173–254 and accompanying text.

¹⁷³ See *infra* notes 173–254 and accompanying text. This Note assumes that the Service's reasoning in the TAM expresses the reasoning of the Service in general. Therefore, references to the reasoning as expressed in the TAM and the Service's reasoning are treated as interchangeable.

¹⁷⁴ See *infra* notes 247–54 and accompanying text.

¹⁷⁵ See *infra* notes 255–56 and accompanying text.

¹⁷⁶ Compare *Plainfield Union v. Commissioner*, 39 T.C. 333, 338, 341 (1962) (allowing current deduction of upgrade costs), with Rev. Rul. 88–57, 1988–2 C.B. 36, 37 (holding that refurbishment of railroad cars was capital expenditure).

¹⁷⁷ See TAM 96–18–004 (Jan. 23, 1996); *Costs*, *supra* note 8, at 57 (making point that TAM is consistent with Service's expansion of 263).

¹⁷⁸ This result is the reverse of the principle that a current deduction is worth more to a taxpayer because of the time value of money. From the government's perspective, gaining more tax revenues in the short term is worth more than having those revenues spread over future years. See *LeBlanc*, *supra* note 52, at 465–66; see also *Ingalls*, *supra* note 6, at 1170 n.32 and accompanying text.

¹⁷⁹ See *LeBlanc*, *supra* note 52, at 465–66; see also *Ingalls*, *supra* note 6, at 1170 n.32 and accompanying text.

¹⁸⁰ See *infra* notes 181–96. It would not have been entirely novel for the Service to grant relief from the tax consequences of the doctrine of rehabilitation for policy reasons. See *Joint Committee on Taxation Staff Description (JCX–37–96) of Selected Federal Tax Provisions that Impact Land Use, Prepared for July 16 House Ways and Means Oversight Subcommittee Hearing, Issued July 11, 1996*

cases where a single capital asset is improved pursuant to a plan.¹⁸¹ In contrast, the Airline in the TAM was repairing many distinct capital assets.¹⁸² The Service attempted to overcome this distinction by relying heavily on *Rev. Rul. 88-57*, but *88-57* is factually distinguishable from the TAM on three counts.¹⁸³ First, the railroad in *88-57* rehabilitated its cars on a ten-year cycle.¹⁸⁴ In contrast, the Airline conducts major inspections using a cycle less than half as long as the railroad in *88-57*.¹⁸⁵ Second, the railroad cars were stripped to the frame and rebuilt from the ground up for every major rehabilitation.¹⁸⁶ The airplane engines, on the other hand, only received replacement parts where such parts were specifically needed according to FAA specifications.¹⁸⁷ Third, when the railroad rehabilitated a car, it would then last as long as a new car.¹⁸⁸ When the Airline performed a major inspection, the engine inspected could not necessarily be expected to last as long as a newly-purchased engine.¹⁸⁹

Note the common aspect in each of these distinctions.¹⁹⁰ In each case, the benefits from the railroad's expenses lasted longer than the benefits of the Airline's expenditures.¹⁹¹ When compared in this way, and using the matching principle described above, the Airline's expenses more closely resemble current expenses than those of the railroad.¹⁹² The railroad was basically replacing its fleet of cars, while the Airline was simply repairing its existing equipment.¹⁹³

(corrected text), DAILY TAX REPORT, July 15, 1996, available in WESTLAW, BNA-TX database (discussing tax credit for costs of rehabilitating historic structures). The Service does just this in certain cases where historic landmarks are rehabilitated in order to foster more historic restoration. See *id.* A similar argument has been made that the Service should treat inspection costs as currently deductible to foster increased airline safety. See generally *Webwire-Archer Urges I.R.S. to Reverse Stand on Airline Safety Inspections*, 1996 WL 11125352, available in WESTLAW, GOVPR database (quoting Congressman as saying TAM goes against safety concerns).

¹⁸¹ See *Moss v. Commissioner*, 831 F.2d 833, 839, 840-42 (9th Cir. 1987). *Wolfsen Land & Cattle Co. v. Commissioner*, 72 T.C. 1, 18 (1979) (applying doctrine of rehabilitation to multiple assets) and *Rev. Rul. 88-57*, 1988-2 C.B. 36, 37 (applying doctrine of rehabilitation to multiple assets) are exceptions.

