

This 2001 Revenue Ruling represents a pro taxpayer ruling by the IRS concerning tax treatment of aircraft maintenance, repair, refurbishing expenses.

Historically, if an expenditure extended the life of an asset or increased the value of the asset, then the cost of the asset had to be capitalized and depreciated over its useful life.

However, this ruling liberalizes the treatment for many expenses connected with heavy maintenance visits for airliners. Therefore, a careful reading of this ruling may uncover many tax planning/expensing opportunities for expenditures that previously had to be depreciated over a useful life lasting several years. The IRS has apparently "softened" its stance requiring capitalization of major overhaul expenses. Each situation must be evaluated on a case-by-case basis.

Code Secs. 162, 263, 263A

<<FULL TEXT>>

26 CFR 1.162-1: Business expenses.

(Also sections 263; 263A; sections 1.162-4, 1.263(a)-1, 1.263A-1)

Aircraft maintenance costs. Costs incurred by a taxpayer to perform work on its aircraft airframe as part of a heavy maintenance visit generally are deductible as ordinary and necessary business expenses under section 162 of the Code. However, costs incurred in conjunction with a heavy maintenance visit must be capitalized to the extent they materially add to the value of, substantially prolong the useful life of, or adapt the airframe to a new or different use. In addition, costs incurred as part of a plan of rehabilitation, modernization, or improvement must be capitalized.

REV. RUL. 2001-4

ISSUE

Are costs incurred by a taxpayer to perform work on its aircraft airframe, including the costs of a "heavy maintenance visit," deductible as ordinary and necessary business expenses under section 162 of the Internal Revenue Code, or must they be capitalized under sections 263 and 263A?

FACTS

X is a commercial airline engaged in the business of transporting passengers and freight throughout the United States and abroad. To conduct its business, X owns or leases various types of aircraft. As a condition of maintaining its operating license and airworthiness certification for these aircraft, X is required by the Federal Aviation Administration "FAA" to establish and adhere to a continuous maintenance program for each aircraft within its fleet. These programs, which are designed by X and the aircraft's manufacturer and approved by the FAA, are incorporated into each aircraft's maintenance manual. The maintenance manuals require a variety of periodic maintenance visits at various intervals during the operating lives of each aircraft. The most extensive of these for X is termed a "heavy maintenance visit" (also known in the industry as a "D check," "heavy C check," or "overhaul"), which is required to be performed by X approximately every eight years of aircraft operation. The purpose of a heavy maintenance visit, according to X's maintenance manual, is to prevent deterioration of the inherent safety and reliability levels of the aircraft equipment and, if such deterioration occurs, to restore the equipment to their inherent levels.

In each of the following three situations, X reasonably anticipated at the time the aircraft was placed in service that the aircraft would be useful in its trade or business for up to 25 years, taking into account

the repairs and maintenance necessary to keep the aircraft in an ordinarily efficient operating condition. In addition, each of the aircraft in the following three situations is fully depreciated for federal income tax purposes at the time of the heavy maintenance visit.

SITUATION 1

In 2000, X incurred \$2 million for the labor and materials necessary to perform a heavy maintenance visit on the airframe of Aircraft 1, which X acquired in 1984 for \$15 million (excluding the cost of engines). To perform the heavy maintenance visit, X extensively disassembled the airframe, removing items such as its engines, landing gear, cabin and passenger compartment seats, side and ceiling panels, baggage stowage bins, galleys, lavatories, floor boards, cargo loading systems, and flight control surfaces. As specified by X's maintenance manual for Aircraft 1, X then performed certain tasks on the disassembled airframe for the purpose of preventing deterioration of the inherent safety and reliability levels of the airframe. These tasks included lubrication and service; operational and visual checks; inspection and functional checks; restoration of minor parts and components; and removal, discard, and replacement of certain life-limited single cell parts, such as cartridges, canisters, cylinders, and disks.

