

records. K elects to apply the de minimis safe harbor under paragraph (f) of this section in Year 1 and does not capitalize the amounts paid for each invoice pursuant to the safe harbor. Under paragraph (f)(6) of this section, K has applied the de minimis rule to amounts substantiated with invoices created to componentize property that is generally acquired as a single unit of tangible property in the taxpayer's type of business, and this property, if treated as single unit, would exceed the limitations provided under the de minimis rule. Accordingly, K is deemed to manipulate the transaction to acquire the truck with the intent to avoid the purposes of this paragraph (f). As a result, K may not apply the de minimis rule to these amounts and is subject to appropriate adjustments.

(g) *Accounting method changes.* Except for paragraph (f) of this section (the de minimis safe harbor election), a change to comply with this section is a change in method of accounting to which the provisions of sections 446 and 481 and the accompanying regulations apply. A taxpayer seeking to change to a method of accounting permitted in this section must secure the consent of the Commissioner in accordance with §1.446-1(e) and follow the administrative procedures issued under §1.446-1(e)(3)(ii) for obtaining the Commissioner's consent to change its accounting method.

(h) *Effective/applicability date*—(1) *In general.* Except for paragraph (f) of this section, this section generally applies to taxable years beginning on or after January 1, 2014. Paragraph (f) of this section applies to amounts paid in taxable years beginning on or after January 1, 2014. Except as provided in paragraph (h)(1) and paragraph (h)(2) of this section, §1.263(a)-1 as contained in 26 CFR part 1 edition revised as of April 1, 2011, applies to taxable years beginning before January 1, 2014.

(2) *Early application of this section*—(i) *In general.* Except for paragraph (f) of this section, a taxpayer may choose to apply this section to taxable years beginning on or after January 1, 2012. A taxpayer may choose to apply paragraph (f) of this section to amounts paid in taxable years beginning on or after January 1, 2012.

(ii) *Transition rule for de minimis safe harbor election on 2012 or 2013 returns.* If under paragraph (h)(2)(i) of this section, a taxpayer chooses to make the

election to apply the de minimis safe harbor under paragraph (f) of this section for amounts paid in its taxable year beginning on or after January 1, 2012, and ending on or before September 19, 2013 (applicable taxable year), and the taxpayer did not make the election specified in paragraph (f)(5) of this section on its timely filed original Federal tax return for the applicable taxable year, the taxpayer must make the election specified in paragraph (f)(5) of this section for the applicable taxable year by filing an amended Federal tax return for the applicable taxable year on or before 180 days from the due date including extensions of the taxpayer's Federal tax return for the applicable taxable year, notwithstanding that the taxpayer may not have extended the due date.

(3) *Optional application of TD 9564.* A taxpayer may choose to apply §1.263(a)-1T as contained in TD 9564 (76 FR 81060) December 27, 2011, to taxable years beginning on or after January 1, 2012, and before January 1, 2014.

[T.D. 9636, 78 FR 57710, Sept. 19, 2013, as amended by T.D. 9636, 79 FR 42191, July 21, 2014]

§ 1.263(a)-2 Amounts paid to acquire or produce tangible property.

(a) *Overview.* This section provides rules for applying section 263(a) to amounts paid to acquire or produce a unit of real or personal property. Paragraph (b) of this section contains definitions. Paragraph (c) of this section contains the rules for coordinating this section with other provisions of the Internal Revenue Code (Code). Paragraph (d) of this section provides the general requirement to capitalize amounts paid to acquire or produce a unit of real or personal property. Paragraph (e) of this section provides the requirement to capitalize amounts paid to defend or perfect title to real or personal property. Paragraph (f) of this section provides the rules for determining the extent to which taxpayers must capitalize transaction costs related to the acquisition of tangible property. Paragraphs (g) and (h) of this section address the treatment and recovery of capital expenditures. Paragraph (i) of this section provides for changes in methods of accounting to comply with

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this section, and paragraph (j) of this section provides the effective and applicability dates for the rules under this section.

