

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 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 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.

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### § 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. Paragraph (l) of this section provides rules for amounts paid to adapt the unit of property to a new or different use. Paragraph (m) of this section provides an optional regulatory accounting method. Paragraph (n) of this section provides an election to capitalize repair and maintenance costs consistent with books and records. Paragraphs (o) and (p) of this section provide for the treatment and recovery of amounts capitalized under this section. Paragraphs (q) and (r) of this section provide for accounting method changes and state the effective/applicability date for the rules in 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 *amounts 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 also 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) *Owner* means the taxpayer that has the benefits and burdens of ownership of the unit of property for Federal income tax purposes.

(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 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 and property acquired for resale.

(2) *Materials and supplies.* A material or supply as defined in § 1.162-3(c)(1) that is acquired and used to improve a unit of tangible property is subject to this section and is not treated as a material or supply under § 1.162-3.

(3) *Example.* The following example illustrates the rules of this paragraph (c):

*Example. Railroad rolling stock X* is a railroad that properly treats amounts paid for the rehabilitation of railroad rolling stock as deductible expenses under section 263(d). X is not required to capitalize the amounts paid because nothing in this section changes the treatment of amounts specifically provided for under section 263(d).

(d) *Requirement to capitalize amounts paid for improvements.* Except as provided in paragraph (h) or paragraph (n) of this section or under § 1.263(a)-1(f), a taxpayer generally must capitalize the related amounts (as defined in paragraph (g)(3) of this section) paid to improve a unit of property owned by the taxpayer. However, paragraph (f) of

this section applies to the treatment of amounts paid to improve leased property. Section 263A provides the requirement to capitalize the direct and allocable indirect costs of property produced by the taxpayer and property acquired for resale. Section 1016 provides for the addition of capitalized amounts to the basis of the property, and section 168 governs the treatment of additions or improvements for depreciation purposes. For purposes of this section, a unit of property is improved if the amounts paid for activities performed after the property is placed in service by the taxpayer—

(1) Are for a betterment to the unit of property (see paragraph (j) of this section);

(2) Restore the unit of property (see paragraph (k) of this section); or

(3) Adapt the unit of property to a new or different use (see paragraph (l) of this section).

(e) *Determining the unit of property—*

(1) *In general.* The unit of property rules in this paragraph (e) apply only for purposes of section 263(a) and §§1.263(a)-1, 1.263(a)-2, 1.263(a)-3, and 1.162-3. Unless otherwise specified, the unit of property determination is based upon the functional interdependence standard provided in paragraph (e)(3)(i) of this section. However, special rules are provided for buildings (see paragraph (e)(2) of this section), plant property (see paragraph (e)(3)(ii) of this section), network assets (see paragraph (e)(3)(iii) of this section), leased property (see paragraph (e)(2)(v) of this section for leased buildings and paragraph (e)(3)(iv) of this section for leased property other than buildings), and improvements to property (see paragraph (e)(4) of this section). Additional rules are provided if a taxpayer has assigned different MACRS classes or depreciation methods to components of property or subsequently changes the class or depreciation method of a component or other item of property (see paragraph (e)(5) of this section). Property that is aggregated or subject to a general asset account election or accounted for in a multiple asset account (that is, pooled) may not be treated as a single unit of property.

(2) *Building—(i) In general.* Except as otherwise provided in paragraphs (e)(4),

and (e)(5)(ii) of this section, in the case of a building (as defined in §1.48-1(e)(1)), each building and its structural components (as defined in §1.48-1(e)(2)) is a single unit of property (“building”). Paragraph (e)(2)(iii) of this section provides the unit of property for condominiums, paragraph (e)(2)(iv) of this section provides the unit of property for cooperatives, and paragraph (e)(2)(v) of this section provides the unit of property for leased buildings.

(ii) *Application of improvement rules to a building.* An amount is paid to improve a building under paragraph (d) of this section if the amount is paid for an improvement under paragraphs (j), (k), or paragraph (l) of this section to any of the following:

(A) *Building structure.* A building structure consists of the building (as defined in §1.48-1(e)(1)), and its structural components (as defined in §1.48-1(e)(2)), other than the structural components designated as buildings systems in paragraph (e)(2)(ii)(B) of this section.

(B) *Building system.* Each of the following structural components (as defined in §1.48-1(e)(2)), including the components thereof, constitutes a building system that is separate from the building structure, and to which the improvement rules must be applied—

(1) Heating, ventilation, and air conditioning (“HVAC”) systems (including motors, compressors, boilers, furnace, chillers, pipes, ducts, radiators);

(2) Plumbing systems (including pipes, drains, valves, sinks, bathtubs, toilets, water and sanitary sewer collection equipment, and site utility equipment used to distribute water and waste to and from the property line and between buildings and other permanent structures);

(3) Electrical systems (including wiring, outlets, junction boxes, lighting fixtures and associated connectors, and site utility equipment used to distribute electricity from the property line to and between buildings and other permanent structures);

(4) All escalators;

(5) All elevators;

(6) Fire-protection and alarm systems (including sensing devices, computer controls, sprinkler heads, sprinkler mains, associated piping or plumbing, pumps, visual and audible alarms, alarm control panels, heat and smoke detection devices, fire escapes, fire doors, emergency exit lighting and signage, and fire fighting equipment, such as extinguishers, and hoses);

(7) Security systems for the protection of the building and its occupants (including window and door locks, security cameras, recorders, monitors, motion detectors, security lighting, alarm systems, entry and access systems, related junction boxes, associated wiring and conduit);

(8) Gas distribution system (including associated pipes and equipment used to distribute gas to and from the property line and between buildings or permanent structures); and

(9) Other structural components identified in published guidance in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter) that are excepted from the building structure under paragraph (e)(2)(ii)(A) of this section and are specifically designated as building systems under this section.

(iii) *Condominium*—(A) *In general.* In the case of a taxpayer that is the owner of an individual unit in a building with multiple units (such as a condominium), the unit of property (“condominium”) is the individual unit owned by the taxpayer and the structural components (as defined in § 1.48-1(e)(2)) that are part of the unit.

(B) *Application of improvement rules to a condominium.* An amount is paid to improve a condominium under paragraph (d) of this section if the amount is paid for an improvement under paragraphs (j), (k), or paragraph (l) of this section to the building structure (as defined in paragraph (e)(2)(ii)(A) of this section) that is part of the condominium or to the portion of any building system (as defined in paragraph (e)(2)(ii)(B) of this section) that is part of the condominium. In the case of the condominium management association, the association must apply the improvement rules to the building structure or to any building system de-

scribed under paragraphs (e)(2)(ii)(A) and (e)(2)(ii)(B) of this section.

(iv) *Cooperative*—(A) *In general.* In the case of a taxpayer that has an ownership interest in a cooperative housing corporation, the unit of property (“cooperative”) is the portion of the building in which the taxpayer has possessory rights and the structural components (as defined in § 1.48-1(e)(2)) that are part of the portion of the building subject to the taxpayer’s possessory rights (cooperative).

(B) *Application of improvement rules to a cooperative.* An amount is paid to improve a cooperative under paragraph (d) of this section if the amount is paid for an improvement under paragraphs (j), (k), or (l) of this section to the portion of the building structure (as defined in paragraph (e)(2)(ii)(A) of this section) in which the taxpayer has possessory rights or to the portion of any building system (as defined in paragraph (e)(2)(ii)(B) of this section) that is part of the portion of the building structure subject to the taxpayer’s possessory rights. In the case of a cooperative housing corporation, the corporation must apply the improvement rules to the building structure or to any building system as described under paragraphs (e)(2)(ii)(A) and (e)(2)(ii)(B) of this section.

(v) *Leased building*—(A) *In general.* In the case of a taxpayer that is a lessee of all or a portion of a building (such as an office, floor, or certain square footage), the unit of property (“leased building property”) is each building and its structural components or the portion of each building subject to the lease and the structural components associated with the leased portion.

(B) *Application of improvement rules to a leased building.* An amount is paid to improve a leased building property under paragraphs (d) and (f)(2) of this section if the amount is paid for an improvement, under paragraphs (j), (k), or (l) of this section, to any of the following:

(1) *Entire building.* In the case of a taxpayer that is a lessee of an entire building, the building structure (as defined under paragraph (e)(2)(ii)(A) of this section) or any building system (as defined under paragraph (e)(2)(ii)(B) of

this section) that is part of the leased building.

(2) *Portion of a building.* In the case of a taxpayer that is a lessee of a portion of a building (such as an office, floor, or certain square footage), the portion of the building structure (as defined under paragraph (e)(2)(ii)(A) of this section) subject to the lease or the portion of any building system (as defined under paragraph (e)(2)(ii)(B) of this section) subject to the lease.

(3) *Property other than building*—(i) *In general.* Except as otherwise provided in paragraphs (e)(3), (e)(4), (e)(5), and (f)(1) of this section, in the case of real or personal property other than property described in paragraph (e)(2) of this section, all the components that are functionally interdependent comprise a single unit of property. Components of property are functionally interdependent if the placing in service of one component by the taxpayer is dependent on the placing in service of the other component by the taxpayer.

(ii) *Plant property*—(A) *Definition.* For purposes of this paragraph (e), the term *plant property* means functionally interdependent machinery or equipment, other than network assets, used to perform an industrial process, such as manufacturing, generation, warehousing, distribution, automated materials handling in service industries, or other similar activities.

(B) *Unit of property for plant property.* In the case of plant property, the unit of property determined under the general rule of paragraph (e)(3)(i) of this section is further divided into smaller units comprised of each component (or group of components) that performs a discrete and major function or operation within the functionally interdependent machinery or equipment.

(iii) *Network assets*—(A) *Definition.* For purposes of this paragraph (e), the term *network assets* means railroad track, oil and gas pipelines, water and sewage pipelines, power transmission and distribution lines, and telephone and cable lines that are owned or leased by taxpayers in each of those respective industries. The term includes, for example, trunk and feeder lines, pole lines, and buried conduit. It does not include property that would be included as building structure or building

systems under paragraphs (e)(2)(ii)(A) and (e)(2)(ii)(B) of this section, nor does it include separate property that is adjacent to, but not part of a network asset, such as bridges, culverts, or tunnels.

(B) *Unit of property for network assets.* In the case of network assets, the unit of property is determined by the taxpayer's particular facts and circumstances except as otherwise provided in published guidance in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter). For these purposes, the functional interdependence standard provided in paragraph (e)(3)(i) of this section is not determinative.

(iv) *Leased property other than buildings.* In the case of a taxpayer that is a lessee of real or personal property other than property described in paragraph (e)(2) of this section, the unit of property for the leased property is determined under paragraphs (e)(3)(i),(ii), (iii), and (e)(5) of this section except that, after applying the applicable rules under those paragraphs, the unit of property may not be larger than the property subject to the lease.

(4) *Improvements to property.* An improvement to a unit of property generally is not a unit of property separate from the unit of property improved. For the unit of property for lessee improvements, see also paragraph (f)(2)(ii) of this section. If a taxpayer elects to treat as a capital expenditure under § 1.162-3(d) the amount paid for a rotatable spare part, temporary spare part, or standby emergency spare part, and such part is used in an improvement to a unit of property, then for purposes of applying paragraph (d) of this section to the unit of property improved, the part is not a unit of property separate from the unit of property improved.

(5) *Additional rules*—(i) *Year placed in service.* Notwithstanding the unit of property determination under paragraph (e)(3) of this section, a component (or a group of components) of a unit property must be treated as a separate unit of property if, at the time the unit of property is initially placed in service by the taxpayer, the taxpayer has properly treated the component as being within a different class of

property under section 168(e) (MACRS classes) than the class of the unit of property of which the component is a part, or the taxpayer has properly depreciated the component using a different depreciation method than the depreciation method of the unit of property of which the component is a part.

(ii) *Change in subsequent taxable year.* Notwithstanding the unit of property determination under paragraphs (e)(2), (3), (4), or (5)(i) of this section, in any taxable year after the unit of property is initially placed in service by the taxpayer, if the taxpayer or the Internal Revenue Service changes the treatment of that property (or any portion thereof) to a proper MACRS class or a proper depreciation method (for example, as a result of a cost segregation study or a change in the use of the property), then the taxpayer must change the unit of property determination for that property (or the portion thereof) under this section to be consistent with the change in treatment for depreciation purposes. Thus, for example, if a portion of a unit of property is properly reclassified to a MACRS class different from the MACRS class of the unit of property of which it was previously treated as a part, then the reclassified portion of the property should be treated as a separate unit of property for purposes of this section.

(6) *Examples.* The following examples illustrate the application of this paragraph (e) and assume that the taxpayer has not made a general asset account election with regard to property or accounted for property in a multiple asset account. In addition, unless the facts specifically indicate otherwise, assume that the additional rules in paragraph (e)(5) of this section do not apply:

*Example 1. Building systems* A owns an office building that contains a HVAC system. The HVAC system incorporates ten roof-mounted units that service different parts of the building. The roof-mounted units are not connected and have separate controls and duct work that distribute the heated or cooled air to different spaces in the building's interior. A pays an amount for labor and materials for work performed on the roof-mounted units. Under paragraph (e)(2)(i) of this section, A must treat the building and its structural components as a single

unit of property. As provided under paragraph (e)(2)(ii) of this section, an amount is paid to improve a building if it is for an improvement to the building structure or any designated building system. Under paragraph (e)(2)(ii)(B)(1) of this section, the entire HVAC system, including all of the roof-mounted units and their components, comprise a building system. Therefore, under paragraph (e)(2)(ii) of this section, if an amount paid by A for work on the roof-mounted units is an improvement (for example, a betterment) to the HVAC system, A must treat this amount as an improvement to the building.

*Example 2. Building systems* B owns a building that it uses in its retail business. The building contains two elevator banks in different locations in its building. Each elevator bank contains three elevators. B pays an amount for labor and materials for work performed on the elevators. Under paragraph (e)(2)(i) of this section, B must treat the building and its structural components as a single unit of property. As provided under paragraph (e)(2)(ii) of this section, an amount is paid to improve a building if it is for an improvement to the building structure or any designated building system. Under paragraph (e)(2)(ii)(B)(5) of this section, all six elevators, including all their components, comprise a building system. Therefore, under paragraph (e)(2)(ii) of this section, if an amount paid by B for work on the elevators is an improvement (for example, a betterment) to the elevator system, B must treat this amount as an improvement to the building.

*Example 3. Building structure and systems; condominium* C owns a condominium unit in a condominium office building. C uses the condominium unit in its business of providing medical services. The condominium unit contains two restrooms, each of which contains a sink, a toilet, water and drainage pipes and other bathroom fixtures. C pays an amount for labor and materials to perform work on the pipes, sinks, toilets, and plumbing fixtures that are part of the condominium. Under paragraph (e)(2)(iii) of this section, C must treat the individual unit that it owns, including the structural components that are part of that unit, as a single unit of property. As provided under paragraph (e)(2)(iii)(B) of this section, an amount is paid to improve the condominium if it is for an improvement to the building structure that is part of the condominium or to a portion of any designated building system that is part of the condominium. Under paragraph (e)(2)(ii)(B)(2) of this section, the pipes, sinks, toilets, and plumbing fixtures that are part of C's condominium comprise the plumbing system for the condominium. Therefore, under paragraph (e)(2)(iii) of this section, if an amount paid by C for work on pipes, sinks, toilets, and plumbing fixtures is

an improvement (for example, a betterment) to the portion of the plumbing system that is part of C's condominium, C must treat this amount as an improvement to the condominium.

*Example 4. Building structure and systems; property other than buildings* D, a manufacturer, owns a building adjacent to its manufacturing facility that contains office space and related facilities for D's employees that manage and administer D's manufacturing operations. The office building contains equipment, such as desks, chairs, computers, telephones, and bookshelves that are not building structure or building systems. D pays an amount to add an extension to the office building. Under paragraph (e)(2)(i) of this section, D must treat the building and its structural components as a single unit of property. As provided under paragraph (e)(2)(ii) of this section, an amount is paid to improve a building if it is for an improvement to the building structure or any designated building system. Therefore, under paragraph (e)(2)(ii) of this section, if an amount paid by D for the addition of an extension to the office building is an improvement (for example, a betterment) to the building structure or any of the building systems, D must treat this amount as an improvement to the building. In addition, because the equipment contained within the office building constitutes property other than the building, the units of property for the office equipment are initially determined under paragraph (e)(3)(i) of this section and are comprised of all the components that are functionally interdependent (for example, each desk, each chair, and each book shelf).

*Example 5. Plant property; discrete and major function* E is an electric utility company that operates a power plant to generate electricity. The power plant includes a structure that is not a building under § 1.48-1(e)(1), and, among other things, one pulverizer that grinds coal, a single boiler that produces steam, one turbine that converts the steam into mechanical energy, and one generator that converts mechanical energy into electrical energy. In addition, the turbine contains a series of blades that cause the turbine to rotate when affected by the steam. Because the plant is composed of real and personal tangible property other than a building, the unit of property for the generating equipment is initially determined under the general rule in paragraph (e)(3)(i) of this section and is comprised of all the components that are functionally interdependent. Under this rule, the initial unit of property is the entire plant because the components of the plant are functionally interdependent. However, because the power plant is plant property under paragraph (e)(3)(ii) of this section, the initial unit of property is further divided into smaller units of property by determining the components

(or groups of components) that perform discrete and major functions within the plant. Under this paragraph, E must treat the structure, the boiler, the turbine, the generator, and the pulverizer each as a separate unit of property because each of these components performs a discrete and major function within the power plant. E may not treat components, such as the turbine blades, as separate units of property because each of these components does not perform a discrete and major function within the plant.

*Example 6. Plant property; discrete and major function* F is engaged in a uniform and linen rental business. F owns and operates a plant that utilizes many different machines and equipment in an assembly line-like process to treat, launder, and prepare rental items for its customers. F utilizes two laundering lines in its plant, each of which can operate independently. One line is used for uniforms and another line is used for linens. Both lines incorporate a sorter, boiler, washer, dryer, ironer, folder, and waste water treatment system. Because the laundering equipment contained within the plant is property other than a building, the unit of property for the laundering equipment is initially determined under the general rule in paragraph (e)(3)(i) of this section and is comprised of all the components that are functionally interdependent. Under this rule, the initial units of property are each laundering line because each line is functionally independent and is comprised of components that are functionally interdependent. However, because each line is comprised of plant property under paragraph (e)(3)(ii) of this section, F must further divide these initial units of property into smaller units of property by determining the components (or groups of components) that perform discrete and major functions within the line. Under paragraph (e)(3)(ii) of this section, F must treat each sorter, boiler, washer, dryer, ironer, folder, and waste water treatment system in each line as a separate unit of property because each of these components performs a discrete and major function within the line.

*Example 7. Plant property; industrial process* G operates a restaurant that prepares and serves food to retail customers. Within its restaurant, G has a large piece of equipment that uses an assembly line-like process to prepare and cook tortillas that G serves only to its restaurant customers. Because the tortilla-making equipment is property other than a building, the unit of property for the equipment is initially determined under the general rule in paragraph (e)(3)(i) of this section and is comprised of all the components that are functionally interdependent. Under this rule, the initial unit of property is the entire tortilla-making equipment because the various components of the equipment are functionally interdependent. The equipment is not plant property under paragraph

(e)(3)(ii) of this section because the equipment is not used in an industrial process, as it performs a small-scale function in G's restaurant operations. Thus, G is not required to further divide the equipment into separate units of property based on the components that perform discrete and major functions.

*Example 8. Personal property* H owns locomotives that it uses in its railroad business. Each locomotive consists of various components, such as an engine, generators, batteries, and trucks. H acquired a locomotive with all its components. Because H's locomotive is property other than a building, the initial unit of property is determined under the general rule in paragraph (e)(3)(i) of this section and is comprised of the components that are functionally interdependent. Under paragraph (e)(3)(i) of this section, the locomotive is a single unit of property because it consists entirely of components that are functionally interdependent.

*Example 9. Personal property* J provides legal services to its clients. J purchased a laptop computer and a printer for its employees to use in providing legal services. Because the computer and printer are property other than a building, the initial units of property are determined under the general rule in paragraph (e)(3)(i) of this section and are comprised of the components that are functionally interdependent. Under paragraph (e)(3)(i) of this section, the computer and the printer are separate units of property because the computer and the printer are not components that are functionally interdependent (that is, the placing in service of the computer is not dependent on the placing in service of the printer).

*Example 10. Building structure and systems; leased building* K is a retailer of consumer products. K conducts its retail sales in a building that it leases from L. The leased building consists of the building structure (including the floor, walls, and roof) and various building systems, including a plumbing system, an electrical system, an HVAC system, a security system, and a fire protection and prevention system. K pays an amount for labor and materials to perform work on the HVAC system of the leased building. Under paragraph (e)(2)(v)(A) of this section, because K leases the entire building, K must treat the leased building and its structural components as a single unit of property. As provided under paragraph (e)(2)(v)(B) of this section, an amount is paid to improve a leased building property if it is for an improvement (for example, a betterment) to the leased building structure or to any building system within the leased building. Therefore, under paragraphs (e)(2)(v)(B)(I) and (e)(2)(ii)(B)(I) of this section, if an amount paid by K for work on the HVAC system is for an improvement to the HVAC system in the leased building, K must treat this

amount as an improvement to the entire leased building property.

*Example 11. Production of real property related to leased property* Assume the same facts as in *Example 10*, except that K receives a construction allowance from L, and K uses the construction allowance to build a driveway adjacent to the leased building. Assume that under the terms of the lease, K, the lessee, is treated as the owner of any property that it constructs on or nearby the leased building. Also assume that section 110 does not apply to the construction allowance. Finally, assume that the driveway is not plant property or a network asset. Because the construction of the driveway consists of the production of real property other than a building, all the components of the driveway are functionally interdependent and are a single unit of property under paragraphs (e)(3)(i) and (e)(3)(iv) of this section.