¹⁸² See TAM 96-18-004.

¹⁸³ Compare generally TAM 96-18-004, with *88-57*, 1988-2 C.B. 36. See Raby, *supra* note 38.

¹⁸⁴ See TAM 96-18-004; *88-57*, 1988-2 C.B. at 36-37; see also Raby, *supra* note 38.

¹⁸⁵ See TAM 96-18-004; *88-57*, 1988-2 C.B. at 36-37; see also Raby, *supra* note 38.

¹⁸⁶ See *88-57*, 1988-2 C.B. at 36-37.

¹⁸⁷ Compare TAM 96-18-004, with *88-57*, 1988-2 C.B. at 36-37.

¹⁸⁸ See *88-57*, 1988-2 C.B. at 36-37; Raby, *supra* note 8.

¹⁸⁹ See TAM 96-18-004; Raby, *supra* note 8.

¹⁹⁰ See *supra* notes 183-89 and accompanying text.

¹⁹¹ See *supra* notes 188-89 and accompanying text.

¹⁹² See *supra* notes 183-89 and accompanying text.

¹⁹³ See *supra* notes 183-89 and accompanying text.

Further, *Plainfield Union* and similar cases support the proposition that because the inspections are only a minor part of the Airline's business, they should not be considered a plan of rehabilitation.¹⁹⁴ Other cases have employed a similar analysis, ruling that refurbishing costs can be currently deducted, as long as they are a part of a taxpayer's ongoing business.¹⁹⁵ Thus, the Service's conclusion that a plan of rehabilitation existed in the TAM was in error.¹⁹⁶

The next two arguments against the TAM's reasoning highlight the conflict between the original expectations and 88-57 analyses by considering how the TAM measured how much major inspections increase engine value and prolong engine life.¹⁹⁷ The TAM's test to measure any increase in value resulting from the overhauls was improper.¹⁹⁸ Although the original expectations analysis of *Plainfield Union* should have been employed to measure the increase in value of the airplane engines, the Service used the questionable method of 88-57.¹⁹⁹

The Airline examined in the TAM purchased the engines for a price commensurate with the expectation that the engines would be serviced regularly and kept within FAA specifications.²⁰⁰ Under the test enunciated in *Plainfield Union*, inspecting the engines should not be a capital expenditure.²⁰¹ Under the *Plainfield Union* test, the inspections do not increase the engines' value; those inspections simply allow the engines to realize the value the airline expected them to have at the time of purchase.²⁰² Therefore, because there was no increase in value, the inspections should not be treated as capital expenditures.²⁰³

Unfortunately for the Airline, the Service chose to use the method of *Rev. Rul. 88-57* to measure increased value—perhaps because using this method allows the Service to raise greater tax revenues.²⁰⁴ As the

¹⁹⁴ See *Plainfield Union v. Commissioner*, 39 T.C. 333, 339 (1962); see also TAM 96-18-004.

¹⁹⁵ See *Moss v. Commissioner*, 831 F.2d 833, 840-42 (9th Cir. 1987).

¹⁹⁶ See *supra* notes 180-95 and accompanying text.

¹⁹⁷ See TAM 96-18-004; *infra* notes 198-218 and accompanying text.

¹⁹⁸ See TAM 96-18-004; Lyke, *supra* note 52; see also Raby, *supra* note 38.

¹⁹⁹ See *Plainfield Union*, 39 T.C. at 338; *Rev. Rul. 88-57*, 1988-2 C.B. at 37; Lyke, *supra* note 52.

²⁰⁰ See TAM 96-18-004; Field, *supra* note 7 (stating that the inspections just allow the engines to live out their design lives).

²⁰¹ See *Plainfield Union*, 39 T.C. at 338; see also *Teitelbaum v. Commissioner*, 294 F.2d 541, 548 (7th Cir. 1961) (Major, J., concurring in part and dissenting in part).

²⁰² See *Plainfield Union*, 39 T.C. at 338; see also *Teitelbaum*, 294 F.2d at 548 (Major, J., concurring in part and dissenting in part).

²⁰³ See *Plainfield Union*, 39 T.C. at 338; see also *Teitelbaum*, 294 F.2d at 548 (Major, J., concurring in part and dissenting in part).