Whenever the execution of a task revealed cracks, corrosion, excessive wear, or dysfunctional operation, X was required by the maintenance manual to restore the airframe to an acceptable condition. This restoration involved burnishing corrosion; repairing cracks, dents, gouges, punctures, or scratches by burnishing, blending, stop-drilling, or applying skin patches or doublers over the affected area; tightening or replacing loose or missing fasteners, rivets, screws, bolts, nuts, or clamps; repairing or replacing torn or damaged seats, gaskets, or valves; repairing or replacing damaged or missing placards, decals, labels, or stencils; additional cleaning, lubricating, or painting; further inspecting or testing, including the use of sophisticated non-destructive inspection methods; repairing fiberglass or laminated parts; replacing bushings, bearings, hinges, handles, switches, gauges, or indicators; repairing chaffed or damaged wiring; repairing or adjusting various landing gear or flight surface control cables; replacing light bulbs, window panes, leases, or shields; replacing anti-skid materials and stops on floors, pedals, and stairways; replacing floor boards; and performing minor repairs on ribs, spars, frames, longerons, stringers, beams, and supports. In addition to the tasks described above, X also performed additional work as part of the heavy maintenance visit for Aircraft 1. This work included applying corrosion prevention and control compounds; stripping and repainting the aircraft exterior; and cleaning, repairing, and painting airframe interior items such as seats, carpets, baggage stowage bins, ceiling and sidewall panels, lavatories, galleys, and passenger service units. Other additional work included implementing certain outstanding service bulletins ("SBs") issued by the aircraft manufacturer and airworthiness directives ("ADs") issued by the FAA. Implementing these SBs and ADs involved inspecting specific skin locations and applying doublers over the areas where cracks were found; inspecting bolts or fasteners at specific locations, and replacing those found to be broken, worn, or missing; and installing structural reinforcements between body frames in a small area in the lower aft fuselage to reduce skin wrinkling and replacing a small number of the wrinkled skin panels in this area with stronger skin panels. None of the work performed by X as part of the heavy maintenance visit (including the execution of SBs and ADs) for Aircraft 1 resulted in a material upgrade or addition to its airframe or involved the replacement of any (or a significant portion of any) major component or substantial structural part of the airframe. This work maintained the relative value of the aircraft. The value of the aircraft declines as it ages even if the heavy maintenance work is performed.

After 45 days, the heavy maintenance visit was completed, and Aircraft 1 was reassembled, tested, and returned to X's fleet. X then continued to use Aircraft 1 for the same purposes and in the same manner that it did prior to the performance of the heavy maintenance visit. The performance of the heavy maintenance visit did not extend the useful life of the airframe beyond the 25-year useful life that X anticipated when it acquired the airframe.

SITUATION 2

Also in 2000, X incurred costs to perform work in conjunction with a heavy maintenance visit on the airframe of Aircraft 2. The heavy maintenance visit on Aircraft 2 involved all of the same work described in Situation 1. In addition, X found significant wear and corrosion of fuselage skins of Aircraft 2 that necessitated more extensive work than was performed on Aircraft 1. Namely, X decided to remove all of the skin panels on the belly of Aircraft 2's fuselage and replace them with new skin panels. The replaced skin panels represented a significant portion of all of the skin panels of Aircraft 2, and the work performed materially added to the value of the airframe.

Because Aircraft 2 was already out of service and its airframe disassembled for the heavy maintenance visit, X also performed certain modifications to the airframe. These modifications involved installing a cabin smoke and fire detection and suppression system, a ground proximity warning system, and an air phone system to enable passengers to send and receive voice calls, faxes, and other electronic data while in flight.