*Example 12. Leasehold improvements; construction allowance used for lessor-owned improvements* Assume the same facts as *Example 11*, except that, under the terms of the lease, L, the lessor, is treated as the owner of any property constructed on the leased premises. Because L, the lessor, is the owner of the driveway and the driveway is real property other than a building, all the components of the driveway are functionally interdependent and are a single unit of property under paragraph (e)(3)(i) of this section.

*Example 13. Buildings and structural components; leased office space* M provides consulting services to its clients. M conducts its consulting services business in two office spaces in the same building, each of which it leases from N under separate lease agreements. Each office space contains a separate HVAC system, which is part of the leased property. Both lease agreements provide that M is responsible for maintaining, repairing, and replacing the HVAC system that is part of the leased property. M pays amounts to perform work on the HVAC system in each office space. Because M leases two separate office spaces subject to two leases, M must treat the portion of the building structure and the structural components subject to each lease as a separate unit of property under paragraph (e)(2)(v)(A) of this section. As provided under paragraph (e)(2)(v)(B) of this section, an amount is paid to improve a leased building property, if it is for an improvement to the leased portion of the building structure or the portion of any designated building system subject to each lease. Under paragraphs (e)(2)(v)(B)(I) and (e)(2)(ii)(B)(I) of this section, M must treat the HVAC system associated with each leased office space as a building system of that leased building property. Thus, M must treat the HVAC system associated with the first leased office space as a building system of the first leased office space and the HVAC



system associated with the second leased office space as a building system of the second leased office space. Under paragraph (e)(2)(v)(B) of this section, if the amount paid by M for work on the HVAC system in one leased office space is for an improvement (for example, a betterment) to the HVAC system that is part of that leased space, then M must treat the amount as an improvement to that individual leased property.

*Example 14. Leased property; personal property* N is engaged in the business of transporting passengers on private jet aircraft. To conduct its business, N leases several aircraft from O. Under paragraph (e)(3)(iv) of this section (referencing paragraph (e)(3)(i) of this section), N must treat all of the components of each leased aircraft that are functionally interdependent as a single unit of property. Thus, N must treat each leased aircraft as a single unit of property.

*Example 15. Improvement property* (i) P is a retailer of consumer products. In Year 1, P purchases a building from Q, which P intends to use as a retail sales facility. Under paragraph (e)(2)(i) of this section, P must treat the building and its structural components as a single unit of property. As provided under paragraph (e)(2)(ii) of this section, an amount is paid to improve a building if it is for an improvement to the building structure or any designated building system.

(ii) In Year 2, P pays an amount to construct an extension to the building to be used for additional warehouse space. Assume that the extension involves the addition of walls, floors, roof, and doors, but does not include the addition or extension of any building systems described in paragraph (e)(2)(ii)(B) of this section. Also assume that the amount paid to build the extension is a betterment to the building structure under paragraph (j) of this section, and is therefore treated as an amount paid for an improvement to the entire building under paragraph (e)(2)(ii) of this section. Accordingly, P capitalizes the amount paid as an improvement to the building under paragraph (d) of this section. Under paragraph (e)(4) of this section, the extension is not a unit of property separate from the building, the unit of property improved. Thus, to determine whether any future expenditure constitutes an improvement to the building under paragraph (e)(2)(ii) of this section, P must determine whether the expenditure constitutes an improvement to the building structure, including the building extension, or to any of the designated building systems.

*Example 16. Additional rules; year placed in service* R is engaged in the business of transporting freight throughout the United States. To conduct its business, R owns a fleet of truck tractors and trailers. Each tractor and trailer is comprised of various components, including tires. R purchased a truck tractor with all of its components, in-

cluding tires. The tractor tires have an average useful life to R of more than one year. At the time R placed the tractor in service, it treated the tractor tires as a separate asset for depreciation purposes under section 168. R properly treated the tractor (excluding the cost of the tires) as 3-year property and the tractor tires as 5-year property under section 168(e). Because R's tractor is property other than a building, the initial units of property for the tractor are determined under the general rule in paragraph (e)(3)(i) of this section and are comprised of all the components that are functionally interdependent. Under this rule, R must treat the tractor, including its tires, as a single unit of property because the tractor and the tires are functionally interdependent (that is, the placing in service of the tires is dependent upon the placing in service of the tractor). However, under paragraph (e)(5)(i) of this section, R must treat the tractor and tires as separate units of property because R properly treated the tires as being within a different class of property under section 168(e).

*Example 17. Additional rules; change in subsequent year* S is engaged in the business of leasing nonresidential real property to retailers. In Year 1, S acquired and placed in service a building for use in its retail leasing operation. In Year 5, to accommodate the needs of a new lessee, S incurred costs to improve the building structure. S capitalized the costs of the improvement under paragraph (d) of this section and depreciated the improvement in accordance with section 168(i)(6) as nonresidential real property under section 168(e). In Year 7, S determined that the structural improvement made in Year 5 qualified under section 168(e)(8) as qualified retail improvement property and, therefore, was 15-year property under section 168(e). In Year 7, S changed its method of accounting to use a 15-year recovery period for the improvement. Under paragraph (e)(5)(ii) of this section, in Year 7, S must treat the improvement as a unit of property separate from the building.

*Example 18. Additional rules; change in subsequent year* In Year 1, T acquired and placed in service a building and parking lot for use in its retail operations. Under § 1.263(a)-2 of the regulations, T capitalized the cost of the building and the parking lot and began depreciating the building and the parking lot as nonresidential real property under section 168(e). In Year 3, T completed a cost segregation study under which it properly determined that the parking lot qualified as 15-year property under section 168(e). In Year 3, T changed its method of accounting for the parking lot to use a 15-year recovery period and the 150-percent declining balance method of depreciation. Under paragraph (e)(5)(ii) of this section, beginning in Year 3, T must treat the parking lot as a unit of property separate from the building.

*Example 19. Additional rules; change in subsequent year.* In Year 1, U acquired and placed in service a building for use in its manufacturing business. U capitalized the costs allocable to the building's wiring separately from the building and depreciated the wiring as 7-year property under section 168(e). U capitalized the cost of the building and all other structural components of the building and began depreciating them as nonresidential real property under section 168(e). In Year 3, U completed a cost segregation study under which it properly determined that the wiring is a structural component of the building and, therefore, should have been depreciated as nonresidential real property. In Year 3, U changed its method of accounting to treat the wiring as nonresidential real property. Under paragraph (e)(5)(ii) of this section, U must change the unit of property for the wiring in a manner that is consistent with the change in treatment for depreciation purposes. Therefore, U must change the unit of property for the wiring to treat it as a structural component of the building, and as part of the building unit of property, in accordance with paragraph (e)(2)(i) of this section.

(f) *Improvements to leased property*—(1) *In general.* Except as provided in paragraph (h) of this section (safe harbor for small taxpayers) and under § 1.263(a)-1(f) (de minimis safe harbor), this paragraph (f) provides the exclusive rules for determining whether amounts paid by a taxpayer are for an improvement to a leased property and must be capitalized. In the case of a leased building or a leased portion of a building, an amount is paid to improve a leased property if the amount is paid for an improvement to any of the properties specified in paragraph (e)(2)(ii) of this section (for lessor improvements) or in paragraph (e)(2)(v)(B) of this section (for lessee improvements, except as provided in paragraph (f)(2)(ii) of this section). Section 1.263(a)-4 does not apply to amounts paid for improvements to leased property or to amounts paid for the acquisition or production of leasehold improvement property.

(2) *Lessee improvements*—(i) *Requirement to capitalize.* A taxpayer lessee must capitalize the related amounts, as determined under paragraph (g)(3) of this section, that it pays to improve, as defined under paragraph (d) of this section, a leased property except to the extent that section 110 applies to a construction allowance received by the lessee for the purpose of such improve-

ment or when the improvement constitutes a substitute for rent. See § 1.61-8(c) for the treatment of lessee expenditures that constitute a substitute for rent. A taxpayer lessee must also capitalize the related amounts that a lessor pays to improve, as defined under paragraph (d) of this section, a leased property if the lessee is the owner of the improvement, except to the extent that section 110 applies to a construction allowance received by the lessee for the purpose of such improvement. An amount paid for a lessee improvement under this paragraph (f)(2)(i) is treated as an amount paid to acquire or produce a unit of real or personal property under § 1.263(a)-2(d)(1) of the regulations.

(ii) *Unit of property for lessee improvements.* For purposes of determining whether an amount paid by a lessee constitutes a lessee improvement to a leased property under paragraph (f)(2)(i) of this section, the unit of property and the improvement rules are applied to the leased property in accordance with paragraph (e)(2)(v) (leased buildings) or paragraph (e)(3)(iv) (leased property other than buildings) of this section and include previous lessee improvements. However, if a lessee improvement is comprised of an entire building erected on leased property, then the unit of property for the building and the application of the improvement rules to the building are determined under paragraphs (e)(2)(i) and (e)(2)(ii) of this section.

(3) *Lessor improvements*—(i) *Requirement to capitalize.* A taxpayer lessor must capitalize the related amounts, as determined under paragraph (g)(3) of this section, that it pays directly, or indirectly through a construction allowance to the lessee, to improve, as defined in paragraph (d) of this section, a leased property when the lessor is the owner of the improvement or to the extent that section 110 applies to the construction allowance. A lessor must also capitalize the related amounts that the lessee pays to improve a leased property, as defined in paragraph (e) of this section, when the lessee's improvement constitutes a substitute for rent. See § 1.61-8(c) for treatment of expenditures by lessees that constitute a substitute for rent. Amounts capitalized by the

lessor under this paragraph (f)(3)(i) may not be capitalized by the lessee. If a lessor improvement is comprised of an entire building erected on leased property, then the amount paid for the building is treated as an amount paid by the lessor to acquire or produce a unit of property under § 1.263(a)-2(d)(1). See paragraph (e)(2) of this section for the unit of property for a building and paragraph (e)(3) of this section for the unit of property for real or personal property other than a building.

(ii) *Unit of property for lessor improvements.* In general, an amount capitalized as a lessor improvement under paragraph (f)(3)(i) of this section is not a unit of property separate from the unit of property improved. See paragraph (e)(4) of this section. However, if a lessor improvement is comprised of an entire building erected on leased property, then the unit of property for the building and the application of the improvement rules to the building are determined under paragraphs (e)(2)(i) and (e)(2)(ii) of this section.

(4) *Examples.* The following examples illustrate the application of this paragraph (f) and do not address whether capitalization is required under another provision of the Code (for example, section 263A). For purposes of the following examples, assume that section 110 does not apply to the lessee and the amounts paid by the lessee are not a substitute for rent.

*Example 1. Lessee improvements; additions to building.* (i) T is a retailer of consumer products. In Year 1, T leases a building from L, which T intends to use as a retail sales facility. The leased building consists of the building structure under paragraph (e)(2)(ii)(A) of this section and various building systems under paragraph (e)(2)(ii)(B) of this section, including a plumbing system, an electrical system, and an HVAC system. Under the terms of the lease, T is permitted to improve the building at its own expense. Under paragraph (e)(2)(v)(A) of this section, because T leases the entire building, T must treat the leased building and its structural components as a single unit of property. As provided under paragraph (e)(2)(v)(B)(I) of this section, an amount is paid to improve a leased building property if the amount is paid for an improvement to the leased building structure or to any building system within the leased building. Therefore, under paragraphs (e)(2)(v)(B)(I) and (e)(2)(ii) of this section, if T pays an amount that improves

the building structure, the plumbing system, the electrical system, or the HVAC system, then T must treat this amount as an improvement to the entire leased building property.

(ii) In Year 2, T pays an amount to construct an extension to the building to be used for additional warehouse space. Assume that this amount is for a betterment (as defined under paragraph (j) of this section) to T's leased building structure and does not affect any building systems. Accordingly, the amount that T pays for the building extension is for a betterment to the leased building structure, and thus, under paragraph (e)(2)(v)(B)(I) of this section, is treated as an improvement to the entire leased building under paragraph (d) of this section. Because T, the lessee, paid an amount to improve a leased building property, T is required to capitalize the amount paid for the building extension as a leasehold improvement under paragraph (f)(2)(i) of this section. In addition, paragraph (f)(2)(i) of this section requires T to treat the amount paid for the improvement as the acquisition or production of a unit of property (leasehold improvement property) under § 1.263(a)-2(d)(1).

(iii) In Year 5, T pays an amount to add a large overhead door to the building extension that it constructed in Year 2 to accommodate the loading of larger products into the warehouse space. Under paragraph (f)(2)(ii) of this section, to determine whether the amount paid by T is for a leasehold improvement, the unit of property and the improvement rules are applied in accordance with paragraph (e)(2)(v) of this section and include T's previous improvements to the leased property. Therefore, under paragraph (e)(2)(v)(A) of this section, the unit of property is the entire leased building, including the extension built in Year 2. In addition, under paragraph (e)(2)(v)(B) of this section, the leased building property is improved if the amount is paid for an improvement to the building structure or any building system. Assume that the amount paid to add the overhead door is for a betterment, under paragraph (j) of this section, to the building structure, which includes the extension. Accordingly, T must capitalize the amounts paid to add the overhead door as a leasehold improvement to the leased building property. In addition, paragraph (f)(2)(i) of this section requires T to treat the amount paid for the improvement as the acquisition or production of a unit of property (leasehold improvement property) under § 1.263(a)-2(d)(1). However, to determine whether a future amount paid by T is for a leasehold improvement to the leased building, the unit of property and the improvement rules are again applied in accordance with paragraph (e)(2)(v) of this section and include the new overhead door.

*Example 2. Lessee improvements; additions to certain structural components of buildings* (i) Assume the same facts as *Example 1* except that in Year 2, T also pays an amount to construct an extension of the HVAC system into the building extension. Assume that the extension is a betterment, under paragraph (j) of this section, to the leased HVAC system (a building system under paragraph (e)(2)(ii)(B)(1) of this section). Accordingly, the amount that T pays for the extension of the HVAC system is for a betterment to the leased building system, the HVAC system, and thus, under paragraph (e)(2)(v)(B)(1) of this section, is treated as an improvement to the entire leased building property under paragraph (d) of this section. Because T, the lessee, pays an amount to improve a leased building property, T is required to capitalize the amount paid as a leasehold improvement under paragraph (f)(2)(i) of this section. Under paragraph (f)(2)(i) of this section, T must treat the amount paid for the HVAC extension as the acquisition and production of a unit of property (leasehold improvement property) under § 1.263(a)-2(d)(1).

(ii) In Year 5, T pays an amount to add an additional chiller to the portion of the HVAC system that it constructed in Year 2 to accommodate the climate control requirements for new product offerings. Under paragraph (f)(2)(ii) of this section, to determine whether the amount paid by T is for a leasehold improvement, the unit of property and the improvement rules are applied in accordance with paragraph (e)(2)(v) of this section and include T's previous improvements to the leased building property. Therefore, under paragraph (e)(2)(v)(B) of this section, the leased building property is improved if the amount is paid for an improvement to the building structure or any building system. Assume that the amount paid to add the chiller is for a betterment, under paragraph (j) of this section, to the HVAC system, which includes the extension of the system in Year 2. Accordingly, T must capitalize the amounts paid to add the chiller as a leasehold improvement to the leased building property. In addition, paragraph (f)(2)(i) of this section requires T to treat the amount paid for the chiller as the acquisition or production of a unit of property (leasehold improvement property) under § 1.263(a)-2(d)(1). However, to determine whether a future amount paid by T is for a leasehold improvement to the leased building, the unit of property and the improvement rules are again applied in accordance with paragraph (e)(2)(v) of this section and include the new chiller.

*Example 3. Lessor Improvements; additions to building* (i) T is a retailer of consumer products. In Year 1, T leases a building from L, which T intends to use as a retail sales facility. Pursuant to the lease, L provides a construction allowance to T, which T intends to

use to construct an extension to the retail sales facility for additional warehouse space. Assume that the amount paid for any improvement to the building does not exceed the construction allowance and that L is treated as the owner of any improvement to the building. Under paragraph (e)(2)(i) of this section, L must treat the building and its structural components as a single unit of property. As provided under paragraph (e)(2)(ii) of this section, an amount is paid to improve a building if it is paid for an improvement to the building structure or to any building system.

(ii) In Year 2, T uses L's construction allowance to construct an extension to the leased building to provide additional warehouse space in the building. Assume that the extension is a betterment (as defined under paragraph (j) of this section) to the building structure, and therefore, the amount paid for the extension results in an improvement to the building under paragraph (d) of this section. Under paragraph (f)(3)(i) of this section, L, the lessor and owner of the improvement, must capitalize the amounts paid to T to construct the extension to the retail sales facility. T is not permitted to capitalize the amounts paid for the lessor-owned improvement. Finally, under paragraph (f)(3)(ii) of this section, the extension to L's building is not a unit of property separate from the building and its structural components.

*Example 4. Lessee property; personal property added to leased building* T is a retailer of consumer products. T leases a building from L, which T intends to use as a retail sales facility. Pursuant to the lease, L provides a construction allowance to T, which T uses to acquire and construct partitions for fitting rooms, counters, and shelving. Assume that each partition, counter, and shelving unit is a unit of property under paragraph (e)(3) of this section. Assume that for Federal income tax purposes T is treated as the owner of the partitions, counters, and shelving. T's expenditures for the partitions, counters, and shelving are not improvements to the leased property under paragraph (d) of this section, but rather constitute amounts paid to acquire or produce separate units of personal property under § 1.263(a)-2(d)(1).

*Example 5. Lessor property; buildings on leased property* L is the owner of a parcel of unimproved real property that L leases to T. Pursuant to the lease, L provides a construction allowance to T of \$500,000, which T agrees to use to construct a building costing not more than \$500,000 on the leased real property and to lease the building from L after it is constructed. Assume that for Federal income tax purposes, L is treated as the owner of the building that T will construct. T uses the \$500,000 to construct the building as required under the lease. The building consists of the building structure and the following building systems: (1) a plumbing

system; (2) an electrical system; and (3) an HVAC system. Because L provides a construction allowance to T to construct a building and L is treated as the owner of the building, L must capitalize the amounts that it pays indirectly to T to construct the building as a lessor improvement under paragraph (f)(3)(i) of this section. In addition, the amounts paid by L for the construction allowance are treated as amounts paid by L to acquire and produce the building under §1.263(a)-2(d)(1). Further, under paragraph (e)(2)(i) of this section, L must treat the building and its structural components as a single unit of property. Under paragraph (f)(3)(i) of this section, T, the lessee, may not capitalize the amounts paid (with the construction allowance received from L) for construction of the building.

*Example 6. Lessee contribution to construction costs* Assume the same facts as in *Example 5*, except T spends \$600,000 to construct the building. T uses the \$500,000 construction allowance provided by L plus \$100,000 of its own funds to construct the building that L will own pursuant to the lease. Also assume that the additional \$100,000 that T pays is not a substitute for rent. For the reasons discussed in *Example 5*, L must capitalize the \$500,000 it paid T to construct the building under §1.263(a)-2(d)(1). In addition, because T spends its own funds to complete the building, T has a depreciable interest of \$100,000 in the building and must capitalize the \$100,000 it paid to construct the building as a leasehold improvement under §1.263(a)-2(d)(1) of the regulations. Under paragraph (e)(2)(i) of this section, L must treat the building as a single unit of property to the extent of its depreciable interest of \$500,000. In addition, under paragraphs (f)(2)(ii) and (e)(2)(i) of this section, T must also treat the building as a single unit of property to the extent of its depreciable interest of \$100,000.

(g) *Special rules for determining improvement costs—(1) Certain costs incurred during an improvement—(i) In general.* A taxpayer must capitalize all the direct costs of an improvement and all the indirect costs (including, for example, otherwise deductible repair costs) that directly benefit or are incurred by reason of an improvement. Indirect costs arising from activities that do not directly benefit and are not incurred by reason of an improvement are not required to be capitalized under section 263(a), regardless of whether the activities are performed at the same time as an improvement.

(ii) *Exception for individuals' residences.* A taxpayer who is an individual may capitalize amounts paid for repairs and maintenance that are made

at the same time as capital improvements to units of property not used in the taxpayer's trade or business or for the production of income if the amounts are paid as part of an improvement (for example, a remodeling) of the taxpayer's residence.

(2) *Removal costs—(i) In general.* If a taxpayer disposes of a depreciable asset, including a partial disposition under Prop. Reg. §1.168(i)-1(e)(2)(ix) (September 19, 2013), or §1.168(i)-8(d), for Federal income tax purposes and has taken into account the adjusted basis of the asset or component of the asset in realizing gain or loss, then the costs of removing the asset or component are not required to be capitalized under this section. If a depreciable asset is included in a general asset account under section 168(i)(4), and neither the regulations under section 168(i)(4) and §1.168(i)-1(e)(3), apply to a disposition of such asset, or a portion of such asset under §1.168(i)-1(e)(1)(ii), a loss is treated as being realized in the amount of zero upon the disposition of the asset solely for purposes of this paragraph (g)(2)(i). If a taxpayer disposes of a component of a unit of property, but the disposal of the component is not a disposition for Federal tax purposes, then the taxpayer must deduct or capitalize the costs of removing the component based on whether the removal costs directly benefit or are incurred by reason of a repair to the unit of property or an improvement to the unit of property. But see §1.280B-1 for the rules applicable to demolition of structures.