²⁰⁴ See TAM 96-18-004; 88-57, 1988-2 C.B. at 37; see also *supra* note 178.

Illinois Trust and *Plainfield Union* decisions point out, under the 88-57 test for increase in value, nearly all repairs can be considered capital expenditures.²⁰⁵ This is true because the 88-57 test simply compares the value of an asset immediately prior to the repair with the asset's value immediately after the repair.²⁰⁶ Thus, under this method, the Service can deem almost any properly performed repair expense a capital expenditure.²⁰⁷ As one commentator has pointed out, this method for measuring value *ignores* clear language from the case law.²⁰⁸

Thus, the taxpayer's dilemma is to guess which method the Service will use in a given instance to measure increase in value.²⁰⁹ Currently, both the original expectations analysis and the valuation method of 88-57 are good law.²¹⁰ In addition, as mentioned above, these two methods can lead to conflicting results; this makes capitalization/deduction decisions for taxpayers very difficult.²¹¹

Consider the "hot inspections" the Airline performs as an example of this anomalous situation. The FAA requires airlines to perform such inspections, just as it requires major inspections.²¹² But "hot inspections" occur about every two years, while major inspections occur about every four years.²¹³ In addition, "hot inspections" do not include, as major inspections do, examining all the major components of the engine.²¹⁴ In short, "hot inspections" are much less comprehensive than major inspections and occur twice as often as major inspections, making "hot inspections" a much larger portion of current expenditures under the matching principle.²¹⁵ Despite all this, under the 88-57 test, "hot inspections" could be classified as capital expenditures.²¹⁶ This is true simply because any properly performed "hot inspection" increases an engine's value over what it was before the inspection.²¹⁷ The original expectations analysis would avoid such a problematic result and classify the "hot inspections" as current expenditures, be-

²⁰⁵ See *Plainfield Union*, 39 T.C. at 338; *In re Illinois Merchants Trust Co.*, 4 B.T.A. 103, 107 (1926).

²⁰⁶ See 88-57, 1988-2 C.B. at 37.

²⁰⁷ See TAM 96-18-004.

²⁰⁸ See Lyke, *supra* note 52.

²⁰⁹ See *supra* note 46 and accompanying text.

²¹⁰ See *supra* note 46 and accompanying text.

²¹¹ See *supra* note 46 and accompanying text.

²¹² See TAM 96-18-004.

²¹³ See *id.*

²¹⁴ See *id.*

²¹⁵ See *id.*

²¹⁶ See I.R.C. §§ 162, 263 (1994); 88-57, 1988-2 C.B. at 37; *Costs*, *supra* note 8, at 58.

²¹⁷ See TAM 96-18-004; 88-57, 1988-2 C.B. at 37; *Costs*, *supra* note 8, at 58.

cause under that analysis, the inspections do not increase the engines' value.²¹⁸

Even if we leave aside the problematic conflict between the 88-57 and original expectations tests, that does not cure the flaws in the Service's current method for deciding capitalization/deduction issues. It is questionable to assert that an asset has an increased value solely because it meets government regulations.²¹⁹ One commentator has pointed out that congressional "wisdom" can be imperfect, so basing an increase in value on compliance with regulations can lead to unfair results.²²⁰ This is exactly what occurred in the TAM.²²¹ Although the Service did give figures on how much major inspections normally cost, it never gave a dollar figure on how much a typical major inspection increases the value of an engine.²²² Also, instead of calculating increased value based on the value of any replacement components, the Service mainly attributed increased value to complying with government regulations.²²³ In other words, the Service emphasized complying with government regulations as the real value of major inspections, but it only mentions overhauling the engine by replacing components as an increase in value.²²⁴

In addition, in a move that clearly takes the capitalization/deduction doctrine in a new direction, the Service also used government regulations in the TAM as the measure of how much major inspections prolong engine life.²²⁵ The Service found that major inspections had to occur under FAA regulations about every four years.²²⁶ So, after a finished inspection, the inspected engine is good for about four years from the FAA's perspective.²²⁷ On the other hand, note that with proper periodic inspections, an engine will usually last around twenty-two years.²²⁸ This means that when an airline purchases an engine, the price is commensurate with the twenty-two year expected life span for

²¹⁸ See *Plainfield Union*, 39 T.C. at 338.