SITUATION 3

Also in 2000, X decided to make substantial improvements to Aircraft 3, which was 22 years old and nearing the end of its anticipated useful life, for the purpose of increasing its reliability and extending its useful life. X's improvement of Aircraft 3 involved many modifications to the structure, exterior, and interior of the airframe. The modifications included removing all the belly skin panels on the aircraft's fuselage and replacing them with new skin panels; replacing the metal supports under the lavatories and galleys; removing the wiring in the leading edges of both wings and replacing it with new wiring; removing the fuel tank bladders, harnesses, wiring systems, and connectors and replacing them with new components; opening every lap joint on the airframe and replacing the epoxy and rivets used to seal the lap joints with a non-corrosive sealant and larger rivets; reconfiguring and upgrading the avionics and the equipment in the cockpit; replacing all the seats, overhead bins, sidewall panels, partitions, carpeting, windows, galleys, lavatories, and ceiling panels with new items; installing a cabin smoke and fire detection system, and a ground proximity warning system; and painting the exterior of the aircraft. The work performed on Aircraft 3 also included modifications necessary to terminate every aging aircraft AD applicable to Aircraft 3.

In order to upgrade the airframe to the desired level, X performed much of the same work that would be performed during a heavy maintenance visit (as described in Situation 1). The result of the work performed on Aircraft 3 was to materially increase the value of the airframe and substantially prolong its useful life.

LAW

Section 162 and section 1.162-1(a) of the Income Tax Regulations allow a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including "incidental repairs."

Section 1.162-4 allows a deduction for the cost of incidental repairs that neither materially add to the value of the property nor appreciably prolong its useful life, but keep it in an ordinarily efficient operating condition. However, section 1.162-4 also provides that the cost of repairs in the nature of replacements that arrest deterioration and appreciably prolong the life of the property must be capitalized and depreciated in accordance with section 167.

Section 263(a) provides that no deduction is allowed for (1) any amount paid out for new buildings or permanent improvements or betterments made to increase the value of any property or estate or (2) any amount expended in restoring property or in making good the exhaustion thereof for which an allowance has been made. See also section 1.263(a)-1(a).

Section 1.263(a)-1(b) provides that capital expenditures include amounts paid or incurred to (1) add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or (2) adapt property to a new or different use. However, that regulation also provides that amounts paid or incurred for incidental

repairs and maintenance of property within the meaning of section 162 and section 1.162-4 are not capital expenditures under section 1.263(a)-1.

Section 263A provides that the direct and indirect costs properly allocable to real or tangible personal property produced by the taxpayer must be capitalized. Section 263A(g)(1) provides that, for purposes of section 263A, the term “produce” includes construct, build, install, manufacture, develop, or improve.

The United States Supreme Court has specifically recognized that the “decisive distinctions [between capital and ordinary expenditures] are those of degree and not of kind,” and a careful examination of the particular facts of each case is required. *Deputy v. duPont*, 308 U.S. 488, 496 (1940), quoting *Welch v. Helvering*, 290 U.S. 111, 114 (1933). To determine whether certain costs should be classified as capital expenditures or as repair and maintenance expenses, “it is appropriate to consider the purpose, the physical nature, and the effect of the work for which the expenditures were made.” *American Bemberg Corp. v. Commissioner*, 10 T.C. 361, 376 (1948), *aff’d*, 177 F.2d 200 (6th Cir. 1949).

Any properly performed repair, no matter how routine, could be considered to prolong the useful life and increase the value of the property if it is compared with the situation existing immediately prior to that repair. Consequently, courts have articulated a number of ways to distinguish between deductible repairs and non-deductible capital improvements. For example, in *Illinois Merchants Trust Co. v. Commissioner*, 4 B.T.A. 103, 106 (1926), *acq.*, V-2 C.B. 2, the court explained that repair and maintenance expenses are incurred for the purpose of keeping the property in an ordinarily efficient operating condition over its probable useful life for the uses for which the property was acquired. Capital expenditures, in contrast, are for replacements, alterations, improvements, or additions that appreciably prolong the life of the property, materially increase its value, or make it adaptable to a different use. In *Estate of Walling v. Commissioner*, 373 F.2d 190, 192-193 (3rd Cir. 1966), the court explained that the relevant distinction between capital improvements and repairs is whether the expenditures were made to “put” or “keep” property in ordinary efficient operating condition. In *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333, 338 (1962), *nonacq.* on other grounds, 1964-2 C.B. 8., the court stated that if the expenditure merely restores the property to the state it was in before the situation prompting the expenditure arose and does not make the property more valuable, more useful, or longer-lived, then such an expenditure is usually considered a deductible repair. In contrast, a capital expenditure is generally considered to be a more permanent increment in the longevity, utility, or worth of the property. The Supreme Court’s decision in *INDOPCO Inc. v. Commissioner*, 503 U.S. 79 (1992) does not affect these general principles. See *Rev. Rul. 94-12*, 1994-1 C.B. 36; *Ingram Industries, Inc. v. Commissioner*, T.C.M. 2000-323.

