Proposed Regulations on Repairs

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The stunning defeat of the Internal Revenue Service in *Ingram Industries, Inc & Subs. v Commissioner*¹ and the high profile loss in *FedEx Corp. v. United States*,² provoked the Internal Service to mount a major regulatory overhaul in an effort to reshape the legal terrain over which both battles were fought.³ The controversy appears to be of only modest concern to farmers and ranchers other than for handling overhauls of engines and transmissions on tractors, combines and trucks but the 160 pages of regulations issued on August 21, 2006,⁴ if adopted, would represent a significant shift in the rules governing whether those and similar types of expenditures could continue to be deductible or would have to be capitalized.

**Background**

In general, expenses are deductible as repairs at present if the cost involves “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.”⁵ The rules as to what is a “repair” and can be deducted and what must be capitalized and depreciated have never provided a bright line test for determining how an expense should be handled.⁶ The cases have not always been consistent which is not unexpected when the facts and circumstances of each case are influential if not controlling.⁷

The picture was clouded even further with the 2000 decision in *Ingram Industries, Inc. & Subs. v. Commissioner*,⁸ which allowed costly engine overhauls on towboat diesel engines to be deducted as repairs where the towboats were out of operation for 10 to 12 days. Three years later, a U.S. District Court held (and the Sixth Circuit Court of Appeals has agreed) that aircraft engines are part of a single unit of property (the airplane) under the repair regulations.⁹ Out of that case emerged a four part test of (1) whether the taxpayer created the component part as part of a larger unit of property for any purpose; (2) whether the economic useful life of the component was co-extensive with that of the larger unit; (3) whether the larger unit and smaller unit could function independently; and (4) whether the component part can and is maintained while affixed to the larger unit. In that case, the aircraft was a single unit of property and the costs of engine shop visits were deductible as repairs.¹⁰

**The proposed regulations**

On this issue, the proposed regulations identify four categories of assets (other than for network assets such as oil and gas pipelines) which are intended to cover all real and

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¹ Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.
The repair allowance for that particular MACRS class of property or as currently deductible to the extent they do not exceed the tax reform allowance for most repairs, maintenance and improvement expenses. Taxpayers would be allowed to elect to treat most amounts paid for repairs, maintenance, or improvements as repairs, under the new elective repair allowance method (RAM) that taxpayers would be permitted to use for most repairs, maintenance and improvement expenses. Taxpayers would be allowed to elect to treat most amounts paid as currently deductible to the extent they do not exceed the repair allowance for that particular MACRS class of property or amounts that are required to be capitalized to the extent of any excess. The RAM would apply to Section 1231 real and personal property subject to depreciation and used in the taxpayer’s trade or business or investment property held for the production of income and tangible depreciable property not otherwise subject to MACRS.

The repair allowance would range from 16.5 percent of the unadjusted basis for three year property, down to 1.28 percent of the basis for 39 year property.

The proposed regulations do not explain how a taxpayer would elect (the manner of election is “reserved” in the proposed regulations). However, the RAM, once elected, could not be revoked without the Commissioner’s consent.

Taxpayer response

It is not clear how taxpayers would respond to the proposed system but with the drift in recent years to reposition the line between repairs and amounts required to be capitalized more toward the repair end of the spectrum, and with tax reform proposals uniformly allowing more write-off of expenditures (as well as the recent increased expense method depreciation allowance) it is difficult to imagine that the proposals would be met with a groundswell of enthusiasm.

FOOTNOTES

1 T.C. Memo. 2000-323 (overhaul of towboat diesel engines treated as repairs; out of operation for 10 to 12 days).
3 Prop. Treas. Reg. § 1.263(a)-3(g)(6)(i).
5 Prop. Treas. Reg. § 1.263(a)-3(e).
7 Prop. Treas. Reg. § 1.263(a)-3(d).
8 Prop. Treas. Reg. § 1.263(a)-3(g).
9 Prop. Treas. Reg. § 1.263(a)-3(g)(9).
10 Prop. Treas. Reg. § 1.263(a)-3(g)(8).
11 Prop. Treas. Reg. § 1.263(a)-3(g)(7).
12 Prop. Treas. Reg. § 1.263(a)-3(g)(6)(i).
13 Prop. Treas. Reg. § 1.263(a)-3(g)(5).
14 Prop. Treas. Reg. § 1.263(a)-3(g)(4).
15 Prop. Treas. Reg. § 1.263(a)-3(g)(3).
16 Prop. Treas. Reg. § 1.263(a)-3(g)(2).
17 Prop. Treas. Reg. § 1.263(a)-3(g)(1).