(ii) *Examples.* The following examples illustrate the application of paragraph (g)(2)(i) of this section and, unless otherwise stated, do not address whether capitalization is required under another provision of this section or another provision of the Code (for example, section 263A). For purposes of the following examples, assume that §1.168(i)-1(e) or §1.168(i)-8, applies and that §1.280B-1 does not apply.

*Example 1. Component removed during improvement; no disposition* X owns a factory building with a storage area on the second floor. X pays an amount to remove the original columns and girders supporting the second floor and replace them with new columns and girders to permit storage of supplies with a gross weight 50 percent greater

than the previous load-carrying capacity of the storage area. Assume that the replacement of the columns and girders constitutes a betterment to the building structure and is therefore an improvement to the building unit of property under paragraphs (d)(1) and (j) of this section. Assume that X disposes of the original columns and girders and the disposal of these structural components is not a disposition under § 1.168(i)-1(e) or § 1.168(i)-8. Under paragraphs (g)(2)(i) and (j) of this section, the amount paid to remove the columns and girders must be capitalized as a cost of the improvement, because it directly benefits and is incurred by reason of the improvement to the building.

*Example 2. Component removed during improvement; disposition* Assume the same facts as *Example 1*, except X disposes of the original columns and girders and elects to treat the disposal of these structural components as a partial disposition of the factory building under § 1.168(i)-8(d), taking into account the adjusted basis of the components in realizing loss on the disposition. Under paragraph (g)(2)(i) of this section, the amount paid to remove the columns and girders is not required to be capitalized as part of the cost of the improvement regardless of their relation to the improvement. However, all the remaining costs of replacing the columns and girders must be capitalized as improvements to the building unit of property under paragraphs (d)(1), (j), and (g)(1) of this section.

*Example 3. Component removed during repair or maintenance; no disposition* Y owns a building in which it conducts its retail business. The roof over Y's building is covered with shingles. Over time, the shingles begin to wear and Y begins to experience leaks into its retail premises. However, the building still functions in Y's business. To eliminate the problems, a contractor recommends that Y remove the original shingles and replace them with new shingles. Accordingly, Y pays the contractor to replace the old shingles with new but comparable shingles. The new shingles are comparable to original shingles but correct the leakage problems. Assume that replacement of old shingles with new shingles to correct the leakage is not a betterment or a restoration of the building structure or systems under paragraph (j) or (k) of this section and does not adapt the building structure or systems to a new or different use under paragraph (l) of this section. Thus, the amounts paid by Y to replace the shingles are not improvements to the building unit of property under paragraph (d) of this section. Under paragraph (g)(2)(i) of this section, the amounts paid to remove the shingles are not required to be capitalized because they directly benefit and are incurred by reason of repair or maintenance to the building structure.

*Example 4. Component removed with disposition and restoration* Assume the same facts as *Example 3* except Y disposes of the original shingles, and Y elects to treat the disposal of these components as a partial disposition of the building under § 1.168(i)-8(d), and deducts the adjusted basis of the components as a loss on the disposition. Under paragraph (k)(1)(i) of this section, amounts paid for replacement of the shingles constitute a restoration of the building structure because the amounts are paid for the replacement of a component of the structure and the taxpayer has properly deducted a loss for that component. Thus, under paragraphs (d)(2) and (k) of this section, Y is required to capitalize the amounts paid for the replacement of the shingles as an improvement to the building unit of property. However, under paragraph (g)(2)(i) of this section, the amounts paid by Y to remove the original shingles are not required to be capitalized as part of the costs of the improvement, regardless of their relation to the improvement.

(3) *Related amounts.* For purposes of paragraph (d) of this section, amounts paid to improve a unit of property include amounts paid over a period of more than one taxable year. Whether amounts are related to the same improvement depends on the facts and circumstances of the activities being performed.

(4) *Compliance with regulatory requirements.* For purposes of this section, a Federal, state, or local regulator's requirement that a taxpayer perform certain repairs or maintenance on a unit of property to continue operating the property is not relevant in determining whether the amount paid improves the unit of property.

(h) *Safe harbor for small taxpayers*—(1) *In general.* A qualifying taxpayer (as defined in paragraph (h)(3) of this section) may elect to not apply paragraph (d) or paragraph (f) of this section to an eligible building property (as defined in paragraph (h)(4) of this section) if the total amount paid during the taxable year for repairs, maintenance, improvements, and similar activities performed on the eligible building property does not exceed the lesser of—

(i) 2 percent of the unadjusted basis (as defined under paragraph (h)(5) of this section) of the eligible building property; or

(ii) \$10,000.

(2) *Application with other safe harbor provisions.* For purposes of paragraph

(h)(1) of this section, amounts paid for repairs, maintenance, improvements, and similar activities performed on eligible building property include those amounts not capitalized under the de minimis safe harbor election under § 1.263(a)-1(f) and those amounts deemed not to improve property under the safe harbor for routine maintenance under paragraph (i) of this section.

(3) *Qualifying taxpayer*—(i) *In general.* For purposes of this paragraph (h), the term *qualifying taxpayer* means a taxpayer whose average annual gross receipts as determined under this paragraph (h)(3) for the three preceding taxable years is less than or equal to \$10,000,000.

(ii) *Application to new taxpayers.* If a taxpayer has been in existence for less than three taxable years, the taxpayer determines its average annual gross receipts for the number of taxable years (including short taxable years) that the taxpayer (or its predecessor) has been in existence.

(iii) *Treatment of short taxable year.* In the case of any taxable year of less than 12 months (a short taxable year), the gross receipts shall be annualized by—

(A) Multiplying the gross receipts for the short period by 12; and

(B) Dividing the product determined in paragraph (h)(3)(iii)(A) of this section by the number of months in the short period.

(iv) *Definition of gross receipts.* For purposes of applying paragraph (h)(3)(i) of this section, the term *gross receipts* means the taxpayer's receipts for the taxable year that are properly recognized under the taxpayer's methods of accounting used for Federal income tax purposes for the taxable year. For this purpose, gross receipts include total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments and from incidental or outside sources. For example, gross receipts include interest (including original issue discount and tax-exempt interest within the meaning of section 103), dividends, rents, royalties, and annuities, regardless of whether such amounts are derived in the ordinary course of the taxpayer's trade or business. Gross receipts are not re-

duced by cost of goods sold or by the cost of property sold if such property is described in section 1221(a)(1), (3), (4), or (5). With respect to sales of capital assets as defined in section 1221, or sales of property described in section 1221(a)(2) (relating to property used in a trade or business), gross receipts shall be reduced by the taxpayer's adjusted basis in such property. Gross receipts do not include the repayment of a loan or similar instrument (for example, a repayment of the principal amount of a loan held by a commercial lender) and, except to the extent of gain recognized, do not include gross receipts derived from a non-recognition transaction, such as a section 1031 exchange. Finally, gross receipts do not include amounts received by the taxpayer with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority. If, in contrast, the tax is imposed on the taxpayer under the applicable law, then gross receipts include the amounts received that are allocable to the payment of such tax.

(4) *Eligible building property.* For purposes of this section, the term *eligible building property* refers to each unit of property defined in paragraph (e)(2)(i) (building), paragraph (e)(2)(iii)(A) (condominium), paragraph (e)(2)(iv)(A) (co-operative), or paragraph (e)(2)(v)(A) (leased building or portion of building) of this section, as applicable, that has an unadjusted basis of \$1,000,000 or less.

(5) *Unadjusted basis*—(i) *Eligible building property owned by taxpayer.* For purposes of this section, the unadjusted basis of eligible building property owned by the taxpayer means the basis as determined under section 1012, or other applicable sections of Chapter 1, including subchapters O (relating to gain or loss on dispositions of property), C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). Unadjusted basis is determined without regard to any adjustments described in section 1016(a)(2) or (3) or to amounts for which the taxpayer has elected to

treat as an expense (for example, under sections 179, 179B, or 179C).

(ii) *Eligible building property leased to the taxpayer.* For purposes of this section, the unadjusted basis of eligible building property leased to the taxpayer is the total amount of (undiscounted) rent paid or expected to be paid by the lessee under the lease for the entire term of the lease, including renewal periods if all the facts and circumstances in existence during the taxable year in which the lease is entered indicate a reasonable expectancy of renewal. Section 1.263(a)-4(f)(5)(ii) provides the factors that are significant in determining whether there exists a reasonable expectancy of renewal for purposes of this paragraph.

(6) *Time and manner of election.* A taxpayer makes the election described in paragraph (h)(1) of this section by attaching a statement to the taxpayer's timely filed original Federal tax return (including extensions) for the taxable year in which amounts are paid for repairs, maintenance, improvements, and similar activities performed on the eligible building property providing that such amounts qualify under the safe harbor provided in paragraph (h)(1) of this section. Sections 301.9100-1 through 301.9100-3 of this chapter provide the rules governing extensions of the time to make regulatory elections. The statement must be titled, "Section 1.263(a)-3(h) Safe Harbor Election for Small Taxpayers" and include the taxpayer's name, address, taxpayer identification number, and a description of each eligible building property to which the taxpayer is applying the election. 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. An election may not be made through the filing of an application for change in accounting method or, before obtaining the Commissioner's consent to make a late election, by filing an amended Federal tax return. A taxpayer may not revoke an election made under this paragraph (h). The time and manner of making the election under this paragraph (h) may be modified through guidance of general applicability (see §§ 601.601(d)(2) and 601.602 of this chapter).

(7) *Treatment of safe harbor amounts.* Amounts paid by the taxpayer for repairs, maintenance, improvements, and similar activities to which the taxpayer properly applies the safe harbor under paragraph (h)(1) of this section and for which the taxpayer properly makes the election under paragraph (h)(6) of this section are not treated as improvements under paragraph (d) or (f) of this section and may be deducted under § 1.162-1 or § 1.212-1, as applicable, in the taxable year these amounts are paid, provided the amounts otherwise qualify for a deduction under these sections.

(8) *Safe harbor exceeded.* If total amounts paid by a qualifying taxpayer during the taxable year for repairs, maintenance, improvements, and similar activities performed on an eligible building property exceed the safe harbor limitations specified in paragraph (h)(1) of this section, then the safe harbor election is not available for that eligible building property and the taxpayer must apply the general improvement rules under this section to determine whether amounts are for improvements to the unit of property, including the safe harbor for routine maintenance under paragraph (i) of this section. The taxpayer may also elect to apply the de minimis safe harbor under § 1.263(a)-1(f) to amounts qualifying under that safe harbor irrespective of the application of this paragraph (h).

(9) *Modification of safe harbor amounts.* The amount limitations provided in paragraphs (h)(1)(i), (h)(1)(ii), and (h)(3) of this section may be modified through published guidance in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter).

(10) *Examples.* The following examples illustrate the rules of this paragraph (h). Assume that § 1.212-1 does not apply to the amounts paid.

*Example 1. Safe harbor for small taxpayers applicable.* A is a qualifying taxpayer under paragraph (h)(3) of this section. A owns an office building in which A provides consulting services. In Year 1, A's building has an unadjusted basis of \$750,000 as determined under paragraph (h)(5)(i) of this section. In Year 1, A pays \$5,500 for repairs, maintenance, improvements and similar activities to the office building. Because A's building



unit of property has an unadjusted basis of \$1,000,000 or less, A's building constitutes eligible building property under paragraph (h)(4) of this section. The aggregate amount paid by A during Year 1 for repairs, maintenance, improvements and similar activities on this eligible building property does not exceed the lesser of \$15,000 (2 percent of the building's unadjusted basis of \$750,000) or \$10,000. Therefore, under paragraph (h)(1) of this section, A may elect to not apply the capitalization rule of paragraph (d) of this section to the amounts paid for repair, maintenance, improvements, or similar activities on the office building in Year 1. If A properly makes the election under paragraph (h)(6) of this section for the office building and the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on a trade or business, A may deduct these amounts under §1.162-1 in Year 1.

*Example 2. Safe harbor for small taxpayers in-applicable.* Assume the same facts as in *Example 1*, except that A pays \$10,500 for repairs, maintenance, improvements, and similar activities performed on its office building in Year 1. Because this amount exceeds \$10,000, the lesser of the two limitations provided in paragraph (h)(1) of this section, A may not apply the safe harbor for small taxpayers under paragraph (h)(1) of this section to the total amounts paid for repairs, maintenance, improvements, and similar activities performed on the building. Therefore, A must apply the general improvement rules under this section to determine which of the aggregate amounts paid are for improvements and must be capitalized under paragraph (d) of this section and which of the amounts are for repair and maintenance under §1.162-4.

*Example 3. Safe harbor applied building-by-building.* (i) B is a qualifying taxpayer under paragraph (h)(3) of this section. B owns two rental properties, Building M and Building N. Building M and Building N are both multi-family residential buildings. In Year 1, each property has an unadjusted basis of \$300,000 under paragraph (h)(5) of this section. Because Building M and Building N each have an unadjusted basis of \$1,000,000 or less, Building M and Building N each constitute eligible building property in Year 1 under paragraph (h)(4) of this section. In Year 1, B pays \$5,000 for repairs, maintenance, improvements, and similar activities performed on Building M. In Year 1, B also pays \$7,000 for repairs, maintenance, improvements, and similar activities performed on Building N.

(ii) The total amount paid by B during Year 1 for repairs, maintenance, improvements and similar activities on Building M (\$5,000) does not exceed the lesser of \$6,000 (2 percent of the building's unadjusted basis of \$300,000) or \$10,000. Therefore, under paragraph (h)(1) of this section, for Year 1, B may elect to not apply the capitalization rule

under paragraph (d) of this section to the amounts it paid for repairs, maintenance, improvements, and similar activities on Building M. If B properly makes the election under paragraph (h)(6) of this section for Building M and the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on B's trade or business, B may deduct these amounts under §1.162-1.

(iii) The total amount paid by B during Year 1 for repairs, maintenance, improvements and similar activities on Building N (\$7,000) exceeds \$6,000 (2 percent of the building's unadjusted basis of \$300,000), the lesser of the two limitations provided under paragraph (h)(1) of this section. Therefore, B may not apply the safe harbor under paragraph (h)(1) of this section to the total amounts paid for repairs, maintenance, improvements, and similar activities performed on Building N. Instead, B must apply the general improvement rules under this section to determine which of the total amounts paid for work performed on Building N are for improvements and must be capitalized under paragraph (d) of this section and which amounts are for repair and maintenance under §1.162-4.

*Example 4. Safe harbor applied to leased building property.* C is a qualifying taxpayer under paragraph (h)(3) of this section. C is the lessee of a building in which C operates a retail store. The lease is a triple-net lease, and the lease term is 20 years, including reasonably expected renewals. C pays \$4,000 per month in rent. In Year 1, C pays \$7,000 for repairs, maintenance, improvements, and similar activities performed on the building. Under paragraph (h)(5)(ii) of this section, the unadjusted basis of C's leased unit of property is \$960,000 (\$4,000 monthly rent × 12 months × 20 years). Because C's leased building has an unadjusted basis of \$1,000,000 or less, the building is eligible building property for Year 1 under paragraph (h)(4) of this section. The total amount paid by C during Year 1 for repairs, maintenance, improvements, and similar activities on the leased building (\$7,000) does not exceed the lesser of \$19,200 (2 percent of the building's unadjusted basis of \$960,000) or \$10,000. Therefore, under paragraph (h)(1) of this section, for Year 1, C may elect to not apply the capitalization rule under paragraph (d) of this section to the amounts it paid for repairs, maintenance, improvements, and similar activities on the leased building. If C properly makes the election under paragraph (h)(6) of this section for the leased building and the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on C's trade or business, C may deduct these amounts under §1.162-1.

(i) *Safe harbor for routine maintenance on property—(1) In general.* An amount

paid for routine maintenance (as defined in paragraph (i)(1)(i) or (i)(1)(ii) of this section, as applicable) on a unit of tangible property, or in the case of a building, on any of the properties designated in paragraphs (e)(2)(ii), (e)(2)(iii)(B), (e)(2)(iv)(B), or paragraph (e)(2)(v)(B) of this section, is deemed not to improve that unit of property.

(i) *Routine maintenance for buildings.* Routine maintenance for a building unit of property is the recurring activities that a taxpayer expects to perform as a result of the taxpayer's use of any of the properties designated in paragraphs (e)(2)(ii), (e)(2)(iii)(B), (e)(2)(iv)(B), or (e)(2)(v)(B) of this section to keep the building structure or each building system in its ordinarily efficient operating condition. Routine maintenance activities include, for example, the inspection, cleaning, and testing of the building structure or each building system, and the replacement of damaged or worn parts with comparable and commercially available replacement parts. Routine maintenance may be performed any time during the useful life of the building structure or building systems. However, the activities are routine only if the taxpayer reasonably expects to perform the activities more than once during the 10-year period beginning at the time the building structure or the building system upon which the routine maintenance is performed is placed in service by the taxpayer. A taxpayer's expectation will not be deemed unreasonable merely because the taxpayer does not actually perform the maintenance a second time during the 10-year period, provided that the taxpayer can otherwise substantiate that its expectation was reasonable at the time the property was placed in service. Factors to be considered in determining whether maintenance is routine and whether a taxpayer's expectation is reasonable include the recurring nature of the activity, industry practice, manufacturers' recommendations, and the taxpayer's experience with similar or identical property. With respect to a taxpayer that is a lessor of a building or a part of the building, the taxpayer's use of the building unit of property includes the lessee's use of its unit of property.

(ii) *Routine maintenance for property other than buildings.* Routine maintenance for property other than buildings is the recurring activities that a taxpayer expects to perform as a result of the taxpayer's use of the unit of property to keep the unit of property in its ordinarily efficient operating condition. Routine maintenance activities include, for example, the inspection, cleaning, and testing of the unit of property, and the replacement of damaged or worn parts of the unit of property with comparable and commercially available replacement parts. Routine maintenance may be performed any time during the useful life of the unit of property. However, 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 (as defined in paragraph (i)(4) of this section) of the unit of property. A taxpayer's expectation will not be deemed unreasonable merely because the taxpayer does not actually perform the maintenance a second time during the class life of the unit of property, provided that the taxpayer can otherwise substantiate that its expectation was reasonable at the time the property was placed in service. Factors to be considered in determining whether maintenance is routine and whether the taxpayer's expectation is reasonable include the recurring nature of the activity, industry practice, manufacturers' recommendations, and the taxpayer's experience with similar or identical property. With respect to a taxpayer that is a lessor of a unit of property, the taxpayer's use of the unit of property includes the lessee's use of the unit of property.

(2) *Rotable and temporary spare parts.* Except as provided in paragraph (i)(3) of this section, for purposes of paragraph (i)(1)(ii) of this section, amounts paid for routine maintenance include routine maintenance performed on (and with regard to) rotatable and temporary spare parts.

(3) *Exceptions.* Routine maintenance does not include the following:

(i) Amounts paid for a betterment to a unit of property under paragraph (j) of this section;

(ii) Amounts paid for the replacement of a component of a unit of property for which the taxpayer has properly deducted a loss for that component (other than a casualty loss under § 1.165-7 (see paragraph (k)(1)(i) of this section);

(iii) Amounts paid for the replacement of a component of a unit of property for which the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component (see paragraph (k)(1)(ii) of this section);

(iv) Amounts paid for the restoration of damage to a unit of property for which the taxpayer is required to take a basis adjustment as a result of a casualty loss under section 165, or relating to a casualty event described in section 165, subject to the limitation in paragraph (k)(4) of this section (see paragraph (k)(1)(iii) of this section);

(v) Amounts paid to return a 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 (see paragraph (k)(1)(iv) of this section);

(vi) Amounts paid to adapt a unit of property to a new or different use under paragraph (l) of this section;

(vii) Amounts paid for repairs, maintenance, or improvement of network assets (as defined in paragraph (e)(3)(iii)(A) of this section); or

(viii) Amounts paid for repairs, maintenance, or improvement of rotatable and temporary spare parts to which the taxpayer applies the optional method of accounting for rotatable and temporary spare parts under § 1.162-3(e).

(4) *Class life.* The class life of a unit of property is the recovery period prescribed for the property under sections 168(g)(2) and (3) for purposes of the alternative depreciation system, regardless of whether the property is depreciated under section 168(g). For purposes of determining class life under this section, section 168(g)(3)(A) (relating to tax-exempt use property subject to lease) does not apply. If the unit of property is comprised of components with different class lives, then the class life of the unit of property is

deemed to be the same as the component with the longest class life.

(5) *Coordination with section 263A.* Amounts paid for routine maintenance under this paragraph (i) may be subject to capitalization under section 263A if these amounts comprise the direct or allocable indirect costs of other property produced by the taxpayer or property acquired for resale. See, for example, § 1.263A-1(e)(3)(ii)(O) requiring taxpayers to capitalize the cost of repairing equipment or facilities allocable to property produced or property acquired for resale.

(6) *Examples.* The following examples illustrate the application of this paragraph (i) and, unless otherwise stated, do not address the treatment under other provisions of the Code (for example, section 263A). In addition, unless otherwise stated, assume that the taxpayer has not applied the optional method of accounting for rotatable and temporary spare parts under § 1.162-3(e).

