



June 9, 2008

CC:PA:LPD:PR  
Internal Revenue Service  
Room 5203  
P.O. Box 7604  
Ben Franklin Station  
Washington, DC 20044

**RE: IRS REG-168745-03: Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property; Proposed Rule**

The National Business Aviation Association (NBAA) represents the interests of 8,000 Member companies that operate over 10,000 aircraft to support their businesses. We appreciate the opportunity to submit these comments on behalf of the business aviation community. In order to understand our concerns, some general background information might be helpful.

**Aircraft Operations**

All aircraft operations in the United States must be conducted in accordance with the Federal Aviation Administration (FAA) rules, including the Federal Aviation Regulations (FARs).<sup>1</sup> The FARs generally classify aircraft operations into one of three categories: (1) airline operations conducted under Part 121 of the FARs; (2) charter operations conducted under Part 135; and (3) noncommercial operations conducted under Part 91. Our greatest concern is with general aviation aircraft operated under Parts 91 and 135. This includes aircraft operated under a fractional ownership program - where several joint owners share their aircraft with other joint owners.

General aviation aircraft usage averages 400 hours per year and can vary widely - anywhere from 200 flight hours per year for a business aircraft to over 1200 hours per year for an aircraft that is part of a fractional ownership program. In contrast, airline aircraft usage might be in excess of 6,000 flight hours per year.

**Inspection and Maintenance Programs**

The FARs require the operator of a general aviation aircraft to maintain the aircraft in accordance with specified standards. At a minimum, a Part 91 aircraft must have an annual inspection and/or a 100 hour inspection. In addition, certain parts of the aircraft, such as the altimeter system and transponder, must be inspected at prescribed intervals. Larger aircraft Part 91 aircraft and Part 135 aircraft are subject to a regular series of inspections, called progressive inspections. For example, the owner of a Cessna Citation will perform a series of inspections, known as Phase 1 through 5.

The cost of merely inspecting the aircraft can be significant. However, an inspection does not necessarily involve the repair or replacement of any parts. In many cases, the job of the

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<sup>1</sup> 49 USC 40103.

inspector is to determine whether parts are within tolerance and to look for corrosion, cracks or unusual wear and tear. This may take several days and involve looking at hundreds of parts.

### **Aircraft Repairs and Overhauls**

An aircraft operator may repair and replace parts for several reasons. The parts may have broken or have reached the end of their replacement interval. The inspection may have revealed that the parts are out of tolerance. The manufacturer may have instituted a program requiring or encouraging the replacement of certain parts for safety purposes. The replacement parts may be new, used or reconditioned parts, ranging in price from under \$10 to more than \$250,000.

In many cases, the aircraft owner will have to overhaul the part. For example, in contrast with other transportation property, such as an automobile, an aircraft owner will have to overhaul the engines several times during the life of the aircraft. The owner of an airline aircraft might overhaul the engines every 2 years, while the owner of a general aviation aircraft might overhaul the engines every 5 to 10 years. Nevertheless, in both cases, the general procedures involved are essentially identical.

## **1. ROUTINE MAINTENANCE**

### **a. Definition of Routine Maintenance**

The new regulations contain a “safe harbor” that allows taxpayers to currently deduct the cost of “routine maintenance”. This is a helpful addition to the regulations but may have limited application to general aviation aircraft. The reason is that the regulations provide that: “The activities are routine only if, at the time the unit of property is placed in service by the taxpayer, the taxpayer reasonably expects to perform the activities more than once during the class life . . .”.<sup>2</sup> The class life for commercial aircraft is 12 years and the class life for noncommercial aircraft and all helicopters is 6 years.<sup>3</sup>

We understand and appreciate the IRS effort to create a bright line test. This bright line will work well for airlines that, because of greater utilization rates, perform major maintenance and overhauls several times during a 12 year class life. However, in the case of general aviation aircraft, the bright line falls precisely in the area where it will create the most havoc. For example, the owner of a large aircraft may take several years to conduct all the phases of the inspection and repair process. As a result, a general aviation owner may be unable to take advantage of the safe harbor - even though the expenses are identical to those that might be covered in the case of an airline.

This safe harbor can also create special problems for general aviation aircraft. A general aviation aircraft may fit within either the commercial or noncommercial class, depending on the primary use of the aircraft during the tax year. In some cases, the class can change from year to year. If so, then the treatment of identical expenses can vary from year to year.

To avoid these inequities and problems, we propose that you modify the safe harbor to allow all aircraft to use the same 12 year class life for this purpose.

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<sup>2</sup> Prop. Reg. 1.263(a)-3(e)(1).

<sup>3</sup> Rev. Proc. 87-56, Asset Class 45 [commercial aircraft] and Asset Class 00.21 [noncommercial aircraft and all helicopters].

## **b. Inspections**

In addition to “routine maintenance”, we would propose that you expand the safe harbor to explicitly cover the costs of inspections, regardless of how often they are performed. The reason is that an inspection merely involves examining the property and does not - by itself - involve the repair or replacement of any parts.