<<END RULING>>

Even if the expenditures include the replacement of numerous parts of an asset, if the replacements are a relatively minor portion of the physical structure of the asset, or of any of its major parts, such that the asset as a whole has not gained materially in value or useful life, then the costs incurred may be deducted as incidental repairs or maintenance expenses. See *Buckland v. United States*, 66 F. Supp. 681, 683 (D. Conn. 1946) (costs to replace all window sills in factory building were deductible repairs). See also, e.g., *Libby & Blouin Ltd. v. Commissioner*, 4 B.T.A. 910 (1926) (costs to replace all the tubing in sugar evaporator, which were small parts in a large machine, were deductible repairs). The same conclusion is true even if such minor portion of the asset is replaced with new and improved materials. See, e.g., *Badger Pipeline v. Commissioner*, T.C.M. 1997-457 (costs to replace 1,000 feet of pipeline in a 25-mile section of pipeline were deductible repairs, regardless of whether the new pipe was of better quality or has a longer life). If, however, a major component or a substantial structural part of the asset is replaced and, as a result, the asset as a whole has increased in value, life expectancy, or use then the costs of the replacement must be capitalized. See, e.g., *Denver & Rio Grande Western R.R. Co. v. Commissioner*, 279 F.2d 368 (10th Cir. 1960) (costs to replace major portion of a viaduct—all of the floor planks and 85-90% of the stringers—were capital expenditures); *P. Dougherty Co. v. Commissioner*, 159 F.2d 269, 272 (4th Cir. 1946) (costs to replace entire stem section of barge with new materials were capital expenditures); *Vanalco Inc. v. Commissioner*, T.C.M. 1999-265 (cost to replace the cell lining, an essential and substantial component of the cell, was required to be capitalized); *Stark v. Commissioner*, T.C.M. 1999-1 (cost to replace building roof were capital expenditures); *Rev. Rul. 88-57*, 1988-2 C.B. 36,

modified by Rev. Rul. 94-38, 1994-1 C.B. 35 (costs to perform major cyclical rehabilitations on railroad freight train cars as part of a plan of rehabilitation in which all of the structural components were either reconditioned or replaced were capital expenditures). In addition, although the high cost of the work performed may be considered in determining whether an expenditure is capital in nature, cost alone is not dispositive. Compare *R. R. Hensler, Inc. v. Commissioner*, 73 T.C. 168, 177 (1979), acq. in result, 1980-2 C.B. 1 (the fact that taxpayer's expense was large does not change its character as ordinary); *Buckland* at 683 (replacements of relatively minor proportions of the entire physical asset constitute repairs even where high in cost); and *American Bemberg*, 10 T.C. 361 (1948) (deduction allowed for drilling and grouting to prevent cave-ins even though the total cost of the expenditures exceeded \$1.1 million), with *Wolfsen Land & Cattle Co. v. Commissioner*, 72 T.C. 1, 17 (1979) (costs to dragline an irrigation ditch were capital expenditures, in part, because they could be as high as the cost to construct a new ditch); and *Stoeltzing v. Commissioner*, 266 F.2d 374, 376 (3d Cir. 1959) (expenditures could not be incidental repairs because they exceeded by almost 200% the cost of the building).