²¹⁹ See *Teitelbaum v. Commissioner*, 294 F.2d 541, 548 (7th Cir. 1961) (Major, J., concurring in part and dissenting in part); Lee A. Sheppard, *News Analysis: Is the IRS Abusing Indopco?*, NEWS STORIES, Sept. 1, 1992, available in WESTLAW, 92 TNT 178-10 (questioning such reasoning in context of asbestos removal).

²²⁰ See Sheppard, *supra* note 219 (commenting that bringing asset in line with regulations does not necessarily lead to increased value).

²²¹ See TAM 96-18-004.

²²² See *id.*

²²³ See *id.*

²²⁴ See *id.*

²²⁵ See TAM 96-18-004.

²²⁶ See *id.*

²²⁷ See *id.*

²²⁸ See *id.*

the engine.²²⁹ Putting this in terms of the original expectations analysis, the Airline's original expectations upon purchasing the engines was to keep them flying for around twenty-two years by regularly inspecting or repairing them.²³⁰ Indeed, the proper focus should be on whether the inspections are compensating for anything more than normal wear and tear, as it would be under the original expectations analysis.²³¹ Of course, under this analysis, the inspections compensate for only normal engine use.²³² Thus the inspections do not really prolong the life of the engines.²³³

With this in mind, the Service's finding that each major inspection increases an engine's life by another four years is clearly erroneous.²³⁴ A major inspection simply allows an engine to live out its normally expected operational life.²³⁵ What led to the TAM's anomalous result? By using novel reasoning to bolster its arguments, the Service is taking repairs cases in the capitalization/deduction area in a new direction.²³⁶ In effect, the Service is using compliance with government regulations to say that the operational life of an asset is increased.²³⁷ When government regulations force a taxpayer to perform a certain task regarding an asset, however, that task may not increase the useful life of the asset involved independent of the government regulation.²³⁸ Asbestos removal is a good example of this; removing asbestos pursuant to government regulations does not necessarily increase the useful life of the asset involved.²³⁹ The major inspections at issue in the TAM are similar to asbestos removal in that the inspections do not increase the useful life of the engines involved.²⁴⁰ Therefore, it is erroneous for the Service

²²⁹ See TAM 96-18-004; see also Field, *supra* note 7.

²³⁰ See TAM 96-18-004; see also Field, *supra* note 7.

²³¹ See Raby, *supra* note 38.

²³² See *id.*

²³³ See *id.*

²³⁴ See Field, *supra* note 7.

²³⁵ See *id.*

²³⁶ Compare *Cerda v. United States*, No. 82 C 3852, 1984 WL 2803, at *4-5 (N.D. Ill. Apr. 30, 1984) (mentioning only meeting Chicago's building code as creating increase in value), and *Hotel Sulgrave, Inc. v. Commissioner*, 21 T.C. 619, 620-21 (1954) (mentioning only meeting regulations as creating increase in value), with TAM 96-18-004 (mentioning meeting regulations as something which increases life).

²³⁷ See TAM 96-18-004.

²³⁸ Of course, an asset that can be used under government regulations has a longer useful life than one which cannot, but this conclusion makes for circular logic in this context. For criticism of similar circularity, see *Plainfield Union v. Commissioner*, 39 T.C. 333, 338 (1962) and *In re Illinois Merchants Trust*, 4 B.T.A. 103, 107 (1926).

²³⁹ See Tech. Adv. Mem. 92-40-004 (June 29, 1992).

²⁴⁰ See TAM 96-18-004; Raby, *supra* note 38.

to conclude that each major inspection gives an engine four more years of operational life.²⁴¹

In addition to using this novel reasoning, the Service also failed to address a major technical consideration in the TAM. The Service nearly ignored the issue of whether allowing the Airline to deduct major inspection costs currently would distort its calculation of its taxable income.²⁴² It is true that the Airline was gaining future benefits from the inspections, so presumably, under the matching principles of Code sections 162 and 263, the expenses should have been capitalized.²⁴³ There is a strong argument, however, that currently deducting the expenditures would not distort income.²⁴⁴ As long as the Airline inspects twenty-five percent of its fleet every year, currently deducting the inspection costs would not distort the Airline's income over time.²⁴⁵ With this, one can reasonably assert that allowing the Airline to currently deduct the inspection costs would be congruent with the policies behind Code sections 162 and 263.²⁴⁶