*Example 1. Routine maintenance on component (i)* A is a commercial airline engaged in the business of transporting passengers and freight throughout the United States and abroad. To conduct its business, A owns or leases various types of aircraft. As a condition of maintaining its airworthiness certification for these aircraft, A 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 A 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. One type of maintenance visit is an engine shop visit (ESV), which A expects to perform on its aircraft engines approximately every 4 years to keep its aircraft in its ordinarily efficient operating condition. In Year 1, A purchased a new aircraft, which included four new engines attached to the airframe. The four aircraft engines acquired with the aircraft are not materials or supplies under § 1.162-3(c)(1)(i) because they are acquired as part of a single unit of property, the aircraft. In Year 5, A performs its first ESV on the aircraft engines. The ESV includes disassembly, cleaning, inspection, repair, replacement, reassembly, and testing of the engine and its component parts. During the ESV, the engine is removed from the aircraft and shipped to an outside vendor who performs the ESV. If inspection or testing

discloses a discrepancy in a part's conformity to the specifications in A's maintenance program, the part is repaired, or if necessary, replaced with a comparable and commercially available replacement part. After the ESVs, the engines are returned to A to be reinstalled on another aircraft or stored for later installation. Assume that the class life for A's aircraft, including the engines, is 12 years. Assume that none of the exceptions set out in paragraph (i)(3) of this section apply to the costs of performing the ESVs.

(ii) Because the ESVs involve the recurring activities that A expects to perform as a result of its use of the aircraft to keep the aircraft in ordinarily efficient operating condition and consist of maintenance activities that A expects to perform more than once during the 12 year class life of the aircraft, A's ESVs are within the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section. Accordingly, the amounts paid for the ESVs are deemed not to improve the aircraft and are not required to be capitalized under paragraph (d) of this section.

*Example 2. Routine maintenance after class life* Assume the same facts as in *Example 1*, except that in year 15 A pays amounts to perform an ESV on one of the original aircraft engines after the end of the class life of the aircraft. Because this ESV involves the same routine maintenance activities that were performed on aircraft engines in *Example 1*, this ESV also is within the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section. Accordingly, the amounts paid for this ESV, even though performed after the class life of the aircraft, are deemed not to improve the aircraft and are not required to be capitalized under paragraph (d) of this section.

*Example 3. Routine maintenance on rotatable spare parts* (i) Assume the same facts as in *Example 1*, except that in addition to the four engines purchased as part of the aircraft, A separately purchases four additional new engines that A intends to use in its aircraft fleet to avoid operational downtime when ESVs are required to be performed on the engines previously installed on an aircraft. Later in Year 1, A installs these four engines on an aircraft in its fleet. In Year 5, A performs the first ESVs on these four engines. Assume that these ESVs involve the same routine maintenance activities that were performed on the engines in *Example 1*, and that none of the exceptions set out in paragraph (i)(3) of this section apply to these ESVs. After the ESVs were performed, these engines were reinstalled on other aircraft or stored for later installation.

(ii) The additional aircraft engines are rotatable spare parts under §1.162-3(c)(2) because they were acquired separately from the aircraft, are removable from the aircraft, and are repaired and reinstalled on other air-

craft or stored for later installation. Assume the class life of an engine is the same as the airframe, 12 years. Because the ESVs involve the recurring activities that A expects to perform as a result of its use of the engines to keep the engines in ordinarily efficient operating condition, and consist of maintenance activities that A expects to perform more than once during the 12 year class life of the engine, the ESVs fall within the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section. Accordingly, the amounts paid for the ESVs for the four additional engines are deemed not to improve these engines and are not required to be capitalized under paragraph (d) of this section. For the treatment of amounts paid to acquire the engines, see §1.162-3(a).

*Example 4. Routine maintenance resulting from prior owner's use* (i) In January, Year 1, B purchases a used machine for use in its manufacturing operations. Assume that the machine is the unit of property and has a class life of 10 years. B places the machine in service in January, Year 1, and at that time, B expects to perform manufacturer recommended scheduled maintenance on the machine approximately every three years. The scheduled maintenance includes the cleaning and oiling of the machine, the inspection of parts for defects, and the replacement of minor items such as springs, bearings, and seals with comparable and commercially available replacement parts. At the time B purchased the machine, the machine was approaching the end of a three-year scheduled maintenance period. As a result, in February, Year 1, B pays amounts to perform the manufacturer recommended scheduled maintenance. Assume that none of the exceptions set out in paragraph (i)(3) of this section apply to the amounts paid for the scheduled maintenance.

(ii) The majority of B's costs do not qualify under the routine maintenance safe harbor in paragraph (i)(1)(ii) of this section because the costs were incurred primarily as a result of the prior owner's use of the property and not B's use. B acquired the machine just before it had received its three-year scheduled maintenance. Accordingly, the amounts paid for the scheduled maintenance resulted from the prior owner's, and not B's, use of the property and must be capitalized if those amounts result in a betterment under paragraph (i) of this section, including the amelioration of a material condition or defect, or otherwise result in an improvement under paragraph (d) of this section.

*Example 5. Routine maintenance resulting from new owner's use* Assume the same facts as in *Example 4*, except that after B pays amounts for the maintenance in Year 1, B continues to operate the machine in its manufacturing business. In Year 4, B pays amounts to perform the next scheduled manufacturer recommended maintenance on the

machine. Assume that the scheduled maintenance activities performed are the same as those performed in *Example 4* and that none of the exceptions set out in paragraph (i)(3) of this section apply to the amounts paid for the scheduled maintenance. Because the scheduled maintenance performed in Year 4 involves the recurring activities that B performs as a result of its use of the machine, keeps the machine in an ordinarily efficient operating condition, and consists of maintenance activities that B expects to perform more than once during the 10-year class life of the machine, B's scheduled maintenance costs are within the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section. Accordingly, the amounts paid for the scheduled maintenance in Year 4 are deemed not to improve the machine and are not required to be capitalized under paragraph (d) of this section.

*Example 6. Routine maintenance; replacement of substantial structural part; coordination with section 263A* C is in the business of producing commercial products for sale. As part of the production process, C places raw materials into lined containers in which a chemical reaction is used to convert raw materials into the finished product. The lining, which comprises 60 percent of the total physical structure of the container, is a substantial structural part of the container. Assume that each container, including its lining, is the unit of property and that a container has a class life of 12 years. At the time that C placed the container into service, C was aware that approximately every three years, the container lining would need to be replaced with comparable and commercially available replacement materials. At the end of three years, the container will continue to function, but will become less efficient and the replacement of the lining will be necessary to keep the container in an ordinarily efficient operating condition. In Year 1, C acquired 10 new containers and placed them into service. In Year 4, Year 7, Year 9, and Year 12, C pays amounts to replace the containers' linings with comparable and commercially available replacement parts. Assume that none of the exceptions set out in paragraph (i)(3) of this section apply to the amounts paid for the replacement linings. Because the replacement of the linings involves recurring activities that C expects to perform as a result of its use of the containers to keep the containers in their ordinarily efficient operating condition and consists of maintenance activities that C expects to perform more than once during the 12-year class life of the containers, C's lining replacement costs are within the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section. Accordingly, the amounts that C paid for the replacement of the container linings are deemed not to improve the containers and are not required to

be capitalized under paragraph (d) of this section. However, the amounts paid to replace the lining may be subject to capitalization under section 263A if the amounts paid for this maintenance comprise the direct or allocable indirect costs of the property produced by C. See § 1.263A-1(e)(3)(ii)(O).

*Example 7. Routine maintenance once during class life* D is a Class I railroad that owns a fleet of freight cars. Assume that a freight car, including all its components, is a unit of property and has a class life of 14 years. At the time that D places a freight car into service, D expects to perform cyclical reconditioning to the car every 8 to 10 years to keep the freight car in ordinarily efficient operating condition. During this reconditioning, D pays amounts to disassemble, inspect, and recondition or replace components of the freight car with comparable and commercially available replacement parts. Ten years after D places the freight car in service, D pays amounts to perform a cyclical reconditioning on the car. Because D expects to perform the reconditioning only once during the 14 year class life of the freight car, the amounts D pays for the reconditioning do not qualify for the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section. Accordingly, D must capitalize the amounts paid for the reconditioning of the freight car if these amounts result in an improvement under paragraph (d) of this section.

*Example 8. Routine maintenance; reasonable expectation* Assume the same facts as *Example 7*, except in Year 1, D acquires and places in service several refrigerated freight cars, which also have a class life of 14 years. Because of the special requirements of these cars, at the time they are placed in service, D expects to perform a reconditioning of the refrigeration components of the freight car every 6 years to keep the freight car in an ordinarily efficient operating condition. During the reconditioning, D pays amounts to disassemble, inspect, and recondition or replace the refrigeration components of the freight car with comparable and commercially available replacement parts. Assume that none of the exceptions set out in paragraph (i)(3) of this section apply to the amounts paid for the reconditioning of these freight cars. In Year 6, D pays amounts to perform a reconditioning on the refrigeration components on one of the freight cars. However, because of changes in the frequency that D utilizes this freight car, D does not perform the second reconditioning on the same freight car until Year 15, after the end of the 14-year class life of the car. Under paragraph (i)(1)(ii) of this section, D's reasonable expectation that it would perform the reconditioning every 6 years will not be deemed unreasonable merely because D did not actually perform the reconditioning a

second time during the 14-year class life, provided that D can substantiate that its expectation was reasonable at the time the property was placed in service. If D can demonstrate that its expectation was reasonable in Year 1 using the factors provided in paragraph (i)(1)(ii) of this section, then the amounts paid by D to recondition the refrigerated freight car components in Year 6 and in Year 15 are within the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section.

*Example 9. Routine maintenance on non-rotatable part* E is a towboat operator that owns and leases a fleet of towboats. Each towboat is equipped with two diesel-powered engines. Assume that each towboat, including its engines, is the unit of property and that a towboat has a class life of 18 years. At the time that E places its towboats into service, E is aware that approximately every three to four years E will need to perform scheduled maintenance on the two towboat engines to keep the engines in their ordinarily efficient operating condition. This maintenance is completed while the engines are attached to the towboat and involves the cleaning and inspecting of the engines to determine which parts are within acceptable operating tolerances and can continue to be used, which parts must be reconditioned to be brought back to acceptable tolerances, and which parts must be replaced. Engine parts replaced during these procedures are replaced with comparable and commercially available replacement parts. Assume the towboat engines are not rotatable spare parts under § 1.162-3(c)(2). In Year 1, E acquired a new towboat, including its two engines, and placed the towboat into service. In Year 5, E pays amounts to perform scheduled maintenance on both engines in the towboat. Assume that none of the exceptions set out in paragraph (i)(3) of this section apply to the scheduled maintenance costs. Because the scheduled maintenance involves recurring activities that E expects to perform more than once during the 18-year class life of the towboat, the maintenance results from E's use of the towboat, and the maintenance is performed to keep the towboat in an ordinarily efficient operating condition, the scheduled maintenance on E's towboat is within the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section. Accordingly, the amounts paid for the scheduled maintenance to its towboat engines in Year 5 are deemed not to improve the towboat and are not required to be capitalized under paragraph (d) of this section.

*Example 10. Routine maintenance with related betterments* Assume the same facts as *Example 9*, except that in Year 9 E's towboat engines are due for another scheduled maintenance visit. At this time, E decides to upgrade the engines to increase their horsepower and propulsion, which would permit the towboats

to tow heavier loads. Accordingly, in Year 9, E pays amounts to perform many of the same activities that it would perform during the typical scheduled maintenance activities such as cleaning, inspecting, reconditioning, and replacing minor parts, but at the same time, E incurs costs to upgrade certain engine parts to increase the towing capacity of the boats in excess of the capacity of the boats when E placed them in service. In combination with the replacement of parts with new and upgraded parts, the scheduled maintenance must be completed to perform the horsepower and propulsion upgrade. Thus, the work done on the engines encompasses more than the recurring activities that E expected to perform as a result of its use of the towboats and did more than keep the towboat in its ordinarily efficient operating condition. Rather under paragraph (j) of this section, the amounts paid to increase the horsepower and propulsion of the engines are for a betterment to the towboat, and such amounts are excepted from the routine maintenance safe harbor under paragraph (i)(3)(i) of this section. In addition, under paragraph (g)(1)(i) of this section, the scheduled maintenance procedures directly benefit the upgrades. Therefore, the amounts that E paid in Year 9 for the maintenance and upgrade of the engines do not qualify for the routine maintenance safe harbor described under paragraph (i)(1)(ii) of this section. Rather, E must capitalize the amounts paid for maintenance and upgrades of the engines as an improvement to the towboats under paragraph (d) of this section.

*Example 11. Routine maintenance with unrelated improvements* Assume the same facts as *Example 9*, except in Year 5, in addition to paying amounts to perform the scheduled engine maintenance on both engines, E also incurs costs to upgrade the communications and navigation systems in the pilot house of the towboat with new state-of-the-art systems. Assume the amounts paid to upgrade the communications and navigation systems are for betterments under paragraph (j) of this section, and therefore result in an improvement to the towboat under paragraph (d) of this section. In contrast with *Example 9*, the amounts paid for the scheduled maintenance on E's towboat engines are not otherwise related to the upgrades to the navigation systems. Because the scheduled maintenance on the towboat engines does not directly benefit and is not incurred by reason of the upgrades to the communication and navigation systems, the amounts paid for the scheduled engine maintenance are not a direct or indirect cost of the improvement under paragraph (g)(1)(i) of this section. Accordingly, the amounts paid for the scheduled maintenance to its towboat engines in Year 5 are routine maintenance deemed not to improve the towboat and are not required

to be capitalized under paragraph (d) of this section.

*Example 12. Exceptions to routine maintenance* F owns and operates a farming and cattle ranch with an irrigation system that provides water for crops. Assume that each canal in the irrigation system is a single unit of property and has a class life of 20 years. At the time F placed the canals into service, F expected to have to perform major maintenance on the canals every three years to keep the canals in their ordinarily efficient operating condition. This maintenance includes draining the canals, and then cleaning, inspecting, repairing, and reconditioning or replacing parts of the canal with comparable and commercially available replacement parts. F placed the canals into service in Year 1 and did not perform any maintenance on the canals until Year 6. At that time, the canals had fallen into a state of disrepair and no longer functioned for irrigation. In Year 6, F pays amounts to drain the canals and do extensive cleaning, repairing, reconditioning, and replacing parts of the canals with comparable and commercially available replacement parts. Although the work performed on F's canals was similar to the activities that F expected to perform, but did not perform, every three years, the costs of these activities do not fall within the routine maintenance safe harbor. Specifically, under paragraph (i)(3)(v) of this section, routine maintenance does not include activities that return a unit of property to its former ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use. Accordingly, amounts that F pays for work performed on the canals in Year 6 must be capitalized if they result in improvements under paragraph (d) of this section (for example, restorations under paragraph (k) of this section).

*Example 13. Routine maintenance on a building; escalator system* In Year 1, G acquires a large retail mall in which it leases space to retailers. The mall contains an escalator system with 40 escalators, which includes landing platforms, trusses, tracks, steps, handrails, and safety brushes. In Year 1, when G placed its building into service, G reasonably expected that it would need to replace the handrails on the escalators approximately every four years to keep the escalator system in its ordinarily efficient operating condition. After a routine inspection and test of the escalator system in Year 4, G determines that the handrails need to be replaced and pays an amount to replace the handrails with comparable and commercially available handrails. The escalator system, including the handrails, is a building system under paragraph (e)(2)(ii)(B)(4) of this section. Assume that none of the exceptions in paragraph (i)(3) of this section apply to the

scheduled maintenance costs. Because the replacement of the handrails involves recurring activities that G expects to perform as a result of its use of the escalator system to keep the escalator system in an ordinarily efficient operating condition, and G reasonably expects to perform these activities more than once during the 10-year period beginning at the time building system was placed in service, the amounts paid by G for the handrail replacements are within the routine maintenance safe harbor under paragraph (i)(1)(i) of this section. Accordingly, the amounts paid for the replacement of the handrails in Year 4 are deemed not to improve the building unit of property and are not required to be capitalized under paragraph (d) of this section.

*Example 14. Not routine maintenance; escalator system* Assume the same facts as in *Example 13*, except that in Year 9, G pays amounts to replace the steps of the escalators. In Year 1, when G placed its building into service, G reasonably expected that approximately every 18 to 20 years G would need to replace the steps to keep the escalator system in its ordinarily efficient operating condition. Because the replacement does not involve recurring activities that G expects to perform more than once during the 10-year period beginning at the time the building structure or the building system was placed in service, the costs of these activities do not fall within the routine maintenance safe harbor. Accordingly, amounts that G pays to replace the steps in Year 9 must be capitalized if they result in improvements under paragraph (d) of this section (for example, restorations under paragraph (k) of this section).

*Example 15. Routine maintenance on building; reasonable expectation* In Year 1, H acquires a new office building, which it uses to provide services. The building contains an HVAC system, which is a building system under paragraph (e)(2)(ii)(B)(1) of this section. In Year 1, when H placed its building into service, H reasonably expected that every four years H would need to pay an outside contractor to perform detailed testing, monitoring, and preventative maintenance on its HVAC system to keep the HVAC system in its ordinarily efficient operating condition. This scheduled maintenance includes disassembly, cleaning, inspection, repair, replacement, reassembly, and testing of the HVAC system and many of its component parts. If inspection or testing discloses a problem with any component, the part is repaired, or if necessary, replaced with a comparable and commercially available replacement part. The scheduled maintenance at these intervals is recommended by the manufacturer of the HVAC system and is routinely performed on similar systems in similar buildings. Assume that none of the exceptions in paragraph (i)(3) of this section apply

to the amounts paid for the maintenance on the HVAC system. In Year 4, H pays amounts to a contractor to perform the scheduled maintenance. However, H does not perform this scheduled maintenance on its building again until Year 11. Under paragraph (i)(1)(i) of this section, H's reasonable expectation that it would perform the maintenance every 4 years will not be deemed unreasonable merely because H did not actually perform the maintenance a second time during the 10-year period, provided that H can substantiate that its expectation was reasonable at the time the property was placed in service. If H can demonstrate that its expectation was reasonable in Year 1 using the other factors considered in paragraph (i)(1)(i), then the amounts H paid for the maintenance of the HVAC system in Year 4 and in Year 11 are within the routine maintenance safe harbor under paragraph (i)(1)(i) of this section.

(j) *Capitalization of betterments*—(1) *In general.* A taxpayer must capitalize as an improvement an amount paid for a betterment to a unit of property. An amount is paid for a betterment to a unit of property only if it—

(i) Ameliorates a material condition or defect that either existed prior to the taxpayer's acquisition of the unit of property or arose during the production of the unit of property, whether or not the taxpayer was aware of the condition or defect at the time of acquisition or production;

(ii) Is for a material addition, including a physical enlargement, expansion, extension, or addition of a major component (as defined in paragraph (k)(6) of this section) to the unit of property or a material increase in the capacity, including additional cubic or linear space, of the unit of property; or

(iii) Is reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the unit of property.

(2) *Application of betterment rules*—(i) *In general.* The applicability of each quantitative and qualitative factor provided in paragraphs (j)(1)(ii) and (j)(1)(iii) of this section to a particular unit of property depends on the nature of the unit of property. For example, if an addition or an increase in a particular factor cannot be measured in the context of a specific type of property, this factor is not relevant in the determination of whether an amount has been paid for a betterment to the unit of property.

(ii) *Application of betterment rules to buildings.* An amount is paid to improve a building if it is paid for a betterment, as defined under paragraph (j)(1) of this section, to a property specified under paragraph (e)(2)(ii) (building), paragraph (e)(2)(iii)(B) (condominium), paragraph (e)(2)(iv)(B) (cooperative), or paragraph (e)(2)(v)(B) (leased building or leased portion of building) of this section. For example, an amount is paid to improve a building if it is paid for an increase in the efficiency of the building structure or any one of its building systems (for example, the HVAC system).

(iii) *Unavailability of replacement parts.* If a taxpayer replaces a part of a unit of property that cannot reasonably be replaced with the same type of part (for example, because of technological advancements or product enhancements), the replacement of the part with an improved, but comparable, part does not, by itself, result in a betterment to the unit of property.

(iv) *Appropriate comparison*—(A) *In general.* In cases in which an expenditure is necessitated by normal wear and tear or damage to the unit of property that occurred during the taxpayer's use of the unit of property, the determination of whether an expenditure is for the 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.

(B) *Normal wear and tear.* If the expenditure is made to correct the effects of normal wear and tear to the unit of property that occurred during the taxpayer's use of the unit of property, 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.

(C) *Damage to property.* If the expenditure is made to correct damage to a



unit of property that occurred during the taxpayer's use of the unit of property, the condition of the property immediately prior to the circumstances necessitating the expenditure is the condition of the property immediately prior to damage.

(3) *Examples.* The following examples illustrate the application of this paragraph (j) only and do not address whether capitalization is required under another provision of this section or another provision of the Internal Revenue Code (for example, section 263A). Unless otherwise provided, assume that the appropriate comparison in paragraph (j)(2)(iv) of this section is not applicable under the facts.

*Example 1. Amelioration of pre-existing material condition or defect.* In Year 1, A purchases a store located on a parcel of land that contains underground gasoline storage tanks left by prior occupants. Assume that the parcel of land is the unit of property. The tanks had leaked prior to A's purchase, causing soil contamination. A is not aware of the contamination at the time of purchase. In Year 2, A discovers the contamination and incurs costs to remediate the soil. The remediation costs are for a betterment to the land under paragraph (j)(1)(i) of this section because A incurred the costs to ameliorate a material condition or defect that existed prior to A's acquisition of the land.