Similarly, the fact that a taxpayer is required by a regulatory authority to make certain repairs or to perform certain maintenance on an asset in order to continue operating the asset in its business does not mean that the work performed materially increases the value of such asset, substantially prolongs its useful life, or adapts it to a new use. See, e.g., *Midland Empire Packing Co. v. Commissioner*, 14 T.C. 635 (1950), acq., 1950-2 C.B. 3 (costs of applying concrete liner to basement walls and floors in order to satisfy federal meat inspectors were deductible repairs); *L&L Marine Service Inc. v. Commissioner*, T.C.M. 1987-428 (work performed on barges that was necessary to enable the barges to continue to qualify for sea duty was a deductible repair).

The characterization of any cost as a deductible repair or capital improvement depends on the context in which the cost is incurred. Specifically, where an expenditure is made as part of a general plan of rehabilitation, modernization, and improvement of the property, the expenditure must be capitalized, even though, standing alone, the item may be classified as one of repair or maintenance. *United States v. Wehri*, 400 F.2d 686, 689 (10th Cir. 1968). Whether a general plan of rehabilitation exists, and whether a particular repair or maintenance item is part of it, are questions of fact to be determined based upon all the surrounding facts and circumstances, including, but not limited to, the purpose, nature, extent, and value of the work done. *Id.* at 690. The existence of a written plan, by itself, is not sufficient to trigger the plan of rehabilitation doctrine. See *Moss v. Commissioner*, 831 F.2d 833, 842 (9th Cir. 1987); *Vanalco v. Commissioner*, T.C.M. 1999-265.

In general, the courts have applied the plan of rehabilitation doctrine to require a taxpayer to capitalize otherwise deductible repair and maintenance costs where the taxpayer has a plan to make substantial capital improvements to property and the repairs are incidental to that plan. See, e.g., *California Casket Co. v. Commissioner*, 19 T.C. 32 (1952), acq., 1953-1 C.B. 3 (costs of repairing the foundation although not in the original plan became, when undertaken, incidental to and involved in the plan of completely renovating and remodeling an old warehouse building); *Stoeltzing* at 377 (costs to renovate old building by shoring up floors; constructing steps, landing and new driveway; replacing wiring and plumbing; installing new roof; plastering; insulating; performing carpentry work; patching the gutters; and removing rubbish must be capitalized as part of plan of rehabilitation); *Bank of Houston v. Commissioner*, T.C.M. 1960-110 (costs incurred for various repairs incident to the reconstruction and renovation of a bank building must be capitalized as part of a general plan of rehabilitation). On the other hand, the courts and the Service have not applied the plan of rehabilitation doctrine to situations where the plan did not include substantial capital improvements and repairs to the same asset, the plan primarily involved repair and maintenance items, or the work was performed merely to keep the property in an ordinarily efficient operating condition. See, e.g., *Moss* at 840 (repairs incurred in conjunction with a hotel remodeling project not required to be capitalized as part of a plan of rehabilitation because the project's capital expenditures were not of the nature or scope necessary to trigger the plan of rehabilitation doctrine); *Schroeder v. Commissioner*, T.C.M. 1996-336 (costs of renovating barns were not required to be capitalized as part of a plan of rehabilitation where most of the renovation costs were repairs and maintenance to keep the barns in an efficient operating condition); *Rev. Rul. 70-392*, 1970-2 C.B. 33 (costs incurred to relocate existing capital assets in order to install new assets intended to increase a utility's distribution voltage were not required to

be capitalized as part of a general plan of rehabilitation because the relocation merely kept the existing assets in an ordinarily efficient operating condition).

ANALYSIS

In Situation 1, the heavy maintenance visit on Aircraft 1 primarily involved inspecting, testing, servicing, repairing, reconditioning, cleaning, stripping, and repainting numerous airframe parts and components. The heavy maintenance visit did not involve replacements, alterations, improvements, or additions to the airframe that appreciably prolonged its useful life, materially increased its value, or adapted it to a new or different use. Rather, the heavy maintenance visit merely kept the airframe in an ordinarily efficient operating condition over its anticipated useful life for the uses for which the property was acquired. See *Illinois Merchant Trust Co.* at 106; *Estate of Walling* at 192-193; *Ingram Industries, Inc.* at 538-539. The fact that the taxpayer was required to perform the heavy maintenance visit to maintain its airworthiness certificate does not affect this determination. See *Midland Empire Packing* at 642.