(b) *Definitions.* For purposes of this section, the following definitions apply:

(1) *Amount paid.* In the case of a taxpayer using an accrual method of accounting, the terms *amount paid* and *payment* mean a liability incurred (within the meaning of § 1.446-1(c)(1)(ii)). A liability may not be taken into account under this section prior to the taxable year during which the liability is incurred.

(2) *Personal property* means tangible personal property as defined in § 1.48-1(c).

(3) *Real property* means land and improvements thereto, such as buildings or other inherently permanent structures (including items that are structural components of the buildings or structures) that are not personal property as defined in paragraph (b)(2) of this section. Any property that constitutes other tangible property under § 1.48-1(d) is treated as real property for purposes of this section. Local law is not controlling in determining whether property is real property for purposes of this section.

(4) *Produce* means construct, build, install, manufacture, develop, create, raise, or grow. This definition is intended to have the same meaning as the definition used for purposes of section 263A(g)(1) and § 1.263A-2(a)(1)(i), except that improvements are excluded from the definition in this paragraph (b)(4) and are separately defined and addressed in § 1.263(a)-3.

(c) *Coordination with other provisions of the Code—(1) In general.* Nothing in this section changes the treatment of any amount that is specifically provided for under any provision of the Code or the Treasury Regulations other than section 162(a) or section 212 and the regulations under those sections. For example, see section 263A requiring taxpayers to capitalize the direct and allocable indirect costs of property produced by the taxpayer and property acquired for resale. See also section 195 requiring taxpayers to capitalize certain costs as start-up expenditures.

(2) *Materials and supplies.* Nothing in this section changes the treatment of amounts paid to acquire or produce property that is properly treated as materials and supplies under § 1.162-3.

(d) *Acquired or produced tangible property—(1) Requirement to capitalize.* Except as provided in § 1.162-3 (relating to materials and supplies) and in § 1.263(a)-1(f) (providing a de minimis safe harbor election), a taxpayer must capitalize amounts paid to acquire or produce a unit of real or personal property (as determined under § 1.263(a)-3(e)), including leasehold improvements, land and land improvements, buildings, machinery and equipment, and furniture and fixtures. Section 1.263(a)-3(f) provides the rules for determining whether amounts are for leasehold improvements. Amounts paid to acquire or produce a unit of real or personal property include the invoice price, transaction costs as determined under paragraph (f) of this section, and costs for work performed prior to the date that the unit of property is placed in service by the taxpayer (without regard to any applicable convention under section 168(d)). A taxpayer also must capitalize amounts paid to acquire real or personal property for resale.

(2) *Examples.* The following examples illustrate the rules of this paragraph (d). Unless otherwise provided, assume that the taxpayer does not elect the de minimis safe harbor under § 1.263(a)-1(f) and that the property is not acquired for resale under section 263A.

Example 1. Acquisition of personal property. A purchases new cash registers for use in its retail store located in leased space in a shopping mall. Assume each cash register is a unit of property as determined under § 1.263(a)-3(e) and is not a material or supply under § 1.162-3. A must capitalize under paragraph (d)(1) of this section the amount paid to acquire each cash register.

Example 2. Acquisition of personal property that is a material or supply; coordination with § 1.162-3. B operates a fleet of aircraft. In Year 1, B acquires a stock of component parts, which it intends to use to maintain and repair its aircraft. Assume that each component part is a material or supply under § 1.162-3(c)(1) and B does not make elections under § 1.162-3(d) to treat the materials and supplies as capital expenditures. In Year 2, B uses the component parts in the repair and maintenance of its aircraft. Because

the parts are materials and supplies under §1.162-3, B is not required to capitalize the amounts paid for the parts under paragraph (d)(1) of this section. Rather, to determine the treatment of these amounts, B must apply the rules under §1.162-3, governing the treatment of materials and supplies.