*Example 2. Not amelioration of pre-existing condition or defect.* B owns an office building that was constructed with insulation that contained asbestos. The health dangers of asbestos were not widely known when the building was constructed. Several years after B places the building into service, B determines that certain areas of asbestos-containing insulation have begun to deteriorate and could eventually pose a health risk to employees. Therefore, B pays an amount to remove the asbestos-containing insulation from the building structure and replace it with new insulation that is safer to employees, but no more efficient or effective than the asbestos insulation. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. Although the asbestos is determined to be unsafe under certain circumstances, the presence of asbestos insulation in a building, by itself, is not a pre-existing material condition or defect of the building structure under paragraph (j)(1)(i) of this section. In addition, the removal and replacement of the asbestos is not for a material addition to the building structure or a material increase in the capacity of the

building structure under paragraphs (j)(1)(ii) and (j)(2)(iv) of this section as compared to the condition of the property prior to the deterioration of the insulation. Similarly, the removal and replacement of asbestos is not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the building structure under paragraphs (j)(1)(iii) and (j)(2)(iv) of this section as compared to the condition of the property prior to the deterioration of the insulation. Therefore, the amount paid to remove and replace the asbestos insulation is not for a betterment to the building structure or an improvement to the building under paragraph (j) of this section.

*Example 3. Not amelioration of pre-existing material condition or defect.* (i) In January, Year 1, C purchased a used machine for use in its manufacturing operations. Assume that the machine is a unit of property and has a class life of 10 years. C placed the machine in service in January, Year 1 and at that time expected to perform manufacturer recommended scheduled maintenance on the machine every three years. The scheduled maintenance includes cleaning and oiling the machine, inspecting parts for defects, and replacing minor items, such as springs, bearings, and seals, with comparable and commercially available replacement parts. The scheduled maintenance does not include any material additions or materially increase the capacity, productivity, efficiency, strength, quality, or output of the machine. At the time C purchased the machine, it was approaching the end of a three-year scheduled maintenance period. As a result, in February, Year 1, C pays an amount to perform the manufacturer recommended scheduled maintenance to keep the machine in its ordinarily efficient operating condition.

(ii) The amount that C pays does not qualify under the routine maintenance safe harbor in paragraph (i) of this section, because the cost primarily results from the prior owner's use of the property and not the taxpayer's use. C acquired the machine just before it had received its three-year scheduled maintenance. Accordingly, the amount that C pays for the scheduled maintenance results from the prior owner's use of the property and ameliorates conditions or defects that existed prior to C's ownership of the machine. Nevertheless, considering the purpose and minor nature of the work performed, this amount does not ameliorate a material condition or defect in the machine under paragraph (j)(1)(i) of this section, is not for a material addition to or increase in capacity of the machine under paragraph (j)(1)(ii) of this section, and is not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the machine under paragraph (j)(1)(iii) of this section. Therefore, C is not required to capitalize the amount paid for the scheduled

maintenance as a betterment to the unit of property under this paragraph (j).

*Example 4. Not amelioration of pre-existing material condition or defect* D purchases a used ice resurfacing machine for use in the operation of its ice skating rink. To comply with local regulations, D is required to routinely monitor the air quality in the ice skating rink. One week after D places the machine into service, during a routine air quality check, D discovers that the operation of the machine is adversely affecting the air quality in the skating rink. As a result, D pays an amount to inspect and retune the machine, which includes replacing minor components of the engine that had worn out prior to D's acquisition of the machine. Assume the resurfacing machine, including the engine, is the unit of property. The routine maintenance safe harbor in paragraph (i) of this section does not apply to the amounts paid, because the activities performed do not relate solely to the taxpayer's use of the machine. The amount that D pays to inspect, retune, and replace minor components of the ice resurfacing machine ameliorates a condition or defect that existed prior to D's acquisition of the equipment. Nevertheless, considering the purpose and minor nature of the work performed, this amount does not ameliorate a material condition or defect in the machine under paragraph (j)(1)(i) of this section. In addition, the amount is not paid for a material addition to the machine or a material increase in the capacity of the machine under paragraph (j)(1)(ii) of this section. Also, the activities are not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the machine under paragraph (j)(1)(iii) of this section. Therefore, D is not required to capitalize the amount paid to inspect, retune, and replace minor components of the machine as a betterment under this paragraph (j).

*Example 5. Amelioration of material condition or defect* (i) E acquires a building for use in its business of providing assisted living services. Before and after the purchase, the building functions as an assisted living facility. However, at the time of the purchase, E is aware that the building is in a condition that is below the standards that E requires for facilities used in its business. Immediately after the acquisition and during the following two years, while E continues to use the building as an assisted living facility, E pays amounts for extensive repairs and maintenance, and the acquisition of new property to bring the facility into the high-quality condition for which E's facilities are known. The work on E's building includes repairing damaged drywall, repainting, re-wallpapering, replacing windows, repairing and replacing doors, replacing and re-grouting tile, repairing millwork, and repairing and replacing roofing materials. The

work also involves the replacement of section 1245 property, including window treatments, furniture, and cabinets. The work that E performs affects only the building structure under paragraph (e)(2)(ii)(A) of this section and does not affect any of the building systems described in paragraph (e)(2)(ii)(B) of this section. Assume that each section 1245 property is a separate unit of property.

(ii) Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. Considering the purpose of the expenditure and the effect of the expenditures on the building structure, the amounts that E paid for repairs and maintenance to the building structure comprise a betterment to the building structure under paragraph (j)(1)(i) of this section because the amounts ameliorate material conditions that existed prior to E's acquisition of the building. Therefore, E must treat the amounts paid for the betterment to the building structure as an improvement to the building and must capitalize the amounts under paragraphs (j) and (d)(1) of this section. Moreover, E is required to capitalize the amounts paid to acquire and install each section 1245 property, including each window treatment, each item of furniture, and each cabinet, in accordance with § 1.263(a)-2(d)(1).

*Example 6. Not a betterment; building refresh* (i) F owns a nationwide chain of retail stores that sell a wide variety of items. To maintain the appearance and functionality of its store buildings after several years of wear, F periodically pays amounts to refresh the look and layout of its stores. The work that F performs during a refresh consists of cosmetic and layout changes to the store's interiors and general repairs and maintenance to the store building to modernize the store buildings and reorganize the merchandise displays. The work to each store consists of replacing and reconfiguring display tables and racks to provide better exposure of the merchandise, making corresponding lighting relocations and flooring repairs, moving one wall to accommodate the reconfiguration of tables and racks, patching holes in walls, repainting the interior structure with a new color scheme to coordinate with new signage, replacing damaged ceiling tiles, cleaning and repairing wood flooring throughout the store building, and power washing building exteriors. The display tables and the racks all constitute section 1245 property. F pays amounts to refresh 50 stores during the taxable year. Assume that each section 1245 property within each store is a separate unit of property. Finally, assume that the work does not ameliorate any material conditions or defects that existed when F acquired the store buildings or result in any material additions to the store buildings.

(ii) Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. Considering the facts and circumstances including the purpose of the expenditure, the physical nature of the work performed, and the effect of the expenditure on the buildings' structure and systems, the amounts paid for the refresh of each building are not for any material additions to, or material increases in the capacity of, the buildings' structure or systems as compared with the condition of the structure or systems after the previous refresh. Moreover, the amounts paid are not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of any building structure or system under as compared to the condition of the structures or systems after the previous refresh. Rather, the work performed keeps F's store buildings' structures and buildings' systems in their ordinarily efficient operating condition. Therefore, F is not required to treat the amounts paid for the refresh of its store buildings' structures and buildings' systems as betterments under paragraphs (j)(1)(ii), (j)(1)(iii), and (j)(2)(iv) of this section. However, F is required to capitalize the amounts paid to acquire and install each section 1245 property in accordance with § 1.263(a)-2(d)(1).

*Example 7. Building refresh; limited improvement* (i) Assume the same facts as *Example 6* except, in the course of the refresh to one of its store buildings, F also pays amounts to increase the building's storage space, add a second loading dock, and add a second overhead door. Specifically, at the same time F pays amounts to perform the refresh, F pays additional amounts to construct an addition to the back of the store building, including adding a new overhead door and loading dock to the building. The work also involves upgrades to the electrical system of the building, including the addition of a second service box with increased amperage and new wiring from the service box to provide lighting and power throughout the new space. Although it is performed at the same time, the construction of the additions does not affect, and is not otherwise related to, the refresh of the retail space.

(ii) Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. Under paragraph (j)(1)(ii) of this section, the amounts paid by F to add the storage space, loading dock, overhead door, and expand the electrical system are for betterments to F's building structure and to the electrical system because they are for material additions to, and a material increase in capacity of, the structure and the electrical system of

F's store building. Accordingly, F must treat the amounts paid for these betterments as improvements to the building unit of property and capitalize these amounts under paragraphs (d)(1) and (j) of this section. However, for the reasons discussed in *Example 6*, F is not required to treat the amounts paid for the refresh of its store building structure and systems as a betterments under paragraph (j)(1) of this section. In addition, F is not required under paragraph (g)(1) of this section to capitalize the refresh costs described in *Example 6* because these costs do not directly benefit and are not incurred by reason of the additions to the building structure and electrical system. As in *Example 6*, F is required to capitalize the amounts paid to acquire and install each section 1245 property in accordance with § 1.263(a)-2(d)(1).

*Example 8. Betterment; building remodel* (i) G owns a large chain of retail stores that sell a variety of items. G determines that due to changes in the retail market, it can no longer compete in its current store class and decides to upgrade its stores to offer higher end products to a different type of customer. To offer these products and attract different types of customers, G must substantially remodel its stores. Thus, G pays amounts to remodel its stores by performing work on the buildings' structures and systems as defined under paragraphs (e)(2)(ii)(A) and (e)(2)(ii)(B) of this section. This work includes replacing large parts of the exterior walls with windows, replacing the escalators with a monumental staircase, adding a new glass enclosed elevator, rebuilding the interior and exterior facades, replacing vinyl floors with ceramic flooring, replacing ceiling tiles with acoustical tiles, and removing and rebuilding walls to move changing rooms and create specialty departments. The work also includes upgrades to increase the capacity of the buildings' electrical system to accommodate the structural changes and the addition of new section 1245 property, such as new product information kiosks and point of sale systems. The work to the electrical system also involves the installation of new more efficient and mood enhancing lighting fixtures. In addition, the work includes remodeling all bathrooms by replacing contractor-grade plumbing fixtures with designer-grade fixtures that conserve water and energy. Finally, G also pays amounts to clean debris resulting from construction during the remodel, patch holes in walls that were made to upgrade the electrical system, repaint existing walls with a new color scheme to match the new interior construction, and to power wash building exteriors to enhance the new exterior facade.

(ii) Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. Considering the

facts and circumstances, including the purpose of the expenditure, the physical nature of the work performed, and the effect of the work on the buildings' structures and buildings' systems, the amounts that G pays for the remodeling of its stores result in betterments to the buildings' structures and several of its systems under paragraph (j) of this section. Specifically, the amounts paid to replace large parts of the exterior walls with windows, replace the escalators with a monumental staircase, add a new elevator, rebuild the interior and exterior facades, replace vinyl floors with ceramic flooring, replace the ceiling tiles with acoustical tiles, and to remove and rebuild walls are for material additions, that is the addition of major components, to the building structure under paragraph (j)(1)(ii) of this section and are reasonably expected to increase the quality of the building structure under paragraph (j)(1)(iii) of this section. Similarly, the amounts paid to upgrade the electrical system are to materially increase the capacity of the electrical system under paragraph (j)(1)(ii) of this section and are reasonably expected to increase the quality of this system under paragraph (j)(1)(iii) of this section. In addition, the amounts paid to remodel the bathrooms with higher grade and more resource-efficient materials are reasonably expected to increase the efficiency and quality of the plumbing system under paragraph (j)(1)(iii) of this section. Finally, the amounts paid to clean debris, patch and repaint existing walls with a new color scheme, and to power wash building exteriors, while not betterments by themselves, directly benefitted and were incurred by reason of the improvements to G's store buildings' structures and electrical systems under paragraph (g)(1) of this section. Therefore, G must treat the amounts paid for betterments to the store buildings' structures and systems, including the costs of cleaning, patching, repairing, and power washing the building, as improvements to G's buildings and must capitalize these amounts under paragraphs (d)(1) and (j) of this section. Moreover, G is required to capitalize the amounts paid to acquire and install each section 1245 property in accordance with § 1.263(a)-2(d)(1). For the treatment of amounts paid to remove components of property, see paragraph (g)(2) of this section.

*Example 9. Not betterment; relocation and reinstallation of personal property* In Year 1, H purchases new cash registers for use in its retail store located in leased space in a shopping mall. Assume that each cash register is a unit of property as determined under paragraph (e)(3) of this section. In Year 1, H capitalizes the costs of acquiring and installing the new cash registers under § 1.263(a)-2(d)(1). In Year 3, H's lease expires, and H decides to relocate its retail store to a different building. In addition to various other costs, H

pays \$5,000 to move the cash registers and \$1,000 to reinstall them in the new store. The cash registers are used for the same purpose and in the same manner that they were used in the former location. The amounts that H pays to move and reinstall the cash registers into its new store do not result in a betterment to the cash registers under paragraph (j) of this section.

*Example 10. Betterment; relocation and reinstallation of equipment* J operates a manufacturing facility in Building A, which contains various machines that J uses in its manufacturing business. J decides to expand part of its operations by relocating a machine to Building B to reconfigure the machine with additional components. Assume that the machine is a single unit of property under paragraph (e)(3) of this section. J pays amounts to disassemble the machine, to move the machine to the new location, and to reinstall the machine in a new configuration with additional components. Assume that the reinstallation, including the reconfiguration and the addition of components, is for an increase in capacity of the machine, and therefore is for a betterment to the machine under paragraph (j)(1)(ii) of this section. Accordingly, J must capitalize the costs of reinstalling the machine as an improvement to the machine under paragraphs (j) and (d)(1) of this section. J is also required to capitalize the costs of disassembling and moving the machine to Building B because these costs directly benefit and are incurred by reason of the improvement to the machine under paragraph (g)(1) of this section.

*Example 11. Betterment; regulatory requirement* K owns a building that it uses in its business. In Year 1, City C passes an ordinance setting higher safety standards for buildings because of the hazardous conditions caused by earthquakes. To comply with the ordinance, K pays an amount to add expansion bolts to its building structure. These bolts anchor the wooden framing of K's building to its cement foundation, providing additional structural support and resistance to seismic forces, making the building more resistant to damage from lateral movement. Under paragraphs (e)(2)(ii) and (j)(2)(i) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. The framing and foundation are part of the building structure as defined in paragraph (e)(2)(ii)(A) of this section. Prior to the ordinance, the old building was in good condition but did not meet City C's new requirements for earthquake resistance. The amount paid by K for the addition of the expansion bolts met City C's new requirement, but also materially increased the strength of the building structure under paragraph (j)(1)(iii) of this section. Therefore, K must treat the amount

paid to add the expansion bolts as a betterment to the building structure and must capitalize this amount as an improvement to building under paragraphs (d)(1) and (j) of this section. Under paragraph (g)(4) of this section, City C's new requirement that K's building meet certain safety standards to continue to operate is not relevant in determining whether the amount paid improved the building.

*Example 12. Not a betterment; regulatory requirement* L owns a meat processing plant. After operating the plant for many years, L discovers that oil is seeping through the concrete walls of the plant. Federal inspectors advise L that it must correct the seepage problem or shut down its plant. To correct the problem, L pays an amount to add a concrete lining to the walls from the floor to a height of about four feet and also to add concrete to the floor of the plant. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. The walls are part of the building structure as defined in paragraph (e)(2)(ii)(A) of this section. The condition necessitating the expenditure was the seepage of the oil into the plant. Prior to the seepage, the walls did not leak and were functioning for their intended use. L is not required to treat the amount paid as a betterment under paragraphs (j)(1)(ii) and (j)(2)(iv) of this section because it is not paid for a material addition to, or a material increase in the capacity of, the building's structure as compared to the condition of the structure prior to the seepage of oil. Moreover, the amount paid is not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the building structure under paragraphs (j)(1)(iii) and (j)(2)(iv) as compared to the condition of the structure prior to the seepage of the oil. Therefore, L is not required to treat the amount paid to correct the seepage as a betterment to the building under paragraph (d)(1) or (j) of this section. The federal inspectors' requirement that L correct the seepage to continue operating the plant is not relevant in determining whether the amount paid improves the plant.

*Example 13. Not a betterment; new roof membrane* M owns a building that it uses for its retail business. Over time, the waterproof membrane (top layer) on the roof of M's building begins to wear, and M began to experience water seepage and leaks throughout its retail premises. To eliminate the problems, a contractor recommends that M put a new rubber membrane on the worn membrane. Accordingly, M pays the contractor to add the new membrane. The new membrane is comparable to the worn membrane when it was originally placed in service by the taxpayer. Under paragraphs (e)(2)(ii) and

(j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. The roof is part of the building structure under paragraph (e)(2)(ii)(A) of this section. The condition necessitating the expenditure was the normal wear of M's roof. Under paragraph (j)(2)(iv) of this section, to determine whether the amounts are for a betterment, the condition of the building structure after the expenditure must be compared to the condition of the structure when M placed the building into service because M has not previously corrected the effects of normal wear and tear. Under these facts, the amount paid to add the new membrane to the roof is not for a material addition or a material increase in the capacity of the building structure under paragraph (j)(1)(ii) of this section as compared to the condition of the structure when it was placed in service. Moreover, the new membrane is not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the building structure under paragraph (j)(1)(iii) of this section as compared to the condition of the building structure when it was placed in service. Therefore, M is not required to treat the amount paid to add the new membrane as a betterment to the building under paragraph (d)(1) or (j) of this section.

*Example 14. Material increase in capacity; building* N owns a factory building with a storage area on the second floor. N pays an amount to reinforce the columns and girders supporting the second floor to permit storage of supplies with a gross weight 50 percent greater than the previous load-carrying capacity of the storage area. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. The columns and girders are part of the building structure defined under paragraph (e)(2)(ii)(A) of this section. N must treat the amount paid to reinforce the columns and girders as a betterment under paragraphs (j)(1)(ii) and (j)(1)(iii) of this section because it materially increases the load-carrying capacity and the strength of the building structure. Therefore, N must capitalize this amount as an improvement to the building under paragraphs (d)(1) and (j) of this section.

*Example 15. Material increase in capacity; channel* O owns harbor facilities consisting of a slip for the loading and unloading of barges and a channel leading from the slip to the river. At the time of purchase, the channel was 150 feet wide, 1,000 feet long, and 10 feet deep. Several years after purchasing the harbor facilities, to allow for ingress and egress and for the unloading of larger barges, O decides to deepen the channel to a depth of 20

feet. O pays a contractor to dredge the channel to 20 feet. Assume the channel is the unit of property. O must capitalize the amounts paid for the dredging as an improvement to the channel because they are for a material increase in the capacity of the unit of property under paragraph (j)(1)(ii) of this section.

*Example 16. Not a material increase in capacity; channel* Assume the same facts as in *Example 15*, except that the channel was susceptible to siltation and, after dredging to 20 feet, the channel depth had been reduced to 18 feet. O pays a contractor to redredge the channel to a depth of 20 feet. The expenditure was necessitated by the siltation of the channel. Both prior to the siltation and after the redredging, the depth of the channel was 20 feet. Applying the comparison rule under paragraph (j)(2)(iv) of this section, the amounts paid by O to redredge the channel are not for a betterment under paragraph (j)(1)(ii) of this section because they are not for a material addition to, or a material increase in the capacity of, the unit of property as compared to the condition of the property prior to the siltation. Similarly, these amounts are not for a betterment under paragraph (j)(1)(iii) of this section because the amounts are not reasonably expected to increase the productivity, efficiency, strength, quality, or output of the unit of property as compared to the condition of the property before the siltation. Therefore, O is not required to capitalize these amounts as improvement under paragraphs (d)(1) and (j) of this section.

*Example 17. Material increase in capacity; channel* Assume the same facts as in *Example 16* except that after the redredging, there is more siltation, and the channel depth is reduced back to 18 feet. In addition, to allow for additional ingress and egress and for the unloading of even larger barges, O decides to deepen the channel to a depth of 25 feet. O pays a contractor to redredge the channel to 25 feet. O must capitalize the amounts paid for the dredging as an improvement to the channel because the amounts are for a material increase in the capacity of the unit of property under paragraph (j)(1)(ii) of this section as compared to condition of the unit of property before the siltation. As part of this improvement, O is also required to capitalize the portion of the redredge costs allocable to restoring the depth lost to the siltation because, under paragraph (g)(1)(i) of this section, these amounts directly benefit and are incurred by reason of the improvement to the unit of property.

*Example 18. Not a material increase in capacity; building* P owns a building used in its trade or business. The first floor has a drop-ceiling. To fully expose windows on the first floor, P pays an amount to remove the drop-ceiling and repaint the original ceiling. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a

building unit of property if the amount is paid for a betterment to the building structure or any building system. The ceiling is part of the building structure as defined under paragraph (e)(2)(ii)(A) of this section. P is not required to treat the amount paid to remove the drop-ceiling as a betterment to the building because it was not for a material addition or material increase in the capacity of the building structure under paragraph (j)(1)(ii) of this section and it was not reasonably expected to materially increase to the efficiency, strength, or quality of the building structure under paragraph (j)(1)(iii) of this section. In addition, under paragraph (j)(2)(i) of this section, because the effect on productivity and output of the building structure cannot be measured in this context, these factors are not relevant in determining whether there is a betterment to the building structure.

*Example 19. Material increase in capacity; building* Q owns a building that it uses in its retail business. The building contains one floor of retail space with very high ceilings. Q pays an amount to add a stairway and a mezzanine for the purposes of adding additional selling space within its building. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. The stairway and the mezzanine are part of the building structure as defined under paragraph (e)(2)(ii)(A) of this section. Q is required to treat the amount paid to add the stairway and mezzanine as a betterment because it is for a material addition to, and an increase in the capacity of, the building structure under paragraph (j)(1)(ii) of this section. Therefore, Q must capitalize this amount as an improvement to the building unit of property under paragraphs (d)(1) and (j) of this section.