## **2. DEDUCTIONS ON PREVIOUSLY OWNED AIRCRAFT**

The current proposed regulations, like the old proposed regulations, prescribe a special rule for purchasers of used property that will create significant problems for purchasers of used aircraft. In determining whether an expenditure is a betterment or a repair, both the old and current proposed regulations have adopted the “Plainfield Union test”.<sup>4</sup> The current proposed regulations provide that “the determination of whether an expenditure results in a betterment of the unit of property is made by comparing the condition of the property immediately after the expenditure with the condition of the property immediately prior to the circumstances necessitating the expenditure”.<sup>5</sup>

However, where a taxpayer purchases used property, the current proposed regulations modify this test by providing that “the condition of the property immediately prior to the circumstances necessitating the expenditure is the condition of the property after the last time the taxpayer corrected the effects of normal wear and tear (whether the amounts paid were for maintenance or improvements) or, if the taxpayer has not previously corrected the effects of normal wear and tear, the condition of the property when placed in service by the taxpayer”.<sup>6</sup>

In our view, this modification of the “Plainfield Union test” is unwarranted and will create an accounting nightmare for the purchasers of used aircraft and their IRS auditors. The number of used aircraft sold is significant given that the average age of the general aviation fleet is in excess of 30 years.

We can understand how the IRS might want to create a rule to prevent used aircraft buyers from buying a “run out” aircraft and deducting significant repair costs. The current proposed regulations require capitalization of an expense that “[r]eturns the unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use”.<sup>7</sup> However, the proposed modification of the Plainfield Union test will go much further.

Every used aircraft has thousands of used parts. Over time, the owner will have to inspect and replace almost all of these parts. This means that, under the proposed modification, an aircraft owner will have to keep track of several thousand parts to determine when each part is repaired or replaced for the first time after purchase. The process of repairing or replacing all parts could take years, or even decades.

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<sup>4</sup> Plainfield-Union Water Co., 39 T.C. 333 (1962).

<sup>5</sup> Prop. Reg. 1.263(a)-3(f)(2)(iii)(A).

<sup>6</sup> Prop. Reg. 1.263(a)-3(f)(2)(iii)(B).

<sup>7</sup> Prop. Reg. 1.263(a)-3(g)(1)(iv).

Furthermore, determining the prior owner's use will prove difficult, if not impossible. At the time of sale, the purchaser will not have information to determine the status of these parts. A typical contract for the sale of a used aircraft requires that the aircraft be in an airworthy condition with all inspections current. However, this merely indicates that the aircraft parts are within allowable tolerances and provides no indication of the actual condition of each aircraft part. This process is further complicated where, for example, the repair is necessitated by an event that takes place after the purchase. For example, if an owner is forced to replace parts as the result of a bird strike or Foreign Object Damage, the owner may be unable to tell the extent of prior use.

For all of these reasons, we believe that the IRS should eliminate the modified Plainfield Union test. Nevertheless, if the IRS insists on adopting this rule, we propose that that the regulations should explicitly state that the owner only has to capitalize the proportion of expenses attributable to the prior owner's use. We believe that this is implicit in the rule, but would prefer to set the matter to rest.

### 3. 50% RULE

The general capitalization regulations have consistently provided that expenses that "substantially prolong the life of the property" are capital expenses.<sup>8</sup> The old proposed regulations defined this kind of expense as a "restoration".<sup>9</sup> In addition, the old proposed regulation created a class of "deemed restoration" expenses, stating that: "Amounts paid will be deemed to substantially prolong the economic useful life of the unit of property if they result in the unit of property or a major component or substantial structural part of the unit of property being restored to a like-new condition (including bringing the unit of property or a major component or substantial structural part of the property to the status of new, rebuilt, remanufactured, or similar status under the terms of any Federal regulatory guideline or the manufacturer's original specifications)."<sup>10</sup>

The current proposed regulations also contain the "deemed restoration" rule.<sup>11</sup> In order to eliminate ambiguity about the application of the rule, the current proposed regulations provide that "the replacement of a major component or a substantial structural part means the replacement of - (1) A part or a combination of parts of the unit of property, the cost of which comprises 50 percent or more of the replacement cost of the unit of property; or (2) A part or a combination of parts of the unit of property that comprise 50 percent or more of the physical structure of the unit of property."<sup>12</sup>

In our view, the IRS should abandon this effort to create a "deemed restoration" rule, for several reasons:

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<sup>8</sup> Reg. 1.263(a)-1(b).

<sup>9</sup> Previous Prop. Reg. 1.263(a)-3(f) provided that "A taxpayer must capitalize amounts paid that restore a unit of property" and that amounts paid restore property if the amounts paid "substantially prolong the economic useful life of the unit of property".

<sup>10</sup> Previous Prop. Reg. 1.263(a)-3(f)(3)(iii).

<sup>11</sup> Prop. Reg. 1.263(a)-3(g)(2)(vi).

<sup>12</sup> Prop. Reg. 1.263(a)-3(g)(3).

- First, the “deemed restoration” rule is not supported by statute or case law. To the contrary, the rule is inconsistent with the case law - which only considers the condition of the entire unit of property, not isolated components.
- Second, because the rule is an untested “innovation”, we anticipate that the rule will lead to unexpected complications. For example, the 50% physical structure rule appears to require the capitalization of airframe overhaul expenses, which is in direct contradiction to Rev. Rul. 2001-4. The 50% of cost rule will also lead to complications. For example, if an aircraft has more than one engine, must the owner treat all engines as a single component, even if the owner is only overhauling one engine? If not, the rule would appear to discriminate in favor of multi-engine aircraft and encourage owners to overhaul only one engine at a time. If so, then the IRS needs to issue significant additional guidance to identify the “deemed payments” that will become part of the “deemed restoration”.
- Third, because the rule is not based on statutory principles or an established body of case law, the IRS will have to create all the additional rules necessary to answer these and other questions that will arise.

Please contact NBAA if we can provide any additional information. Thank you for your consideration.

Sincerely,



Mike Nichols  
Vice President, Operations, Education & Economics