Example 3. Acquisition of unit of personal property; coordination with §1.162-3. C operates a rental business that rents out a variety of small individual items to customers (rental items). C maintains a supply of rental items on hand to replace worn or damaged items. C purchases a large quantity of rental items to be used in its business. Assume that each of these rental items is a unit of property under §1.263(a)-3(e). Also assume that a portion of the rental items are materials and supplies under §1.162-3(c)(1). Under paragraph (d)(1) of this section, C must capitalize the amounts paid for the rental items that are not materials and supplies under §1.162-3(c)(1). However, C must apply the rules in §1.162-3 to determine the treatment of the rental items that are materials and supplies under §1.162-3(c)(1).

Example 4. Acquisition or production cost. D purchases and produces jigs, dies, molds, and patterns for use in the manufacture of D's products. Assume that each of these items is a unit of property as determined under §1.263(a)-3(e) and is not a material and supply under §1.162-3(c)(1). D is required to capitalize under paragraph (d)(1) of this section the amounts paid to acquire and produce the jigs, dies, molds, and patterns.

Example 5. Acquisition of land. F purchases a parcel of undeveloped real estate. F must capitalize under paragraph (d)(1) of this section the amount paid to acquire the real estate. See paragraph (f) of this section for the treatment of amounts paid to facilitate the acquisition of real property.

Example 6. Acquisition of building. G purchases a building. G must capitalize under paragraph (d)(1) of this section the amount paid to acquire the building. See paragraph (f) of this section for the treatment of amounts paid to facilitate the acquisition of real property.

Example 7. Acquisition of property for resale and production of property for sale; coordination with section 263A. H purchases goods for resale and produces other goods for sale. H must capitalize under paragraph (d)(1) of this section the amounts paid to acquire and produce the goods. See section 263A for the amounts required to be capitalized to the property produced or to the property acquired for resale.

Example 8. Production of building; coordination with section 263A. J constructs a building. J must capitalize under paragraph (d)(1) of this section the amount paid to construct the building. See section 263A for the costs required to be capitalized to the real property produced by J.

Example 9. Acquisition of assets constituting a trade or business. K owns tangible and intangible assets that constitute a trade or business. L purchases all the assets of K in a taxable transaction. L must capitalize under paragraph (d)(1) of this section the amount paid for the tangible assets of K. See §1.263(a)-4 for the treatment of amounts paid to acquire or create intangibles and §1.263(a)-5 for the treatment of amounts paid to facilitate the acquisition of assets that constitute a trade or business. See section 1060 for special allocation rules for certain asset acquisitions.

Example 10. Work performed prior to placing the property in service. In Year 1, M purchases a building for use as a business office. Prior to placing the building in service, M pays amounts to repair cement steps, refinish wood floors, patch holes in walls, and paint the interiors and exteriors of the building. In Year 2, M places the building in service and begins using the building as its business office. Assume that the work that M performs does not constitute an improvement to the building or its structural components under §1.263(a)-3. Under §1.263-3(e)(2)(i), the building and its structural components is a single unit of property. Under paragraph (d)(1) of this section, the amounts paid must be capitalized as amounts to acquire the building unit of property because they were for work performed prior to M's placing the building in service.

Example 11. Work performed prior to placing the property in service. In January Year 1, N purchases a new machine for use in an existing production line of its manufacturing business. Assume that the machine is a unit of property under §1.263(a)-3(e) and is not a material or supply under §1.162-3. N pays amounts to install the machine, and after the machine is installed, N pays amounts to perform a critical test on the machine to ensure that it will operate in accordance with quality standards. On November 1, Year 1, the critical test is complete, and N places the machine in service on the production line. N pays amounts to perform periodic quality control testing after the machine is placed in service. Under paragraph (d)(1) of this section, the amounts paid for the installation and the critical test performed before the machine is placed in service must be capitalized by N as amounts to acquire the machine. However, amounts paid for periodic quality control testing after N placed the machine in service are not required to be capitalized as amounts paid to acquire the machine.

(e) *Defense or perfection of title to property—(1) In general.* Amounts paid to defend or perfect title to real or personal property are amounts paid to acquire or produce property within the

meaning of this section and must be capitalized.