*Example 20. Not material increase in efficiency; HVAC system* R owns an office building that it uses to provide services to customers. The building contains an HVAC system that incorporates 10 roof-mounted units that provide heating and air conditioning for different parts of the building. The HVAC system also consists of controls for the entire system and duct work that distributes the heated or cooled air to the various spaces in the building's interior. After many years of use of the HVAC system, R begins to experience climate control problems in various offices throughout the office building and consults with a contractor to determine the cause. The contractor recommends that R replace two of the roof-mounted units. R pays an amount to replace the two specified units. The two new units are expected to eliminate the climate control problems and to be 10 percent more energy efficient than

the replaced units in their original condition. No work is performed on the other roof-mounted heating/cooling units, the duct work, or the controls. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. The HVAC system, including the two-roof mounted units, is a building system under paragraph (e)(2)(ii)(B)(1) of this section. The replacement of the two roof-mounted units is not a material addition to or a material increase in the capacity of the HVAC system under paragraphs (j)(1)(ii) and (j)(3)(ii) of this section as compared to the condition of the system prior to the climate control problems. In addition, given the 10 percent efficiency increase in two units of the entire HVAC system, the replacement is not expected to materially increase the productivity, efficiency, strength, quality, or output of the HVAC system under paragraphs (j)(1)(iii) and (j)(2)(iv) of this section as compared to the condition of the system prior to the climate control problems. Therefore, R is not required to capitalize the amounts paid for these replacements as betterments to the building unit of property under paragraphs (d)(1) and (j) of this section.

*Example 21. Material increase in efficiency; building* S owns a building that it uses in its service business. S conducts an energy assessment and determines that it could significantly reduce its energy costs by adding insulation to its building. S pays an insulation contractor to apply a combination of loose-fill, spray foam, and blanket insulation throughout S's building structure, including within the attic, walls, and crawl spaces. S reasonably expects the new insulation to make the building more energy efficient because the contractor indicated that the new insulation would reduce its annual energy and power costs by approximately 50 percent of its annual costs during the last five years. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building if the amount is paid for a betterment to the building structure or any building system. Therefore, under paragraphs (d)(1) and (j) of this section, S must capitalize as a betterment the amount paid to add the insulation because the insulation is reasonably expected to materially increase the efficiency of the building structure under paragraph (j)(1)(iii) of this section.

*Example 22. Material addition; building* T owns and operates a restaurant, which provides a variety of prepared foods to its customers. To better accommodate its customers and increase customer traffic, T decides to add a drive-through service area. As a result, T pays amounts to partition an area within its restaurant for a drive-through service counter, to construct a service win-

dow with necessary security features, to build an overhang for vehicles, and to construct a drive-up menu board. Assume that the drive-up menu board is section 1245 property that is a separate unit of property under paragraph (e)(3) of this section. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. The amounts paid for the partition, service window and overhang are betterments to the building structure because they comprise a material addition (that is, a physical expansion, extension, and addition of a major component) to the building structure under paragraph (j)(1)(ii) of this section. Accordingly, T must capitalize as an improvement the amounts paid to add the partition, drive-through window, and overhang under paragraphs (d)(1) and (j) of this section. T is also required to capitalize the amounts paid to acquire and install each section 1245 property in accordance with § 1.263(a)-2(d)(1).

*Example 23. Costs incurred during betterment* U owns a building that it uses in its service business. To accommodate new employees and equipment, U pays amounts to increase the load capacity of its electrical system by adding a second electrical panel with additional circuits and adding wiring and outlets throughout the electrical system of its building. To complete the upgrades to the electrical system, the contractor makes several holes in walls. As a result, U also incurs costs to patch the holes and repaint several walls. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. The amounts paid to upgrade the panel and wiring are for betterments to U's electrical system because they increase the capacity of the electrical system under paragraph (j)(1)(ii) of this section and increase the strength and output of the electrical system under paragraph (j)(1)(iii) of this section. Accordingly, U is required to capitalize the costs of the upgrade to the electrical system as an improvement to the building unit of property under paragraphs (d)(1) and (j) of this section. Moreover, under paragraph (g)(1) of this section, U is required to capitalize the amounts paid to patch holes and repaint several walls in its building because these costs directly benefit and are incurred by reason of the improvement to U's building unit of property.

(k) *Capitalization of restorations—(1) In general.* A taxpayer must capitalize as an improvement an amount paid to restore a unit of property, including an amount paid to make good the exhaustion for which an allowance is or has

been made. An amount restores a unit of property only if it—

(i) Is for the replacement of a component of a unit of property for which the taxpayer has properly deducted a loss for that component, other than a casualty loss under § 1.165-7;

(ii) Is for the replacement of a component of a unit of property for which the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component;

(iii) Is for the restoration of damage to a unit of property for which the taxpayer is required to take a basis adjustment as a result of a casualty loss under section 165, or relating to a casualty event described in section 165, subject to the limitation in paragraph (k)(4) of this section;

(iv) Returns 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;

(v) Results in the rebuilding of the unit of property to a like-new condition as determined under paragraph (k)(5) of this section after the end of its class life as defined in paragraph (i)(4) of this section; or

(vi) Is for the replacement of a part or combination of parts that comprise a major component or a substantial structural part of a unit of property as determined under paragraph (k)(6) of this section.

(2) *Application of restorations to buildings.* An amount is paid to improve a building if it is paid to restore, as defined under paragraph (k)(1) of this section, a property specified under paragraph (e)(2)(ii) (building), paragraph (e)(2)(iii)(B) (condominium), paragraph (e)(2)(iv)(B) (cooperative), or paragraph (e)(2)(v)(B) (leased building or portion of building) of this section. For example, an amount is paid to improve a building if it is paid for the replacement of a part or combination of parts that comprise a major component or substantial structural part of the building structure or any one of its building systems (for example, the HVAC system). See paragraph (k)(6) of this section.

(3) *Exception for losses based on salvage value.* A taxpayer is not required to treat as a restoration amounts paid under paragraph (k)(1)(i) or paragraph (k)(1)(ii) of this section if the unit of property has been fully depreciated and the loss is attributable only to remaining salvage value as computed for federal income tax purposes.

(4) *Restoration of damage from casualty—(i) Limitation.* For purposes of paragraph (k)(1)(iii) of this section, the amount paid for restoration of damage to the unit of property that must be capitalized under this paragraph (k) is limited to the excess (if any) of—

(A) The amount prescribed by § 1.1011-1 as the adjusted basis of the single, identifiable property (under § 1.167-7(b)(2)(i)) for determining the loss allowable on account of the casualty, over

(B) The amount paid for restoration of damage to the unit of property under paragraph (k)(1)(iii) of this section that also constitutes an improvement under any other provision of paragraph (k)(1) of this section.

(ii) *Amounts in excess of limitation.* The amounts paid for restoration of damage to a unit of property as described in paragraph (k)(1)(iii) of this section, but that exceed the limitation provided in paragraph (k)(4)(i) of this section, must be treated in accordance with the provisions of the Internal Revenue Code and regulations that are otherwise applicable. See, for example, § 1.162-4 (repairs and maintenance); § 1.263(a)-2 (costs to acquire and produce units of property); and § 1.263(a)-3 (costs to improve units of property).

(5) *Rebuild to like-new condition.* For purposes of paragraph (k)(1)(v) of this section, a unit of property is rebuilt to a like-new condition if it is brought to the status of new, rebuilt, remanufactured, or a similar status under the terms of any federal regulatory guideline or the manufacturer's original specifications. Generally, a comprehensive maintenance program, even though substantial, does not return a unit of property to a like-new condition.

(6) *Replacement of a major component or a substantial structural part—(i) In general.* To determine whether an amount is for the replacement of a part



or a combination of parts that comprise a major component or a substantial structural part of the unit of property under paragraph (k)(1)(vi) of this section, it is appropriate to consider all the facts and circumstances. These facts and circumstances include the quantitative and qualitative significance of the part or combination of parts in relation to the unit of property.

(A) *Major component.* A major component is a part or combination of parts that performs a discrete and critical function in the operation of the unit of property. An incidental component of the unit of property, even though such component performs a discrete and critical function in the operation of the unit of property, generally will not, by itself, constitute a major component.

(B) *Substantial structural part.* A substantial structural part is a part or combination of parts that comprises a large portion of the physical structure of the unit of property.

(ii) *Major components and substantial structural parts of buildings.* In the case of a building, an amount is for the replacement of a major component or a substantial structural part of the building unit of property if—

(A) The replacement includes a part or combination of parts that comprise a major component (as defined in paragraph (k)(6)(i)(A) of this section), or a significant portion of a major component, of any of the properties designated in paragraph (e)(2)(ii) (building), paragraph (e)(2)(iii)(B) (condominium), paragraph (e)(2)(iv)(B) (cooperative), or paragraph (e)(2)(v)(B) (leased building or leased portion of a building) of this section; or

(B) The replacement includes a part or combination of parts that comprises a large portion of the physical structure of any of the properties designated in paragraph (e)(2)(ii) (building), paragraph (e)(2)(iii)(B) (condominium), paragraph (e)(2)(iv)(B) (cooperative), or paragraph (e)(2)(v)(B) (leased building or portion of building) of this section.

(7) *Examples.* The following examples illustrate the application of this paragraph (k) only and do not address whether capitalization is required under another provision of this section or another provision of the Code (for

example, section 263A). Unless otherwise stated, assume that the taxpayer has not properly deducted a loss for, nor taken into account the adjusted basis on a sale or exchange of, any unit of property, asset, or component of a unit of property that is replaced.

*Example 1. Replacement of loss component.* A owns a manufacturing building containing various types of manufacturing equipment. A does a cost segregation study of the manufacturing building and properly determines that a walk-in freezer in the manufacturing building is section 1245 property as defined in section 1245(a)(3). The freezer is not part of the building structure or the HVAC system under paragraph (e)(2)(i) or (e)(2)(ii)(B)(1) of this section. Several components of the walk-in freezer cease to function, and A decides to replace them. A abandons the old freezer components and properly recognizes a loss from the abandonment of the components. A replaces the abandoned freezer components with new components and incurs costs to acquire and install the new components. Under paragraph (k)(1)(i) of this section, A must capitalize the amounts paid to acquire and install the new freezer components because A replaced components for which it had properly deducted a loss.

*Example 2. Replacement of sold component.* Assume the same facts as in *Example 1*, except that A did not abandon the components but instead sold them to another party and properly recognized a loss on the sale. Under paragraph (k)(1)(i) of this section, A must capitalize the amounts paid to acquire and install the new freezer components because A replaced components for which it had properly taken into account the adjusted basis of the components in realizing a loss from the sale of the components.

*Example 3. Restoration after casualty loss.* B owns an office building that it uses in its trade or business. A storm damages the office building at a time when the building has an adjusted basis of \$500,000. B deducts under section 165 a casualty loss in the amount of \$50,000, and properly reduces its basis in the office building to \$450,000. B hires a contractor to repair the damage to the building, including the repair of the building roof and the removal of debris from the building premises. B pays the contractor \$50,000 for the work. Under paragraph (k)(1)(iii) of this section, B must treat the \$50,000 amount paid to the contractor as a restoration of the building structure because B properly adjusted its basis in that amount as a result of a casualty loss under section 165, and the amount does not exceed the limit in paragraph (k)(4) of this section. Therefore, B must treat the amount paid as an improvement to the building unit of property and,

under paragraph (d)(2) of this section, must capitalize the amount paid.

*Example 4. Restoration after casualty event* Assume the same facts as in *Example 3*, except that B receives insurance proceeds of \$50,000 after the casualty to compensate for its loss. B cannot deduct a casualty loss under section 165 because its loss was compensated by insurance. However, B properly reduces its basis in the property by the amount of the insurance proceeds. Under paragraph (k)(1)(iii) of this section, B must treat the \$50,000 amount paid to the contractor as a restoration of the building structure because B has properly taken a basis adjustment relating to a casualty event described in section 165, and the amount does not exceed the limit in paragraph (k)(4) of this section. Therefore, B must treat the amount paid as an improvement to the building unit of property and, under paragraph (d)(2) of this section, must capitalize the amount paid.

*Example 5. Restoration after casualty loss; limitation* (i) C owns a building that it uses in its trade or business. A storm damages the building at a time when the building has an adjusted basis of \$500,000. C determines that the cost of restoring its property is \$750,000, deducts a casualty loss under section 165 in the amount of \$500,000, and properly reduces its basis in the building to \$0. C hires a contractor to repair the damage to the building and pays the contractor \$750,000 for the work. The work involves replacing the entire roof structure of the building at a cost of \$350,000 and pumping water from the building, cleaning debris from the interior and exterior, and replacing areas of damaged dry wall and flooring at a cost of \$400,000. Although resulting from the casualty event, the pumping, cleaning, and replacing damaged drywall and flooring, does not directly benefit and is not incurred by reason of the roof replacement.

(ii) Under paragraph (k)(1)(vi) of this section, C must capitalize as an improvement the \$350,000 amount paid to the contractor to replace the roof structure because the roof structure constitutes a major component and a substantial structural part of the building unit of property. In addition, under paragraphs (k)(1)(iii) and (k)(4)(i), C must treat as a restoration the remaining costs, limited to the excess of the adjusted basis of the building over the amounts paid for the improvement under paragraph (k)(1)(vi). Accordingly, C must treat as a restoration \$150,000 (\$500,000—\$350,000) of the \$400,000 paid for the portion of the costs related to repairing and cleaning the building structure under paragraph (k)(1)(iii) of this section. Thus, in addition to the \$350,000 to replace the roof structure, C must also capitalize the \$150,000 as an improvement to the building unit of property under paragraph (d)(2) of this section. C is not required to capitalize

the remaining \$250,000 repair and cleaning costs under paragraph (k)(1)(iii) of this section.

*Example 6. Restoration of property in a state of disrepair* D owns and operates a farm with several barns and outbuildings. D did not use or maintain one of the outbuildings on a regular basis, and the outbuilding fell into a state of disrepair. The outbuilding previously was used for storage but can no longer be used for that purpose because the building is not structurally sound. D decides to restore the outbuilding and pays an amount to shore up the walls and replace the siding. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount is paid to restore the building structure or any building system. The walls and siding are part of the building structure under paragraph (e)(2)(ii)(A) of this section. Under paragraph (k)(1)(iv) of this section, D must treat the amount paid to shore up the walls and replace the siding as a restoration of the building structure because the amounts return the building structure to its ordinarily efficient operating condition after it had deteriorated to a state of disrepair and was no longer functional for its intended use. Therefore, D must treat the amount paid to shore up the walls and replace the siding as an improvement to the building unit of property and, under paragraph (d)(2) of this section, must capitalize the amount paid.

*Example 7. Rebuild of property to like-new condition before end of class life* E is a Class I railroad that owns a fleet of freight cars. Assume the freight cars have a recovery period of 7 years under section 168(c) and a class life of 14 years. Every 8 to 10 years, E rebuilds its freight cars. Ten years after E places the freight car in service, E performs a rebuild to the manufacturer's original specification, which includes a complete disassembly, inspection, and reconditioning or replacement of components of the suspension and draft systems, trailer hitches, and other special equipment. E also modifies the car to upgrade various components to the latest engineering standards. The freight car is stripped to the frame, with all of its substantial components either reconditioned or replaced. The frame itself is the longest-lasting part of the car and is reconditioned. The walls of the freight car are replaced or are sandblasted and repainted. New wheels are installed on the car. All the remaining components of the car are restored before they are reassembled. At the end of the rebuild, the freight car has been restored to like-new condition under the manufacturer's specifications. Assume the freight car is the unit of property. E is not required to treat as an improvement and capitalize the amounts paid to rebuild the freight car under paragraph (k)(1)(v) of this section because, although the amounts paid restore the freight car to like-new condition,

the amounts were not paid after the end of the class life of the freight car. However, paragraphs (k)(1)(vi) and (k)(6) of this section are applicable for determining whether any amounts must be capitalized because they are paid for the replacement of a major component or a substantial structural part of the unit of property.

*Example 8. Rebuild of property to like-new condition after end of class life* Assume the same facts as in *Example 7*, except that E rebuilds the freight car 15 years after E places it in service. Under paragraph (k)(1)(v) of this section, E must treat as an improvement and capitalize the amounts paid to rebuild the freight car because the amounts paid restore the freight car to like-new condition after the end of the class life of the freight car.

*Example 9. Not a rebuild to a like-new condition* F is a commercial airline engaged in the business of transporting freight and passengers. To conduct its business, F owns several aircraft. As a condition of maintaining its airworthiness certificates, F is required by the FAA to establish and adhere to a continuous maintenance program for each aircraft in its fleet. F performs heavy maintenance on its airframes every 8 to 10 years. In Year 1, F purchased an aircraft for \$15 million. In Year 16, F paid \$2 million for the labor and materials necessary to perform the second heavy maintenance visit on the airframe of an aircraft. To perform the heavy maintenance visit, F extensively disassembles the airframe, removing items such as 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 F's maintenance manual for the aircraft, F then performs certain tasks on the disassembled airframe for the purpose of preventing deterioration of the inherent safety and reliability levels of the airframe. These tasks include lubrication and service, operational and visual checks, inspection and functional checks, reconditioning of minor parts and components, and removal, discard, and replacement of certain life-limited single cell parts, such as cartridges, canisters, cylinders, and disks. Reconditioning of parts includes burnishing corrosion, repairing cracks, dents, gouges, punctures, tightening or replacing loose or missing fasteners, replacing damaged seals, gaskets, or valves, and similar activities. In addition to the tasks described above, to comply with certain FAA airworthiness directives, F inspects specific skin locations, applies doublers over small areas where cracks were found, adds structural reinforcements, and replaces skin panels on a small section of the fuselage. However, the heavy maintenance does not include the replacement of any major components or substantial structural

parts of the aircraft with new components. In addition, the heavy maintenance visit does not bring the aircraft to the status of new, rebuilt, remanufactured, or a similar status under FAA guidelines or the manufacturer's original specifications. After the heavy maintenance, the aircraft was reassembled. Assume the aircraft, including the engines, is a unit of property and has a class life of 12 years under section 168(c). Although the heavy maintenance is performed after the end of the class life of the aircraft, F is not required to treat the heavy maintenance as a restoration and improvement of the unit of property under paragraph (k)(1)(v) of this section because, although extensive, the amounts paid do not restore the aircraft to like-new condition. See also paragraph (i)(1)(iii) of this section for the application of the safe harbor for routine maintenance.

*Example 10. Replacement of major component or substantial structural part; personal property* G is a common carrier that owns a fleet of petroleum hauling trucks. G pays amounts to replace the existing engine, cab, and petroleum tank with a new engine, cab, and tank. Assume the tractor of the truck (which includes the cab and the engine) is a single unit of property and that the trailer (which contains the petroleum tank) is a separate unit of property. The new engine and the cab each constitute a part or combination of parts that comprise a major component of G's tractor, because they perform a discrete and critical function in the operation of the tractor. In addition, the cab constitutes a part or combination of parts that comprise a substantial structural part of G's tractor. Therefore, the amounts paid for the replacement of the engine and the cab must be capitalized under paragraph (k)(1)(vi) of this section. Moreover, the new petroleum tank constitutes a part or combination of parts that comprise a major component and a substantial structural part of the trailer. Accordingly, the amounts paid for the replacement of the tank also must be capitalized under paragraph (k)(1)(vi) of this section.

*Example 11. Repair performed during restoration* Assume the same facts as in *Example 10*, except that, at the same time the engine and cab of the tractor are replaced, G pays amounts to paint the cab of the tractor with its company logo and to fix a broken taillight on the tractor. The repair of the broken taillight and the painting of the cab generally are deductible expenses under § 1.162-4. However, under paragraph (g)(1)(i) of this section, a taxpayer must capitalize all the direct costs of an improvement and all the indirect costs that directly benefit or are incurred by reason of an improvement. Repairs and maintenance that do not directly benefit or are not incurred by reason of an improvement are not required to be capitalized under section 263(a), regardless of whether they are made at the same time as an improvement.

For the amounts paid to paint the logo on the cab, G's need to paint the logo arose from the replacement of the cab with a new cab. Therefore, under paragraph (g)(1)(i) of this section, G must capitalize the amounts paid to paint the cab as part of the improvement to the tractor because these amounts directly benefit and are incurred by reason of the restoration of the tractor. The amounts paid to repair the broken taillight are not for the replacement of a major component, do not directly benefit, and are not incurred by reason of the replacement of the cab or the engine under paragraph (g)(1)(i) of this section, even though the repair was performed at the same time as these replacements. Thus, G is not required to capitalize the amounts paid to repair the broken taillight.

*Example 12. Related amounts to replace major component or substantial structural part; personal property* (i) H owns a retail gasoline station, consisting of a paved area used for automobile access to the pumps and parking areas, a building used to market gasoline, and a canopy covering the gasoline pumps. The premises also consist of underground storage tanks (USTs) that are connected by piping to the pumps and are part of the gasoline pumping system used in the immediate retail sale of gas. The USTs are components of the gasoline pumping system. To comply with regulations issued by the Environmental Protection Agency, H is required to remove and replace leaking USTs. In Year 1, H hires a contractor to perform the removal and replacement, which consists of removing the old tanks and installing new tanks with leak detection systems. The removal of the old tanks includes removing the paving material covering the tanks, excavating a hole large enough to gain access to the old tanks, disconnecting any strapping and pipe connections to the old tanks, and lifting the old tanks out of the hole. Installation of the new tanks includes placement of a liner in the excavated hole, placement of the new tanks, installation of a leak detection system, installation of an overfill system, connection of the tanks to the pipes leading to the pumps, backfilling of the hole, and replacement of the paving. H also is required to pay a permit fee to the county to undertake the installation of the new tanks.