Although the heavy maintenance visit did involve the replacement of numerous airframe parts with new parts, none of these replacements required the substitution of any (or a significant portion of any) major components or substantial structural parts of the airframe so that the airframe as a whole increased in value, life expectancy, or use. Compare *Buckland* at 683 with *P. Dougherty* at 272. Thus, the facts in Situation 1 are distinguishable from those in *Rev. Rul. 88-57* in which all of the structural components of a railroad freight car were either reconditioned or replaced so that the car was restored to a "like new" condition with a new, additional service life of 12 to 14 years. Moreover, the heavy maintenance visit also did not restore the airframe, or make good exhaustion for which an allowance had been made, within the meaning of section 263(a)(2). In order to have a restoration under section 263(a)(2), much more extensive work would have to be done so as to substantially prolong the useful life of the airframe. See *Denver & Rio Grande* at 373. Thus, the costs of the heavy maintenance visit constitute expenses for incidental repairs and maintenance under section 1.162-4.

Finally, the costs of the heavy maintenance visit are not required to be capitalized under sections 263 or 263A as part of a plan of rehabilitation, modernization, or improvement to the airframe. Because the heavy maintenance visit involved only repairs for the purpose of keeping the airframe in an ordinarily efficient operating condition, it did not include the type of substantial capital improvements necessary to trigger the plan of rehabilitation doctrine. See *Schroeder v. Commissioner, T.C.M. 1996-336*; *Moss* at 842. Accordingly, the costs incurred by X for the heavy maintenance visit in Situation 1 may be deducted as ordinary and necessary business expenses under section 162.

In Situation 2, in addition to performing all of the work described in Situation 1 on Aircraft 2, X replaced all of the skin panels on the belly of the fuselage and installed a cabin smoke and fire detection and suppression system, a ground proximity warning system and an air phone system. Because the replacement of the skin panels involved replacing a significant portion of the airframe's skin panels (which in the aggregate represented a substantial structural part of the airframe) thereby materially adding to the value of and improving the airframe, the cost of replacing the skin panels must be capitalized. See *Vanalco, T.C.M. 1999-265*; *P. Dougherty* at 272. In addition, the additions and upgrades to Aircraft 2 in the form of the fire protection, air phone, and ground proximity warning systems must be capitalized because they materially improved the airframe. See *Phillips and Easton Supply Co. v. Commissioner, 20 T.C. 455, 460 (1953)*. Accordingly, the costs incurred by X for labor and materials allocable to these capital improvements must be treated as capital expenditures under section 263. Moreover, because the improvement of property constitutes production within the meaning of section 263A(g)(1), X is required to capitalize under section 263A the direct costs and a proper share of the allocable indirect costs associated with these improvements.

Further, the mere fact that these capital improvements were made at the same time that the work described in Situation 1 was performed on Aircraft 2 does not require capitalization of the cost of the heavy maintenance visit under the plan of rehabilitation doctrine. Whether a general plan of rehabilitation exists is a question of fact to be determined based on all the facts and circumstances. See *Wehrli* at 690. X's plan in Situation 2 was not to rehabilitate Aircraft 2, but merely to perform discrete capital improvements to the airframe. See *Moss* at 839; *Schroeder v. Commissioner, T.C.M. 1996-336*; *Rev. Rul. 70-392*. For this reason, the facts of Situation 2 are distinguishable from *Rev. Rul. 88-57*, which involved

a major rehabilitation that constituted a plan of rehabilitation undertaken near the end of the freight car's life for the purpose of restoring it to a "like new" condition. Accordingly, the costs of the work described in Situation 1 are not part of a general plan of rehabilitation, modernization, or improvement to the airframe. The costs incurred by X for the work performed on Aircraft 2 must be allocated between capital improvements, which must be capitalized under sections 263 and 263A, and repairs and maintenance, which may be deducted under section 162.