In light of the arguments above, and given the ambiguity of current precedents, now is the time for a more predictable, logically sound method for determining when an expense should be capitalized and when it can be currently deducted.²⁴⁷ For taxpayers like the Airline in the TAM, the classification of recurring expenses has significant financial consequences.²⁴⁸ Yet, under the current statutory language and

²⁴¹ See TAM 96-18-004; Raby, *supra* note 38. The Code supports this assertion. Under the applicable class life system, the engines have a life of twelve years. See Treas. Reg. § 1.167(a)-12(d)(3)(ii) (1997). With this in mind, for the Service to say that the engines have four year operational lives based on government regulations goes against the Internal Revenue Code itself. See *id.*

²⁴² The TAM never discussed this argument directly. See generally TAM 96-18-004. It is true, though, that the policy rationales behind Code sections 162 and 263 are to properly match income with the expenses paid to generate that income. See *Indopco, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992); TAM 96-18-004.

²⁴³ See TAM 96-18-004.

²⁴⁴ See Lee, *supra* note 51; Lee, *supra* note 2.

²⁴⁵ See Lee, *supra* note 51; Lee, *supra* note 2.

²⁴⁶ See Lee, *supra* note 51; Lee, *supra* note 2; see also I.R.C. §§ 162, 263; TAM 96-18-004.

²⁴⁷ See LeBlanc, *supra* note 52 (commenting on capitalization/deduction area in cases not dealing with repairs); Lee, *supra* note 51 (suggesting alternative of treating any cost that exceeds certain percentage of asset's depreciation allowance as capital expenditure); Lee, *supra* note 2 (stating alternative of treating any cost which exceeds certain percentage of asset's resale value as a capital expenditure). The Service implicitly rejected such an approach when it said that even a minor replacement could trigger capital gains treatment where the repair resulted in an increase in value. See TAM 96-18-004. Of course, this brings the discussion back to the argument over the proper measure of increase in value. See Gunn, *supra* note 3 (stating that the only meaningful difference between currently deductible expenses and capital expenditures are amount of money spent and frequency of occurrence).

²⁴⁸ See *supra* note 1 and accompanying text.

case law for classifying repair expenditures, it is difficult for a taxpayer to plan for future tax liabilities.²⁴⁹ This is true because, as pointed out above, tests used to measure increase in value and prolonged life clearly give conflicting results.²⁵⁰ This leaves taxpayers guessing as to when the Service will choose to deem a given repair expense a capital expenditure.²⁵¹ There have been several proposals for more predictable tests. The Service and Congress should study these proposals to see if they are viable.²⁵² One alternative suggests that any expense over a certain percentage of an asset's depreciation value should be a capital expenditure.²⁵³ A second alternative suggests treating any expense over a certain percentage of the asset's resale value as a capital expenditure.²⁵⁴

Until a change occurs, practitioners should keep in mind that under the current standard, almost any repair expense that creates benefits lasting beyond the current year can be considered a capital expenditure.²⁵⁵ This creates a tough situation for tax practitioners advising clients who are incurring repair expenses that generate benefits into future years.²⁵⁶ Certainly, the most conservative advice would be to capitalize any repair expense that generates benefits into future years. Beyond this, it is tough to make a definitive judgment about how repair expenses should be treated.

CONCLUSION

A clearer standard for distinguishing repairs and capital costs is sorely needed. As TAM 96-18-004 illustrates, along with the cases cited above, the present state of the doctrine can leave taxpayers guessing as to the proper treatment for business expenditures. A more predictable system would save taxpayers and practitioners alike time and energy without significantly compromising policy considerations. Congress and the Service should address this issue with all deliberate speed.

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²⁴⁹ See *supra* note 197 and accompanying text.

²⁵⁰ See *supra* note 197 and accompanying text.

²⁵¹ See *supra* note 197 and accompanying text.

²⁵² See *supra* notes 253-54 and accompanying text.

²⁵³ See Lee, *supra* note 51.

²⁵⁴ See Lee, *supra* note 2.

²⁵⁵ See *supra* note 205.

²⁵⁶ See *supra* note 205.