(ii) H pays the permit fee to the county on October 15, Year 1. On December 15, Year 1, the contractor completes the removal of the old USTs and bills H for the costs of removal. On January 15, Year 2, the contractor completes the installation of the new USTs and bills H for the remainder of the work. Assume that H computes its taxes on a calendar year basis and H's gasoline pumping system is the unit of property. Under paragraph (k)(1)(vi) of this section, H must capitalize the amounts paid to replace the USTs as a restoration to the gasoline pumping sys-

tem because the USTs are parts or combinations of parts that comprise a major component and substantial structural part of the gasoline pumping system. Moreover, under paragraph (g)(2) of this section, H must capitalize the costs of removing the old USTs because H has not taken a loss on the disposition of the USTs, and the amounts to remove the USTs directly benefit and are incurred by reason of the restoration of, and improvement to, the gasoline pumping system. In addition, under paragraph (g)(1) of this section, H must capitalize the permit fees because they directly benefit and are incurred by reason of the improvement to the gasoline pumping system. Finally, under paragraph (g)(3) of this section, H must capitalize the related amounts paid to improve the gasoline pumping system, including the permit fees, the amount paid to remove the old USTs, and the amount paid to install the new USTs, even though the amounts were separately invoiced, paid to different parties, and incurred in different tax years.

*Example 13. Not replacement of major component; incidental* J owns a machine shop in which it makes dies used by manufacturers. In Year 1, J purchased a drill press for use in its production process. In Year 3, J discovers that the power switch assembly, which controls the supply of electric power to the drill press, has become damaged and cannot operate. To correct this problem, J pays amounts to replace the power switch assembly with comparable and commercially available replacement parts. Assume that the drill press is a unit of property under paragraph (e) of this section and the power switch assembly is a small component of the drill press that may be removed and installed with relative ease. The power switch assembly is not a major component of the unit of property under paragraph (k)(6)(i)(A) of this section because, although the power assembly may affect the function of J's drill press by controlling the supply of electric power, the power assembly is an incidental component of the drill press. In addition, the power assembly is not a substantial structural part of J's drill press under paragraph (k)(6)(i)(B) of this section. Therefore, J is not required to capitalize the costs to replace the power switch assembly under paragraph (k)(1)(vi) of this section.

*Example 14. Replacement of major component or substantial structural part; roof* K owns a manufacturing building. K discovers several leaks in the roof of the building and hires a contractor to inspect and fix the roof. The contractor discovers that a major portion of the decking has rotted and recommends the replacement of the entire roof. K pays the contractor to replace the entire roof, including the decking, insulation, asphalt, and various coatings. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount is paid to

restore the building structure or any building system. The roof is part of the building structure as defined under paragraph (e)(2)(ii)(A) of this section. Because the entire roof performs a discrete and critical function in the building structure, the roof comprises a major component of the building structure under paragraph (k)(6)(ii)(A) of this section. In addition, because the roof comprises a large portion of the physical structure of the building structure, the roof comprises a substantial structural part of the building structure under paragraph (k)(6)(ii)(B) of this section. Therefore, under either analysis, K must treat the amount paid to replace the roof as a restoration of the building under paragraphs (k)(1)(vi) and (k)(2) of this section and must capitalize the amount paid as an improvement under paragraph (d)(2) of this section.

*Example 15. Not replacement of major component or substantial structural part; roof membrane* L owns a building in which it conducts its retail business. The roof decking over L's building is covered with a waterproof rubber membrane. Over time, the rubber membrane begins to wear, and L begins to experience leaks into its retail premises. However, the building is still functioning in L's business. To eliminate the problems, a contractor recommends that L replace the membrane on the roof with a new rubber membrane. Accordingly, L pays the contractor to strip the original membrane and replace it with a new rubber membrane. The new membrane is comparable to the original membrane but corrects the leakage problems. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount is paid to restore the building structure or any building system. The roof, including the membrane, is part of the building structure as defined under paragraph (e)(2)(ii)(A) of this section. Because the entire roof performs a discrete and critical function in the building structure, the roof comprises a major component of the building structure under paragraph (k)(6)(ii)(A) of this section. Although the replacement membrane may aid in the function of the building structure, it does not, by itself, comprise a significant portion of the roof major component under paragraph (k)(6)(ii)(A) of this section. In addition, the replacement membrane does not comprise a substantial structural part of L's building structure under paragraph (k)(6)(ii)(B) of this section. Therefore, L is not required to capitalize the amount paid to replace the membrane as a restoration of the building under paragraph (k)(1)(vi) of this section.

*Example 16. Not a replacement of major component or substantial structural part; HVAC system* M owns a building in which it operates an office that provides medical services. The building contains one HVAC system, which is comprised of three furnaces, three

air conditioning units, and duct work that runs throughout the building to distribute the hot or cold air throughout the building. One furnace in M's building breaks down, and M pays an amount to replace it with a new furnace. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount is paid to restore the building structure or any building system. The HVAC system, including the furnaces, is a building system under paragraph (e)(2)(ii)(B)(1) of this section. As the parts that provide the heating function in the system, the three furnaces, together, perform a discrete and critical function in the operation of the HVAC system and are therefore a major component of the HVAC system under paragraph (k)(6)(i)(A) of this section. However, the single furnace is not a significant portion of this major component of the HVAC system under paragraph (k)(6)(ii)(A) of this section, or a substantial structural part of the HVAC system under paragraph (k)(6)(ii)(B) of this section. Therefore, M is not required to treat the amount paid to replace the furnace as a restoration of the building under paragraph (k)(1)(vi) of this section.

*Example 17. Replacement of major component or substantial structural part; HVAC system* N owns a large office building in which it provides consulting services. The building contains one HVAC system, which is comprised of one chiller unit, one boiler, pumps, duct work, diffusers, air handlers, outside air intake, and a cooling tower. The chiller unit includes the compressor, evaporator, condenser, and expansion valve, and it functions to cool the water used to generate air conditioning throughout the building. N pays an amount to replace the chiller with a comparable unit. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount is paid to restore the building structure or any building system. The HVAC system, including the chiller unit, is a building system under paragraph (e)(2)(ii)(B)(1) of this section. The chiller unit performs a discrete and critical function in the operation of the HVAC system because it provides the cooling mechanism for the entire system. Therefore, the chiller unit is a major component of the HVAC system under paragraph (k)(6)(ii)(A) of this section. Because the chiller unit comprises a major component of a building system, N must treat the amount paid to replace the chiller unit as a restoration to the building under paragraphs (k)(1)(vi) and (k)(2) of this section and must capitalize the amount paid as an improvement to the building under paragraph (d)(2) of this section.

*Example 18. Not replacement of major component or substantial structural part; HVAC system* O owns an office building that it uses to provide services to customers. The building contains a HVAC system that incorporates

ten roof-mounted units that provide heating and air conditioning for the building. The HVAC system also consists of controls for the entire system and duct work that distributes the heated or cooled air to the various spaces in the building's interior. O begins to experience climate control problems in various offices throughout the office building and consults with a contractor to determine the cause. The contractor recommends that O replace three of the roof-mounted heating and cooling units. O pays an amount to replace the three specified units. No work is performed on the other roof-mounted heating and cooling units, the duct work, or the controls. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount restores the building structure or any building system. The HVAC system, including the 10 roof-mounted heating and cooling units, is a building system under paragraph (e)(2)(ii)(B)(1) of this section. As the components that generate the heat and the air conditioning in the HVAC system, the 10 roof-mounted units, together, perform a discrete and critical function in the operation of the HVAC system and, therefore, are a major component of the HVAC system under paragraph (k)(6)(ii)(A) of this section. The three roof-mounted heating and cooling units are not a significant portion of a major component of the HVAC system under (k)(6)(ii)(A) of this section, or a substantial structural part of the HVAC system, under paragraph (k)(6)(ii)(B) of this section. Accordingly, O is not required to treat the amount paid to replace the three roof-mounted heating and cooling units as a restoration of the building under paragraph (k)(1)(iv) of this section.

*Example 19. Replacement of major component or substantial structural part; fire protection system* P owns a building that it uses to operate its business. P pays an amount to replace the sprinkler system in the building with a new sprinkler system. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount restores the building structure or any building system. The fire protection and alarm system, including the sprinkler system, is a building system under paragraph (e)(2)(ii)(B)(6) of this section. As the component that provides the fire suppression mechanism in the system, the sprinkler system performs a discrete and critical function in the operation of the fire protection and alarm system and is therefore a major component of the system under paragraph (k)(6)(ii)(A) of this section. Because the sprinkler system comprises a major component of a building system, P must treat the amount paid to replace the sprinkler system as restoration to the building unit of property under paragraphs (k)(1)(vi) and (k)(2) of this section and must capitalize the amount

paid as an improvement to the building under paragraph (d)(2) of this section.

*Example 20. Replacement of major component or substantial structural part; electrical system* Q owns a building that it uses to operate its business. Q pays an amount to replace the wiring throughout the building with new wiring that meets building code requirements. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount restores the building structure or any building system. The electrical system, including the wiring, is a building system under paragraph (e)(2)(ii)(B)(3) of this section. As the component that distributes the electricity throughout the system, the wiring performs a discrete and critical function in the operation of the electrical system under paragraph (k)(6)(ii)(A) of this section. The wiring also comprises a large portion of the physical structure of the electrical system under paragraph (k)(6)(ii)(B) of this section. Because the wiring comprises a major component and a substantial structural part of a building system, Q must treat the amount paid to replace the wiring as a restoration to the building under paragraphs (k)(1)(vi) and (k)(2) of this section and must capitalize the amount paid as an improvement to the building under paragraph (d)(2) of this section.

*Example 21. Not a replacement of major component or substantial structural part; electrical system* R owns a building that it uses to operate its business. R pays an amount to replace 30 percent of the wiring throughout the building with new wiring that meets building code requirements. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount restores the building structure or any building system. The electrical system, including the wiring, is a building system under paragraph (e)(2)(ii)(B)(3) of this section. All the wiring in the building comprises a major component because it performs a discrete and critical function in the operation of the electrical system. However, the portion of the wiring that was replaced is not a significant portion of the wiring major component under paragraph (k)(6)(ii)(A) of this section, nor does it comprise a substantial structural part of the electrical system under paragraph (k)(6)(ii)(B) of this section. Therefore, under paragraph (k)(6) of this section, the replacement of 30 percent of the wiring is not the replacement of a major component or substantial structural part of the building, and R is not required to treat the amount paid to replace 30 percent of the wiring as a restoration to the building under paragraph (k)(1)(iv) of this section.

*Example 22. Replacement of major component or substantial structural part; plumbing system* S owns a building in which it conducts a retail business. The retail building has three floors. The retail building has men's and

women's restrooms on two of the three floors. S decides to update the restrooms by paying an amount to replace the plumbing fixtures in all of the restrooms, including all the toilets and sinks, with modern style plumbing fixtures of similar quality and function. S does not replace the pipes connecting the fixtures to the building's plumbing system. Under paragraphs (e)(2)(i) and (k)(2) of this section, an amount is paid to improve a building if the amount restores the building structure or any building system. The plumbing system, including the plumbing fixtures, is a building system under paragraph (e)(2)(ii)(B)(2) of this section. All the toilets together perform a discrete and critical function in the operation of the plumbing system, and all the sinks, together, also perform a discrete and critical function in the operation of the plumbing system. Therefore, under paragraph (k)(6)(ii)(A) of this section, all the toilets comprise a major component of the plumbing system, and all the sinks comprise a major component of the plumbing system. Accordingly, S must treat the amount paid to replace all of the toilets and all of the sinks as a restoration of the building under paragraphs (k)(1)(vi) and (k)(2) of this section and must capitalize the amount paid as an improvement to the building under paragraph (d)(2) of this section.

*Example 23. Not replacement of major component or substantial structural part; plumbing system* Assume the same facts as *Example 22* except that S does not update all the bathroom fixtures. Instead, S only pays an amount to replace 8 of the total of 20 sinks located in the various restrooms. The 8 replaced sinks, by themselves, do not comprise a significant portion of a major component (the 20 sinks) of the plumbing system under paragraph (k)(6)(ii)(A) of this section nor do they comprise a large portion of the physical structure of the plumbing system under paragraph (k)(6)(ii)(B) of this section. Therefore, under paragraph (k)(6) of this section, the replacement of the eight sinks does not constitute the replacement of a major component or substantial structural part of the building, and S is not required to treat the amount paid to replace the eight sinks as a restoration of a building under paragraph (k)(1)(iv) of this section.

*Example 24. Replacement of major component or substantial structural part; plumbing system* (i) T owns and operates a hotel building. T decides that, to attract customers and to remain competitive, it needs to update the guest rooms in its facility. Accordingly, T pays amounts to replace the bathtubs, toilets, and sinks, and to repair, repaint, and retile the bathroom walls and floors, which is necessitated by the installation of the new plumbing components. The replacement bathtubs, toilets, sinks, and tile are new and in a different style, but are similar in func-

tion and quality to the replaced items. T also pays amounts to replace certain section 1245 property, such as the guest room furniture, carpeting, drapes, table lamps, and partition walls separating the bathroom area. T completes this work on two floors at a time, closing those floors and leaving the rest of the hotel open for business. In Year 1, T pays amounts to perform the updates for 4 of the 20 hotel room floors and expects to complete the renovation of the remaining rooms over the next two years.

(ii) Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount restores the building structure or any building system. The plumbing system, including the bathtubs, toilets, and sinks, is a building system under paragraph (e)(2)(ii)(B)(2) of this section. All the bathtubs, together, all the toilets, together, and all the sinks together in the hotel building perform discrete and critical functions in the operation of the plumbing system under paragraph (k)(6)(ii)(A) of this section and comprise a large portion of the physical structure of the plumbing system under paragraph (k)(6)(ii)(B) of this section. Therefore, under paragraph (k)(6)(ii) of this section, these plumbing components comprise major components and substantial structural parts of the plumbing system, and T must treat the amount paid to replace these plumbing components as a restoration of, and improvement to, the building under paragraphs (k)(1)(vi) and (k)(2) of this section. In addition, under paragraph (g)(1)(i) of this section, T must treat the costs of repairing, repainting, and retiling the bathroom walls and floors as improvement costs because these costs directly benefit and are incurred by reason of the improvement to the building. Further, under paragraph (g)(3) of this section, T must treat the costs incurred in Years 1, 2, and 3 for the bathroom remodeling as improvement costs, even though they are incurred over a period of several taxable years, because they are related amounts paid to improve the building unit of property. Accordingly, under paragraph (d)(2) of this section, T must treat all the amounts it incurs to update its hotel restrooms as an improvement to the hotel building and capitalize these amounts. In addition, under § 1.263(a)-2 of the regulations, T must capitalize the amounts paid to acquire and install each section 1245 property.

*Example 25. Not replacement of major component or substantial structural part; windows* U owns a large office building that it uses to provide office space for employees that manage U's operations. The building has 300 exterior windows that represent 25 percent of the total surface area of the building. In Year 1, U pays an amount to replace 100 of the exterior windows that had become damaged. At the time of these replacements, U has no plans to replace any other windows in the

near future. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount restores the building structure or any building system. The exterior windows are part of the building structure as defined under paragraph (e)(2)(ii)(A) of this section. The 300 exterior windows perform a discrete and critical function in the operation of the building structure and are, therefore, a major component of the building structure under paragraph (k)(6)(i)(A) of this section. However, the 100 windows do not comprise a significant portion of this major component of the building structure under paragraph (k)(6)(ii)(A) of this section or a substantial structural part of the building structure under paragraph (k)(6)(ii)(B) of this section. Therefore, under paragraph (k)(6) of this section, the replacement of the 100 windows does not constitute the replacement of a major component or substantial structural part of the building, and U is not required to treat the amount paid to replace the 100 windows as restoration of the building under paragraph (k)(1)(iv) of this section.

*Example 26. Replacement of major component; windows* Assume the same facts as *Example 25*, except that that U replaces 200 of the 300 windows on the building. The 300 exterior windows perform a discrete and critical function in the operation of the building structure and are, therefore, a major component of the building structure under paragraph (k)(6)(i)(A) of this section. The 200 windows comprise a significant portion of this major component of the building structure under paragraph (k)(6)(ii)(A) of this section. Therefore, under paragraph (k)(6) of this section, the replacement of the 200 windows comprise the replacement of a major component of the building structure. Accordingly, U must treat the amount paid to replace the 200 windows as a restoration of the building under paragraphs (k)(1)(vi) and (k)(2) of this section and must capitalize the amount paid as an improvement to the building under paragraph (d)(2) of this section.

*Example 27. Replacement of substantial structural part; windows* Assume the same facts as *Example 25*, except that the building is a modern design and the 300 windows represent 90 percent of the total surface area of the building. U replaces 100 of the 300 windows on the building. The 300 exterior windows perform a discrete and critical function in the operation of the building structure and are, therefore, a major component of the building structure under paragraph (k)(6)(i)(A) of this section. The 100 windows do not comprise a significant portion of this major component of the building structure under paragraph (k)(6)(ii)(A) of this section, however, they do comprise a substantial structural part of the building structure under paragraph (k)(6)(ii)(B) of this section. Therefore, under paragraph (k)(6) of this section, the replace-

ment of the 100 windows comprise the replacement of a substantial structural part of the building structure. Accordingly, U must treat the amount paid to replace the 100 windows as a restoration of the building unit of property under paragraphs (k)(1)(vi) and (k)(2) of this section and must capitalize the amount paid as an improvement to the building under paragraph (d)(2) of this section.

*Example 28. Not replacement of major component or substantial structural part; floors* V owns and operates a hotel building. V decides to refresh the appearance of the hotel lobby by replacing the floors in the lobby. The hotel lobby comprises less than 10 percent of the square footage of the entire hotel building. V pays an amount to replace the wood flooring in the lobby with new wood flooring of a similar quality. V did not replace any other flooring in the building. Assume that the wood flooring constitutes section 1250 property. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount restores the building structure or any building system. The wood flooring is part of the building structure under paragraph (e)(2)(ii)(A) of this section. All the floors in the hotel building comprise a major component of the building structure because they perform a discrete and critical function in the operation of the building structure. However, the lobby floors are not a significant portion of a major component (that is, all the floors) under paragraph (k)(6)(ii)(A) of this section, nor do the lobby floors comprise a substantial structural part of the building structure under paragraph (k)(6)(ii)(B) of this section. Therefore, under paragraph (k)(6) of this section, the replacement of the lobby floors is not the replacement of a major component or substantial structural part of the building unit of property, and V is not required to treat the amount paid for the replacement of the lobby floors as a restoration to the building under paragraph (k)(1)(iv) of this section.

*Example 29. Replacement of major component or substantial structural part; floors* Assume the same facts as *Example 28*, except that V decides to refresh the appearance of all the public areas of the hotel building by replacing all the floors in the public areas. To that end, V pays an amount to replace all the wood floors in all the public areas of the hotel building with new wood floors. The public areas include the lobby, the hallways, the meeting rooms, the ballrooms, and other public rooms throughout the hotel interiors. The public areas comprise approximately 40 percent of the square footage of the entire hotel building. All the floors in the hotel building comprise a major component of the building structure because they perform a discrete and critical function in the operation of the building structure. The floors in all the public areas of the hotel comprise a significant portion of a major component



(that is, all the building floors) of the building structure. Therefore, under paragraph (k)(6)(ii)(A) of this section, the replacement of all the public area floors constitutes the replacement of a major component of the building structure. Accordingly, V must treat the amount paid to replace the public area floors as a restoration of the building unit of property under paragraphs (k)(1)(vi) and (k)(2) of this section and must capitalize the amounts as an improvement to the building under paragraph (d)(2) of this section.

*Example 30. Replacement with no disposition* (i) X owns an office building with four elevators serving all floors in the building. X replaces one of the elevators. The elevator is a structural component of the office building. X chooses to apply §1.168(i)-8 to taxable years beginning on or after January 1, 2012, and before the applicability date of the final regulations. In accordance with §1.168(i)-8(c)(4)(ii)(A), the office building (including its structural components) is the asset for tax disposition purposes. X also does not make the partial disposition election provided under §1.168(i)-8(d)(2) for the elevator. Thus, the retirement of the replaced elevator is not a disposition under section 168, and no loss is taken into account for purposes of paragraph (k)(1)(i) of this section.

(ii) Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount restores the building structure or any building system. The elevator system, including all four elevators, is a building system under paragraph (e)(2)(ii)(B)(5) of this section. The replacement elevator does not perform a discrete and critical function in the operation of elevator system under paragraph (k)(6)(ii)(A) of this section nor does it comprise a large portion of the physical structure of the elevator system under paragraph (k)(6)(ii)(B) of this section. Therefore, under paragraph (k)(6) of this section, the replacement elevator does not constitute the replacement of a major component or substantial structural part of the elevator system. Accordingly, X is not required to treat the amount paid to replace the elevator as a restoration to the building under either paragraph (k)(1)(i) or paragraph (k)(1)(vi) of this section.