In Situation 3, X is required to capitalize under section 263 the costs of all the work performed on Aircraft 3. The work in Situation 3 involved replacements of major components and significant portions of substantial structural parts that materially increased the value and substantially prolonged the useful life of the airframe. See P. Dougherty at 272 and Rev. Rul. 88-57. In addition, the value of Aircraft 3 was materially increased as a result of material additions, alterations and upgrades that enabled X to operate Aircraft 3 in an improved way. See *Dominion Resources*, 48 F. Supp. 2d 527, 553. In contrast to Situation 1, the extensiveness of the work performed on Aircraft 3 constitutes a restoration within the meaning of section 263(a)(2). See, e.g. *Denver & Rio Grande* at 373.

X performed much of the same work on Aircraft 3 that would be performed during a heavy maintenance visit (as described in Situation 1) ("Situation 1-type work"). Although these costs, standing alone, generally are deductible expenses under section 162, in this context, they are incurred as part of a general plan of rehabilitation, modernization, and improvement to the airframe of Aircraft 3 and X is required to capitalize under sections 263 and 263A the costs of that work. See *Wehrli* at 689-90. In this situation, X planned to perform substantial capital improvements to upgrade the airframe of Aircraft 3 for the purpose of increasing its reliability and extending its useful life. See Rev. Rul. 88-57. The Situation 1-type work was incidental to X's plan to upgrade Aircraft 3. See *California Casket* at 38. The effect of all the work performed on Aircraft 3, including the inspection, repair, and maintenance items, is to materially increase the value of the airframe and substantially prolong its useful life. Thus, all the work performed by X on Aircraft 3 is part of a general plan of rehabilitation, modernization, and improvement to the airframe and the costs associated with this work must be capitalized under section 263. Further, because the improvement of the airframe constitutes production of property within the meaning of section 263A(g)(1), X is required to capitalize under section 263A the direct costs and a proper share of the allocable indirect costs associated with this improvement plan.

The conclusions in this ruling would be the same whether X transported only freight or only passengers.

HOLDINGS

Costs incurred by a taxpayer to perform work on its aircraft airframe as part of a heavy maintenance visit generally are deductible as ordinary and necessary business expenses under section 162. However, costs incurred in conjunction with a heavy maintenance visit must be capitalized to the extent they materially add to the value of, substantially prolong the useful life of, or adapt the airframe to a new or different use. In addition, costs incurred as part of a plan of rehabilitation, modernization, or improvement must be capitalized.

APPLICATION

Any change in a taxpayer's method of accounting to conform with this revenue ruling is a change in method of accounting to which the provisions of sections 446 and 481 and the regulations thereunder apply. A taxpayer wanting to change its method of accounting to conform with the holding in this revenue ruling must follow the automatic change in accounting method provisions of Rev. Proc. 99-49, 1999-2 C.B. 725, provided the change is made for the first taxable year ending after January 16, 2001. However, the scope limitations in section 4.02 of Rev. Proc. 99-49 do not apply unless the taxpayer's method of accounting for costs incurred to perform work on its aircraft airframes is an issue pending, within the meaning of section 6.01(6) of Rev. Proc. 2000-38, 2000-40 I.R.B. 3 10, at the time the Form 3115 is filed with the national office. If the taxpayer is under examination, before an appeals office, or before a federal court with respect to any income tax issue, the taxpayer must provide a copy of the Form 3115,

Application for Change in Accounting Method, to the examining agent, appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the Form 3115 with the national office. The Form 3115 must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate.

EFFECT ON OTHER DOCUMENTS

Rev. Proc. 99-49 is modified and amplified to include the prospective change in accounting method in the APPENDIX. Rev. Rul. 88-57 is distinguished.

DRAFTING INFORMATION

The principal author of this revenue ruling is Merrill D. Feldstein of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Ms. Feldstein or Beverly Katz at (202) 622-4950 (not a toll-free call).

<<END RULING>>