(2) *Examples.* The following examples illustrate the rule of this paragraph (e):

Example 1. Amounts paid to contest condemnation. X owns real property located in County. County files an eminent domain complaint condemning a portion of X's property to use as a roadway. X hires an attorney to contest the condemnation. The amounts that X paid to the attorney must be capitalized because they were to defend X's title to the property.

Example 2. Amounts paid to invalidate ordinance. Y is in the business of quarrying and supplying for sale sand and stone in a certain municipality. Several years after Y establishes its business, the municipality in which it is located passes an ordinance that prohibits the operation of Y's business. Y incurs attorney's fees in a successful prosecution of a suit to invalidate the municipal ordinance. Y prosecutes the suit to preserve its business activities and not to defend Y's title in the property. Therefore, the attorney's fees that Y paid are not required to be capitalized under paragraph (e)(1) of this section.

Example 3. Amounts paid to challenge building line. The board of public works of a municipality establishes a building line across Z's business property, adversely affecting the value of the property. Z incurs legal fees in unsuccessfully litigating the establishment of the building line. The amounts Z paid to the attorney must be capitalized because they were to defend Z's title to the property.

(f) *Transaction costs*—(1) *In general.* Except as provided in § 1.263(a)-1(f)(3)(i) (for purposes of the de minimis safe harbor), a taxpayer must capitalize amounts paid to facilitate the acquisition of real or personal property. See § 1.263(a)-5 for the treatment of amounts paid to facilitate the acquisition of assets that constitute a trade or business. See § 1.167(a)-5 for allocations of facilitative costs between depreciable and non-depreciable property.

(2) *Scope of facilitate*—(i) *In general.* Except as otherwise provided in this section, an amount is paid to facilitate the acquisition of real or personal property if the amount is paid in the process of investigating or otherwise pursuing the acquisition. Whether an amount is paid in the process of investigating or otherwise pursuing the acquisition is determined based on all of the facts and circumstances. In determining whether an amount is paid to facilitate an acquisition, the fact that the amount would (or would not) have

been paid but for the acquisition is relevant but is not determinative. Amounts paid to facilitate an acquisition include, but are not limited to, inherently facilitative amounts specified in paragraph (f)(2)(ii) of this section.

(ii) *Inherently facilitative amounts.* An amount is paid in the process of investigating or otherwise pursuing the acquisition of real or personal property if the amount is inherently facilitative. An amount is inherently facilitative if the amount is paid for—

(A) Transporting the property (for example, shipping fees and moving costs);

(B) Securing an appraisal or determining the value or price of property;

(C) Negotiating the terms or structure of the acquisition and obtaining tax advice on the acquisition;

(D) Application fees, bidding costs, or similar expenses;

(E) Preparing and reviewing the documents that effectuate the acquisition of the property (for example, preparing the bid, offer, sales contract, or purchase agreement);

(F) Examining and evaluating the title of property;

(G) Obtaining regulatory approval of the acquisition or securing permits related to the acquisition, including application fees;

(H) Conveying property between the parties, including sales and transfer taxes, and title registration costs;

(I) Finders' fees or brokers' commissions, including contingency fees (defined in paragraph (f)(3)(iii) of this section);

(J) Architectural, geological, survey, engineering, environmental, or inspection services pertaining to particular properties; or

(K) Services provided by a qualified intermediary or other facilitator of an exchange under section 1031.

(iii) *Special rule for acquisitions of real property*—(A) *In general.* Except as provided in paragraph (f)(2)(ii) of this section (relating to inherently facilitative amounts), an amount paid by the taxpayer in the process of investigating or otherwise pursuing the acquisition of real property does not facilitate the acquisition if it relates to activities performed in the process of determining

whether to acquire real property and which real property to acquire.

