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# Repair or Capitalize Expenditures?

— by Neil E. Harl*

The rules as to what is a “repair” and, therefore, is deductible,¹ and what must be capitalized and depreciated² have never provided a bright line for determining how an expense should be handled. The cases have not always been consistent³ which is not unexpected when the facts and circumstances of each case are controlling.⁴ Two cases, one in 2000⁵ and another in 2003⁶ have provided useful guidance on where the line should be drawn between repairs and expenses that must be capitalized.

## The regulations

The Internal Revenue Code allows taxpayers to deduct ordinary and necessary business expenses paid or incurred during the taxable year.⁷ The regulations specify that—

“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 ordinary efficient operating condition, may be deducted as an expense.”⁸

On the other hand, the regulation governing capitalization states that expenses are capital expenditures (and are to be depreciated) if the expenses—

“(1) . . . add to the value, or substantially prolong the useful life, of property owned by the taxpayer . . . or (2) to adapt property to a new or different use.”⁹

The capitalization regulation goes on to state that—

“ . . . amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures . . .”¹⁰

As noted, whether an expense is capital is highly dependent on the particular circumstances of a given case and is ultimately a question of fact.¹¹

## The 2003 case

The latest case, *FedEx Corp. & Subs. v. United States*,¹² involved the deductibility of expenses incurred for aircraft maintenance. The court explained that whether an expense

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was a repair or a cost that had to be capitalized depended heavily upon what is the unit of property; thus, the court should determine whether the larger unit of property or the smaller unit of property is the appropriate unit of property.13 Citing two earlier cases,14 the court in FedEx Corp.15 articulated four factors that a court should consider in identifying the appropriate unit of property to which to apply the factors from the repair regulations—(1) the court should consider whether the taxpayer and the industry treat the component part as part of the larger unit of property for regulatory, market, management or accounting purposes; (2) the court should determine whether the economic useful life of the component part is coextensive with the economic useful life of the larger unit of property; (3) whether the larger unit of property and the smaller unit of property can function without each other; and (4) whether the component part can be and is maintained while affixed to the larger unit of property.16

In the FedEx Corp. case,17 the court found that the four factors favored the entire aircraft as the separate unit of property, not the engines.

The court then proceeded to examine whether the repairs in question (involving engine scheduled visits or ESVs) were “incidental repairs” as specified by the repair regulations.18 The court found no support in the cases for treating “incidental” as a separate capitalization requirement under the repair regulations.19

The court next considered whether the expenditure returned the property to the state it was in before the situation prompting the expenditure arose, an expenditure intended to correct a situation,20 or whether the expenditure was a more permanent increment in the longevity, utility or worth of the property.21 The court determined that the appropriate test to apply was the corrective test, that the expenditure returned the property to the state it was in before the situation prompting the expenditure arose.22 Accordingly, the expenditures were all allowable as repairs.23

In conclusion

The reasoning of the court in FedEx Corp. & Subs. v. United States24 and Ingram Industries, Inc. & Subs. v. Commissioner25 is highly relevant to the question of whether a major repair on a combine or tractor engine or transmission should be considered a repair or whether the expenditure would have to be capitalized. Both cases provide useful authority for arguing that even major engine or transmission overhauls should be deductible as repairs. In general, engines and transmissions are treated as part of the larger machine, the economic life of the engine or transmission is typically considered as co-extensive with the economic life of the tractor or combine, a tractor or combine cannot function without an engine or transmission and the engine or transmission can be and generally are maintained while affixed to the tractor or combine, as the case may be.

FOOTNOTES

2 Id.
3 See 4 Harl, supra note 1, § 28.05[2][a].
4 Compare Converse v. Earle, 51-2 U.S. Tax Cas. (CCH) ¶ 9,430 (D. Or. 1951) (costs of constructing logging road found to be deductible) with United States v. Regan, 67-2 U.S. Tax Cas. (CCH) ¶ 9,728 (D. Or. 1967), rev’d, 410 F.2d 744 (9th Cir. 1969), cert. denied, 396 U.S. 834 (1969) (costs of constructing logging road not deductible).
7 I.R.C. § 162.
9 Treas. Reg. § 1.263(a)-1(b).
10 Id.
11 United Dairy Farmers, Inc. v. United States, 267 F.3d 510, 519 (6th Cir. 2001).
13 Id.
14 Ingram Industries, Inc. & Subs. v. Comm’r, T.C. Memo. 2000-323 (towboat diesel engines; out of operation for 10-12 days); Smith v. Comm’r, 300 F.3d 1023, 1030 (9th Cir. 2002).
15 See note 6 supra.
16 Id.
17 Id.
21 See Smith v. Comm’r, 300 F.3d 1023 (9th Cir. 2002).
23 Id.