(B) *Acquisitions of real and personal property in a single transaction.* An amount paid by the taxpayer in the process of investigating or otherwise pursuing the acquisition of personal property facilitates the acquisition of such personal property, even if such property is acquired in a single transaction that also includes the acquisition of real property subject to the special rule set out in paragraph (f)(2)(iii)(A) of this section. A taxpayer may use a reasonable allocation method to determine which costs facilitate the acquisition of personal property and which costs relate to the acquisition of real property and are subject to the special rule of paragraph (f)(2)(iii)(A) of this section.

(iv) *Employee compensation and overhead costs—(A) In general.* For purposes of paragraph (f) of this section, amounts paid for employee compensation (within the meaning of §1.263(a)-4(e)(4)(ii)) and overhead are treated as amounts that do not facilitate the acquisition of real or personal property. However, section 263A provides rules for employee compensation and overhead costs required to be capitalized to property produced by the taxpayer or to property acquired for resale.

(B) *Election to capitalize.* A taxpayer may elect to treat amounts paid for employee compensation or overhead as amounts that facilitate the acquisition of property. The election is made separately for each acquisition and applies to employee compensation or overhead, or both. For example, a taxpayer may elect to treat overhead, but not employee compensation, as amounts that facilitate the acquisition of property. A taxpayer makes the election by treating the amounts to which the election applies as amounts that facilitate the acquisition in the taxpayer's timely filed original Federal tax return (including extensions) for the taxable year during which the amounts are paid. Sections 301.9100-1 through 301.9100-3 of this chapter provide the rules governing extensions of the time to make regulatory elections. In the case of an S corporation or a partnership, the election is made by the S corporation or by the partnership, and not

by the shareholders or partners. A taxpayer may revoke an election made under this paragraph (f)(2)(iv)(B) with respect to each acquisition only by filing a request for a private letter ruling and obtaining the Commissioner's consent to revoke the election. The Commissioner may grant a request to revoke this election if the taxpayer acted reasonably and in good faith and the revocation will not prejudice the interests of Government. See generally §301.9100-3 of this chapter. The manner of electing and revoking the election to capitalize under this paragraph (f)(2)(iv)(B) may be modified through guidance of general applicability (see §§606.601(d)(2) and 601.602 of this section). An election may not be made or revoked through the filing of an application for change in accounting method or, before obtaining the Commissioner's consent to make the late election or to revoke the election, by filing an amended Federal tax return.

(3) *Treatment of transaction costs—(i) In general.* Except as provided under §1.263(a)-1(f)(3)(i) (for purposes of the de minimis safe harbor), all amounts paid to facilitate the acquisition of real or personal property are capital expenditures. Facilitative amounts allocable to real or personal property must be included in the basis of the property acquired.

(ii) *Treatment of inherently facilitative amounts allocable to property not acquired.* Inherently facilitative amounts allocable to real or personal property are capital expenditures related to such property, even if the property is not eventually acquired. Except for contingency fees as defined in paragraph (f)(3)(iii) of this section, inherently facilitative amounts allocable to real or personal property not acquired may be allocated to those properties and recovered as appropriate in accordance with the applicable provisions of the Code and the Treasury Regulations (for example, sections 165, 167, or 168). See paragraph (h) of this section for the recovery of capitalized amounts.

(iii) *Contingency fees.* For purposes of this section, a contingency fee is an amount paid that is contingent on the successful closing of the acquisition of real or personal property. Contingency fees must be included in the basis of

the property acquired and may not be allocated to the property not acquired.

(4) *Examples.* The following examples illustrate the rules of paragraph (f) of this section. For purposes of these examples, assume that the taxpayer does not elect the de minimis safe harbor under § 1.263(a)-1(f):

Example 1. Broker's fees to facilitate an acquisition. A decides to purchase a building in which to relocate its offices and hires a real estate broker to find a suitable building. A pays fees to the broker to find property for A to acquire. Under paragraph (f)(2)(ii)(I) of this section, A must capitalize the amounts paid to the broker because these costs are inherently facilitative of the acquisition of real property.

Example 2. Inspection and survey costs to facilitate an acquisition. B decides to purchase Building X and pays amounts to third-party contractors for a termite inspection and an environmental survey of Building X. Under paragraph (f)(2)(ii)(J) of this section, B must capitalize the amounts paid for the inspection and the survey of the building because these costs are inherently facilitative of the acquisition of real property.

Example 3. Moving costs to facilitate an acquisition. C purchases all the assets of D and, in connection with the purchase, hires a transportation company to move storage tanks from D's plant to C's plant. Under paragraph (f)(2)(ii)(A) of this section, C must capitalize the amount paid to move the storage tanks from D's plant to C's plant because this cost is inherently facilitative to the acquisition of personal property.

Example 4. Geological and geophysical costs; coordination with other provisions. E is in the business of exploring, purchasing, and developing properties in the United States for the production of oil and gas. E considers acquiring a particular property but first incurs costs for the services of an engineering firm to perform geological and geophysical studies to determine if the property is suitable for oil or gas production. Assume that the amounts that E paid to the engineering firm constitute geological and geophysical expenditures under section 167(h). Although the amounts that E paid for the geological and geophysical services are inherently facilitative to the acquisition of real property under paragraph (f)(2)(ii)(J) of this section, E is not required to include those amounts in the basis of the real property acquired. Rather, under paragraph (c) of this section, E must capitalize these costs separately and amortize such costs as required under section 167(h) (addressing the amortization of geological and geophysical expenditures).

Example 5. Scope of facilitate. F is in the business of providing legal services to clients. F is interested in acquiring a new con-

ference table for its office. F hires and incurs fees for an interior designer to shop for, evaluate, and make recommendations to F regarding which new table to acquire. Under paragraphs (f)(1) and (2) of this section, F must capitalize the amounts paid to the interior designer to provide these services because they are paid in the process of investigating or otherwise pursuing the acquisition of personal property.

Example 6. Transaction costs allocable to multiple properties. G, a retailer, wants to acquire land for the purpose of building a new distribution facility for its products. G considers various properties on Highway X in State Y. G incurs fees for the services of an architect to advise and evaluate the suitability of the sites for the type of facility that G intends to construct on the selected site. G must capitalize the architect fees as amounts paid to acquire land because these amounts are inherently facilitative to the acquisition of land under paragraph (f)(2)(ii)(J) of this section.

Example 7. Transaction costs; coordination with section 263A. H, a retailer, wants to acquire land for the purpose of building a new distribution facility for its products. H considers various properties on Highway X in State Y. H incurs fees for the services of an architect to prepare preliminary floor plans for a building that H could construct at any of the sites. Under these facts, the architect's fees are not facilitative to the acquisition of land under paragraph (f) of this section. Therefore, H is not required to capitalize the architect fees as amounts paid to acquire land. However, the amounts paid for the architect's fees may be subject to capitalization under section 263A if these amounts comprise the direct or allocable indirect cost of property produced by H, such as the building.

Example 8. Special rule for acquisitions of real property. J owns several retail stores. J decides to examine the feasibility of opening a new store in City X. In October, Year 1, J hires and incurs costs for a development consulting firm to study City X and perform market surveys, evaluate zoning and environmental requirements, and make preliminary reports and recommendations as to areas that J should consider for purposes of locating a new store. In December, Year 1, J continues to consider whether to purchase real property in City X and which property to acquire. J hires, and incurs fees for, an appraiser to perform appraisals on two different sites to determine a fair offering price for each site. In March, Year 2, J decides to acquire one of these two sites for the location of its new store. At the same time, J determines not to acquire the other site. Under paragraph (f)(2)(iii) of this section, J is not required to capitalize amounts paid to the development consultant in Year 1 because the amounts relate to activities performed in

the process of determining whether to acquire real property and which real property to acquire, and the amounts are not inherently facilitative costs under paragraph (f)(2)(ii) of this section. However, J must capitalize amounts paid to the appraiser in Year 1 because the appraisal costs are inherently facilitative costs under paragraph (f)(2)(ii)(B) of this section. In Year 2, J must include the appraisal costs allocable to property acquired in the basis of the property acquired. In addition, J may recover the appraisal costs allocable to the property not acquired in accordance with paragraphs (f)(3)(ii) and (h) of this section. See, for example, §1.165-2 for losses on the permanent withdrawal of non-depreciable property.

Example 9. Contingency fee K owns several restaurant properties. K decides to open a new restaurant in City X. In October, Year 1, K hires a real estate consultant to identify potential property upon which K may locate its restaurant, and is obligated to compensate the consultant upon the acquisition of property. The real estate consultant identifies three properties, and K decides to acquire one of those properties. Upon closing of the acquisition of that property, K pays the consultant its fee. The amount paid to the consultant constitutes a contingency fee under paragraph (f)(3)(iii) of this section because the payment is contingent on the successful closing of the acquisition of property. Accordingly, under paragraph (f)(3)(iii) of this section, K must include the amount paid to the consultant in the basis of the property acquired. K is not permitted to allocate the amount paid between the properties acquired and not acquired.

Example 10. Employee compensation and overhead L, a freight carrier, maintains an acquisition department whose sole function is to arrange for the purchase of vehicles and aircraft from manufacturers or other parties to be used in its freight carrying business. As provided in paragraph (f)(2)(iv)(A) of this section, L is not required to capitalize any portion of the compensation paid to employees in its acquisition department or any portion of its overhead allocable to its acquisition department. However, under paragraph (f)(2)(iv)(B) of this section, L may elect to capitalize the compensation and/or overhead costs allocable to the acquisition of a vehicle or aircraft by treating these amounts as costs that facilitate the acquisition of that property in its timely filed original Federal tax return for the year the amounts are paid.

(g) *Treatment of capital expenditures.* Amounts required to be capitalized under this section are capital expenditures and must be taken into account through a charge to capital account or basis, or in the case of property that is

inventory in the hands of a taxpayer, through inclusion in inventory costs.

(h) *Recovery of capitalized amounts—*
(1) *In general.* Amounts that are capitalized under this section are recovered through depreciation, cost of goods sold, or by an adjustment to basis at the time the property is placed in service, sold, used, or otherwise disposed of by the taxpayer. Cost recovery is determined by the applicable provisions of the Code and regulations relating to the use, sale, or disposition of property.

(2) *Examples.* The following examples illustrate the rule of paragraph (h)(1) of this section. For purposes of these examples, assume that the taxpayer does not elect the de minimis safe harbor under §1.263(a)-1(f).

Example 1. Recovery when property placed in service X owns a 10-unit apartment building. The refrigerator in one of the apartments stops functioning, and X purchases a new refrigerator to replace the old one. X pays for the acquisition, delivery, and installation of the new refrigerator. Assume that the refrigerator is the unit of property, as determined under §1.263(a)-3(e), and is not a material or supply under §1.162-3. Under paragraph (d)(1) of this section, X is required to capitalize the amounts paid for the acquisition, delivery, and installation of the refrigerator. Under this paragraph (h), the capitalized amounts are recovered through depreciation, which begins when the refrigerator is placed in service by X.

Example 2. Recovery when property used in the production of property Y operates a plant where it manufactures widgets. Y purchases a tractor loader to move raw materials into and around the plant for use in the manufacturing process. Assume that the tractor loader is a unit of property, as determined under §1.263(a)-3(e), and is not a material or supply under §1.162-3. Under paragraph (d)(1) of this section, Y is required to capitalize the amounts paid to acquire the tractor loader. Under this paragraph (h), the capitalized amounts are recovered through depreciation, which begins when Y places the tractor loader in service. However, because the tractor loader is used in the production of property, under section 263A the cost recovery (that is, the depreciation) may also be capitalized to Y's property produced, and, consequently, recovered through cost of goods sold. See §1.263A-1(e)(3)(ii)(I).

(i) *Accounting method changes.* Unless otherwise provided under this section, a change to comply with this section is a change in method of accounting to

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which the provisions of sections 446 and 481 and the accompanying regulations apply. A taxpayer seeking to change to a method of accounting permitted in this section must secure the consent of the Commissioner in accordance with § 1.446-1(e) and follow the administrative procedures issued under § 1.446-1(e)(3)(ii) for obtaining the Commissioner's consent to change its accounting method.

(j) *Effective/applicability date*—(1) *In general.* Except for paragraphs (f)(2)(iii), (f)(2)(iv), and (f)(3)(ii) of this section, this section generally applies to taxable years beginning on or after January 1, 2014. Paragraphs (f)(2)(iii), (f)(2)(iv), and (f)(3)(ii) of this section apply to amounts paid in taxable years beginning on or after January 1, 2014. Except as provided in paragraphs (j)(1) and (j)(2) of this section, § 1.263(a)-2 as contained in 26 CFR part 1 edition revised as of April 1, 2011, applies to taxable years beginning before January 1, 2014.

(2) *Early application of this section*—(i) *In general.* Except for paragraphs (f)(2)(iii), (f)(2)(iv), and (f)(3)(ii) of this section, a taxpayer may choose to apply this section to taxable years beginning on or after January 1, 2012. A taxpayer may choose to apply paragraphs (f)(2)(iii), (f)(2)(iv), and (f)(3)(ii) of this section to amounts paid in taxable years beginning on or after January 1, 2012.

(ii) *Transition rule for election to capitalize employee compensation and overhead costs on 2012 or 2013 returns.* If under paragraph (j)(2)(i) of this section, a taxpayer chooses to make the election to capitalize employee compensation and overhead costs under paragraph (f)(2)(iv)(B) of this section for amounts paid in its taxable year beginning on or after January 1, 2012, and ending on or before September 19, 2013 (applicable taxable year), and the taxpayer did not make the election specified in paragraph (f)(2)(iv)(B) of this section on its timely filed original Federal tax return for the applicable taxable year, the taxpayer must make the election specified in paragraph (f)(2)(iv)(B) of this section for the applicable taxable year by filing an amended Federal tax return for the applicable taxable year on or before 180 days from

the due date including extensions of the taxpayer's Federal tax return for the applicable taxable year, notwithstanding that the taxpayer may not have extended the due date.

(3) *Optional application of TD 9564.* Except for § 1.263(a)-2T(f)(2)(iii), (f)(2)(iv), (f)(3)(ii), and (g), a taxpayer may choose to apply § 1.263(a)-2T as contained in TD 9564 (76 FR 81060) December 27, 2011, to taxable years beginning on or after January 1, 2012, and before January 1, 2014. A taxpayer may choose to apply § 1.263(a)-2T(f)(2)(iii), (f)(2)(iv), (f)(3)(ii) and (g) as contained in TD 9564 (76 FR 81060) December 27, 2011, to amounts paid in taxable years beginning on or after January 1, 2012, and before January 1, 2014.

[T.D. 9636, 78 FR 57714, Sept. 19, 2013, as amended by T.D. 9636, 79 FR 42191, July 21, 2014]

§ 1.263(a)-3 Amounts paid to improve tangible property.

(a) *Overview.* This section provides rules for applying section 263(a) to amounts paid to improve tangible property. Paragraph (b) of this section provides definitions. Paragraph (c) of this section provides rules for coordinating this section with other provisions of the Internal Revenue Code (Code). Paragraph (d) of this section provides the requirement to capitalize amounts paid to improve tangible property and provides the general rules for determining whether a unit of property is improved. Paragraph (e) of this section provides the rules for determining the appropriate unit of property. Paragraph (f) of this section provides rules for leasehold improvements. Paragraph (g) of this section provides special rules for determining improvement costs in particular contexts, including indirect costs incurred during an improvement, removal costs, aggregation of related costs, and regulatory compliance costs. Paragraph (h) of this section provides a safe harbor for small taxpayers. Paragraph (i) provides a safe harbor for routine maintenance costs. Paragraph (j) of this section provides rules for determining whether amounts are paid for betterments to the unit of property. Paragraph (k) of this section provides rules for determining whether amounts are paid to restore the unit of property.