*Example 31. Replacement with disposition* The facts are the same as in *Example 30*, except X makes the partial disposition election provided under paragraph §1.168(i)-8(d)(2) for the elevator. Although the office building (including its structural components) is the asset for disposition purposes, the result of X making the partial disposition election for the elevator is that the retirement of the replaced elevator is a disposition. Thus, depreciation for the retired elevator ceases at the time of its retirement (taking into account the applicable convention), and X recognizes a loss upon this retirement. Accordingly, X must treat the amount paid to replace the

elevator as a restoration of the building under paragraphs (k)(1)(i) and (k)(2) of this section and must capitalize the amount paid as an improvement to the building under paragraph (d)(2) of this section. In addition, the replacement elevator is treated as a separate asset for tax disposition purposes pursuant to §1.168(i)-8(c)(4)(ii)(D), and for depreciation purposes pursuant to section 168(i)(6).

(1) *Capitalization of amounts to adapt property to a new or different use*—(1) *In general.* A taxpayer must capitalize as an improvement an amount paid to adapt a unit of property to a new or different use. In general, an amount is paid to adapt a unit of property to a new or different use if the adaptation is not consistent with the taxpayer's ordinary use of the unit of property at the time originally placed in service by the taxpayer.

(2) *Application of adaption rule to buildings.* In the case of a building, an amount is paid to improve a building if it is paid to adapt to a new or different use a property specified under paragraph (e)(2)(ii) (building), paragraph (e)(2)(iii)(B) (condominium), paragraph (e)(2)(iv)(B) (cooperative), or paragraph (e)(2)(v)(B) (leased building or leased portion of building) of this section. For example, an amount is paid to improve a building if it is paid to adapt the building structure or any one of its buildings systems to a new or different use.

(3) *Examples.* The following examples illustrate the application of this paragraph (1) only and do not address whether capitalization is required under another provision of this section or under another provision of the Code (for example, section 263A). Unless otherwise stated, assume that the taxpayer has not properly deducted a loss for any unit of property, asset, or component of a unit of property that is removed and replaced.

*Example 1. New or different use; change in building use* A is a manufacturer and owns a manufacturing building that it has used for manufacturing since Year 1, when A placed it in service. In Year 30, A pays an amount to convert its manufacturing building into a showroom for its business. To convert the facility, A removes and replaces various structural components to provide a better layout for the showroom and its offices. A also repaints the building interiors as part of the conversion. When building materials are removed and replaced, A uses comparable and

commercially available replacement materials. Under paragraphs (1)(2) and (e)(2)(ii) of this section, an amount is paid to improve A's manufacturing building if the amount adapts the building structure or any designated building system to a new or different use. Under paragraph (1)(1) of this section, the amount paid to convert the manufacturing building into a showroom adapts the building structure to a new or different use because the conversion to a showroom is not consistent with A's ordinary use of the building structure at the time it was placed in service. Therefore, A must capitalize the amount paid to convert the building into a showroom as an improvement to the building under paragraphs (d)(3) and (1) of this section.

*Example 2. Not a new or different use; leased building* B owns and leases out space in a building consisting of twenty retail spaces. The space was designed to be reconfigured; that is, adjoining spaces could be combined into one space. One of the tenants expands its occupancy by leasing two adjoining retail spaces. To facilitate the new lease, B pays an amount to remove the walls between the three retail spaces. Assume that the walls between spaces are part of the building and its structural components. Under paragraphs (1)(2) and (e)(2)(ii) of this section, an amount is paid to improve B's building if it adapts the building structure or any of the building systems to a new or different use. Under paragraph (1)(1) of this section, the amount paid to convert three retail spaces into one larger space for an existing tenant does not adapt B's building structure to a new or different use because the combination of retail spaces is consistent with B's intended, ordinary use of the building structure. Therefore, the amount paid by B to remove the walls does not improve the building under paragraph (1) of this section and is not required to be capitalized under paragraph (d)(3) of this section.

*Example 3. Not a new or different use; preparing building for sale* C owns a building consisting of twenty retail spaces. C decides to sell the building. In anticipation of selling the building, C pays an amount to repaint the interior walls and to refinish the hardwood floors. Under paragraphs (1)(2) and (e)(2)(ii) of this section, an amount is paid to improve C's building to a new or different use if it adapts the building structure or any of the building systems to a new or different use. Preparing the building for sale does not constitute a new or different use for the building structure under paragraph (1)(1) of this section. Therefore, the amount paid by C to prepare the building structure for sale does not improve the building under paragraph (1) of this section and is not required to be capitalized under paragraph (d)(3) of this section.

*Example 4. New or different use; land* D owns a parcel of land on which it previously operated a manufacturing facility. Assume that the land is the unit of property. During the course of D's operation of the manufacturing facility, the land became contaminated with wastes from its manufacturing processes. D discontinues manufacturing operations at the site and decides to develop the property for residential housing. In anticipation of building residential property, D pays an amount to remediate the contamination caused by D's manufacturing process. In addition, D pays an amount to regrade the land so that it can be used for residential purposes. Amounts that D pays to clean up wastes do not adapt the land to a new or different use, regardless of the extent to which the land was cleaned, because this cleanup merely returns the land to the condition it was in before the land was contaminated in D's operations. Therefore, D is not required to capitalize the amount paid for the cleanup under paragraph (1)(1) of this section. However, the amount paid to regrade the land so that it can be used for residential purposes adapts the land to a new or different use that is inconsistent with D's intended ordinary use of the property at the time it was placed in service. Accordingly, the amounts paid to regrade the land must be capitalized as improvements to the land under paragraphs (d)(3) and (1) of this section.

*Example 5. New or different use; part of building* (i) E owns a building in which it operates a retail drug store. The store consists of a pharmacy for filling medication prescriptions and various departments where customers can purchase food, toiletries, home goods, school supplies, cards, over-the-counter medications, and other similar items. E decides to create a walk-in medical clinic where nurse practitioners and physicians' assistants diagnose, treat, and write prescriptions for common illnesses and injuries, administer common vaccinations, conduct physicals and wellness screenings, and provide routine lab tests and services for common chronic conditions. To create the clinic, E pays amounts to reconfigure the pharmacy building. E incurs costs to build new walls creating an examination room, lab room, reception area, and waiting area. E installs additional plumbing, electrical wiring, and outlets to support the lab. E also acquires section 1245 property, such as computers, furniture, and equipment necessary for the new clinic. E treats the amounts paid for those units of property as costs of acquiring new units of property under § 1.263(a)-2.

(ii) Under paragraphs (1)(2) and (e)(2)(ii) of this section, an amount is paid to improve E's building if it adapts the building structure or any of the building systems to a new or different use. Under paragraph (1)(1) of this section, the amount paid to convert part of the retail drug store building structure

into a medical clinic adapts the building structure to a new and different use, because the use of the building structure to provide clinical medical services is not consistent with E's intended ordinary use of the building structure at the time it was placed in service. Similarly, the amounts paid to add to the plumbing system and the electrical systems to support the new medical services is not consistent with E's intended ordinary use of these systems when the systems were placed in service. Therefore, E must treat the amount paid for the conversion of the building structure, plumbing system, and electrical system as an improvement to the building and capitalize the amount under paragraphs (d)(3) and (l) of this section.

*Example 6. Not a new or different use; part of building* (i) F owns a building in which it operates a grocery store. The grocery store includes various departments for fresh produce, frozen foods, fresh meats, dairy products, toiletries, and over-the-counter medicines. The grocery store also includes separate counters for deli meats, prepared foods, and baked goods, often made to order. To better accommodate its customers' shopping needs, F decides to add a sushi bar where customers can order freshly prepared sushi from the counter for take-home or to eat at the counter. To create the sushi bar, F pays amounts to add a sushi counter and chairs, add additional wiring and outlets to support the counter, and install additional pipes and a sink, to provide for the safe handling of the food. F also pays amounts to replace flooring and wall coverings in the sushi bar area with decorative coverings to reflect more appropriate décor. Assume the sushi counter and chairs are section 1245 property, and F treats the amounts paid for those units of property as costs of acquiring new units of property under § 1.263(a)-2.

(ii) Under paragraphs (l)(2) and (e)(2)(ii) of this section, an amount is paid to improve F's building if it adapts the building structure or any of the building systems to a new or different use. Under paragraph (l)(1) of this section, the amount paid to convert a part of F's retail grocery into a sushi bar area does not adapt F's building structure, plumbing system, or electrical system to a new or different use, because the sale of sushi is consistent with F's intended, ordinary use of the building structure and these systems in its grocery sales business, which includes selling food to its customers at various specialized counters. Accordingly, the amount paid by F to replace the wall and floor finishes, add wiring, and add plumbing to create the sushi bar space does not improve the building unit of property under paragraph (l) of this section and is not required to be capitalized under paragraph (d)(3) of this section.

*Example 7. Not a new or different use; part of building* (i) G owns a hospital with various

departments dedicated to the provision of clinical medical care. To better accommodate its patients' needs, G decides to modify the emergency room space to provide both emergency care and outpatient surgery. To modify the space, G pays amounts to move interior walls, add additional wiring and outlets, replace floor tiles and doors, and repaint the walls. To complete the outpatient surgery center, G also pays amounts to install miscellaneous medical equipment necessary for the provision of surgical services. Assume the medical equipment is section 1245 property, and G treats the amounts paid for those units of property as costs of acquiring new units of property under § 1.263(a)-2.

(ii) Under paragraphs (l)(2) and (e)(2)(ii) of this section, an amount is paid to improve G's building if it adapts the building structure or any of the building systems to a new or different use. Under paragraph (l)(1) of this section, the amount paid to convert part of G's emergency room into an outpatient surgery center does not adapt G's building structure or electrical system to a new or different use, because the provision of outpatient surgery is consistent with G's intended, ordinary use of the building structure and these systems in its clinical medical care business. Accordingly, the amounts paid by G to relocate interior walls, add additional wiring and outlets, replace floor tiles and doors, and repaint the walls to create outpatient surgery space do not improve the building under paragraph (l) of this section and are not required to be capitalized under paragraph (d)(3) of this section.

(m) *Optional regulatory accounting method*—(1) *In general.* This paragraph (m) provides an optional simplified method (the regulatory accounting method) for regulated taxpayers to determine whether amounts paid to repair, maintain, or improve tangible property are to be treated as deductible expenses or capital expenditures. A taxpayer that uses the regulatory accounting method described in paragraph (m)(3) of this section must use that method for property subject to regulatory accounting instead of determining whether amounts paid to repair, maintain, or improve property are capital expenditures or deductible expenses under the general principles of sections 162(a), 212, and 263(a). Thus, the capitalization rules in paragraph (d) (and the routine maintenance safe harbor described in paragraph (i)) of this section do not apply to amounts paid to repair, maintain, or improve

property subject to regulatory accounting by taxpayers that use the regulatory accounting method under this paragraph (m).

(2) *Eligibility for regulatory accounting method.* A taxpayer that is engaged in a trade or business in a regulated industry is a regulated taxpayer and may use the regulatory accounting method under this paragraph (m). For purposes of this paragraph (m), a taxpayer is in a regulated industry only if the taxpayer is subject to the regulatory accounting rules of the Federal Energy Regulatory Commission (FERC), the Federal Communications Commission (FCC), or the Surface Transportation Board (STB).

(3) *Description of regulatory accounting method.* Under the regulatory accounting method, a taxpayer must follow the method of accounting for regulatory accounting purposes that it is required to follow for FERC, FCC, or STB (whichever is applicable) in determining whether an amount paid repairs, maintains, or improves property under this section. Therefore, a taxpayer must capitalize for Federal income tax purposes an amount paid that is capitalized as an improvement for regulatory accounting purposes. A taxpayer may not capitalize for Federal income tax purposes under this section an amount paid that is not capitalized as an improvement for regulatory accounting purposes. A taxpayer that uses the regulatory accounting method must use that method for all of its tangible property that is subject to regulatory accounting rules. The method does not apply to tangible property that is not subject to regulatory accounting rules. The method also does not apply to property for the taxable years in which the taxpayer elected to apply the repair allowance under § 1.167(a)-11(d)(2). The regulatory accounting method is a method of accounting under section 446(a).

(4) *Examples.* The following examples illustrate the application of this paragraph (m):

*Example 1. Taxpayer subject to regulatory accounting rules of FERC* W is an electric utility company that operates a power plant that generates electricity and that owns and operates network assets to transmit and distribute the electricity to its customers. W is

subject to the regulatory accounting rules of FERC, and W uses the regulatory accounting method under paragraph (m) of this section. W does not capitalize on its books and records for regulatory accounting purposes the cost of repairs and maintenance performed on its turbines or its network assets. Under the regulatory accounting method, W may not capitalize for Federal income tax purposes amounts paid for repairs performed on its turbines or its network assets.

*Example 2. Taxpayer not subject to regulatory accounting rules of FERC* X is an electric utility company that operates a power plant to generate electricity. X previously was subject to the regulatory accounting rules of FERC, but currently X is not required to use FERC's regulatory accounting rules. X cannot use the regulatory accounting method provided in this paragraph (m).

*Example 3. Taxpayer subject to regulatory accounting rules of FCC* Y is a telecommunications company that is subject to the regulatory accounting rules of the FCC. Y uses the regulatory accounting method under this paragraph (m). Y's assets include a telephone central office switching center, which contains numerous switches and various switching equipment. Y capitalizes on its books and records for regulatory accounting purposes the cost of replacing each switch. Under the regulatory accounting method, Y is required to capitalize for Federal income tax purposes amounts paid to replace each switch.

*Example 4. Taxpayer subject to regulatory accounting rules of STB* Z is a Class I railroad that is subject to the regulatory accounting rules of the STB. Z uses the regulatory accounting method under this paragraph (m). Z capitalizes on its books and records for regulatory accounting purposes the cost of locomotive rebuilds. Under the regulatory accounting method, Z is required to capitalize for Federal income tax purposes amounts paid to rebuild its locomotives.

(n) *Election to capitalize repair and maintenance costs—(1) In general.* A taxpayer may elect to treat amounts paid during the taxable year for repair and maintenance (as defined under § 1.162-4) to tangible property as amounts paid to improve that property under this section and as an asset subject to the allowance for depreciation if the taxpayer incurs these amounts in carrying on the taxpayer's trade or business and if the taxpayer treats these amounts as capital expenditures on its books and records regularly used in computing income ("books and records"). A taxpayer that elects to apply this paragraph (n) in a taxable year must apply this paragraph to all amounts paid for

repair and maintenance to tangible property that it treats as capital expenditures on its books and records in that taxable year. Any amounts for which this election is made shall not be treated as amounts paid for repair or maintenance under § 1.162-4.

(2) *Time and manner of election.* A taxpayer makes this election under this paragraph (n) by attaching a statement to the taxpayer's timely filed original Federal tax return (including extensions) for the taxable year in which the taxpayer pays amounts described under paragraph (n)(1) of this paragraph. Sections 301.9100-1 through 301.9100-3 of this chapter provide the rules governing extensions of the time to make regulatory elections. The statement must be titled "Section 1.263(a)-3(n) Election" and include the taxpayer's name, address, taxpayer identification number, and a statement that the taxpayer is making the election to capitalize repair and maintenance costs under § 1.263(a)-3(n). In the case of a consolidated group filing a consolidated income tax return, the election is made for each member of the consolidated group by the common parent, and the statement must also include the names and taxpayer identification numbers of each member for which the election is made. In the case of an S corporation or a partnership, the election is made by the S corporation or partnership and not by the shareholders or partners. A taxpayer making this election for a taxable year must treat any amounts paid for repairs and maintenance during the taxable year that are capitalized on the taxpayer's books and records as improvements to tangible property. The taxpayer must begin to depreciate the cost of such improvements amounts when they are placed in service by the taxpayer under the applicable provisions of the Code and regulations. An election may not be made through the filing of an application for change in accounting method or, before obtaining the Commissioner's consent to make a late election, by filing an amended Federal tax return. The time and manner of electing to capitalize repair and maintenance costs under this paragraph (n) may be modified through guidance of

general applicability (see §§ 601.601(d)(2) and 601.602 of this chapter).

(3) *Exception.* This paragraph (n) does not apply to amounts paid for repairs or maintenance of rotatable or temporary spare parts to which the taxpayer applies the optional method of accounting for rotatable and temporary spare parts under § 1.162-3(e).

(4) *Examples.* The following examples illustrate the application of this paragraph (n):

*Example 1. Election to capitalize routine maintenance on non-rotatable part* (i) Q is a towboat operator that owns a fleet of towboats that it uses in its trade or business. Each towboat is equipped with two diesel-powered engines. Assume that each towboat, including its engines, is the unit of property and that a towboat has a class life of 18 years. Assume the towboat engines are not rotatable spare parts under § 1.162-3(c)(2). In Year 1, Q acquired a new towboat, including its two engines, and placed the towboat into service. In Year 4, Q pays amounts to perform scheduled maintenance on both engines in the towboat. Assume that none of the exceptions set out in paragraph (i)(3) of this section apply to the scheduled maintenance costs and that the scheduled maintenance on Q's towboat is within the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section. Accordingly, the amounts paid for the scheduled maintenance to its towboat engines in Year 4 are deemed not to improve the towboat and are not required to be capitalized under paragraph (d) of this section.

(ii) On its books and records, Q treats amounts paid for scheduled maintenance on its towboat engines as capital expenditures. For administrative convenience, Q decides to account for these costs in the same way for Federal income tax purposes. Under paragraph (n) of this section, in Year 4, Q may elect to capitalize the amounts paid for the scheduled maintenance on its towboat engines. If Q elects to capitalize such amounts, Q must capitalize all amounts paid for repair and maintenance to tangible property that Q treats as capital expenditures on its books and records in Year 4.

*Example 2. No election to capitalize routine maintenance* Assume the same facts as *Example 1*, except in Year 8, Q pays amounts to perform scheduled maintenance for a second time on the towboat engines. On its books and records, Q treats the amounts paid for this scheduled maintenance as capital expenditures. However, in Year 8, Q decides not to make the election to capitalize the amounts paid for scheduled maintenance under paragraph (n) of this section. Because Q does not make the election under paragraph (n) for Year 8, Q may apply the routine

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maintenance safe harbor under paragraph (i)(1)(ii) of this section to the amounts paid in Year 8, and not treat these amounts as capital expenditures. Because the election is made for each taxable year, there is no effect on the scheduled maintenance costs capitalized by Q on its Federal tax return for Year 4.

*Example 3. Election to capitalize replacement of building component* (i) R owns an office building that it uses to provide services to customers. The building contains a HVAC system that incorporates ten roof-mounted units that provide heating and air conditioning for different parts of the building. In Year 1, R pays an amount to replace 2 of the 10 units to address climate control problems in various offices throughout the office building. Assume that the replacement of the two units does not constitute an improvement to the HVAC system, and, accordingly, to the building unit of property under paragraph (d) of this section, and that R may deduct these amounts as repairs and maintenance under § 1.162-4.

(ii) On its books and records, R treats amounts paid for the two HVAC components as capital expenditures. R determines that it would prefer to account for these amounts in the same way for Federal income tax purposes. Under this paragraph (n), in Year 1, R may elect to capitalize the amounts paid for the new HVAC components. If R elects to capitalize such amounts, R must capitalize all amounts paid for repair and maintenance to tangible property that R treats as capital expenditures on its books and records in Year 1.

(o) *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.

(p) *Recovery of capitalized amounts.* 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 Code and regulation provisions relating to the use, sale, or disposition of property.

(q) *Accounting method changes.* Except as otherwise provided in this section, 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.

(r) *Effective/applicability date—(1) In general.* Except for paragraphs (h), (m), and (n) of this section, this section applies to taxable years beginning on or after January 1, 2014. Paragraphs (h), (m), and (n) of this section apply to amounts paid in taxable years beginning on or after January 1, 2014. Except as provided in paragraphs (r)(2) and (r)(3) of this section, § 1.263(a)-3 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 (h), (m), and (n) 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 (h), (m), and (n) of this section to amounts paid in taxable years beginning on or after January 1, 2012.

(ii) *Transition rule for certain elections on 2012 or 2013 returns.* If under paragraph (r)(2)(i) of this section, a taxpayer chooses to make the election to apply the safe harbor for small taxpayers under paragraph (h) of this section or the election to capitalize repair and maintenance costs under paragraph (n) 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 (h)(6) or paragraph (n)(2) 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 (h)(6) or paragraph (n)(2) of this section for the applicable taxable year by filing an amended Federal tax return (including the required statements) 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)-3T 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 57718, Sept. 19, 2013, as amended by T.D. 9636, 79 FR 42191, July 21, 2014; T.D. 9689, 79 FR 48684, Aug. 18, 2014]

**§ 1.263(a)-4 Amounts paid to acquire or create intangibles.**

(a) *Overview.* This section provides rules for applying section 263(a) to amounts paid to acquire or create intangibles. Except to the extent provided in paragraph (d)(8) of this section, the rules provided by this section do not apply to amounts paid to acquire or create tangible assets. Paragraph (b) of this section provides a general principle of capitalization. Paragraphs (c) and (d) of this section identify intangibles for which capitalization is specifically required under the general principle. Paragraph (e) of this section provides rules for determining the extent to which taxpayers must capitalize transaction costs. Paragraph (f) of this section provides a 12-month rule intended to simplify the application of the general principle to certain payments that create benefits of a brief duration. Additional rules and examples relating to these provisions are provided in paragraphs (g) through (n) of this section. The applicability date of the rules in this section is provided in paragraph (o) of this section. Paragraph (p) of this section provides rules applicable to changes in methods of accounting made to comply with this section.

(b) *Capitalization with respect to intangibles—(1) In general.* Except as otherwise provided in this section, a taxpayer must capitalize—

(i) An amount paid to acquire an intangible (see paragraph (c) of this section);

(ii) An amount paid to create an intangible described in paragraph (d) of this section;

(iii) An amount paid to create or enhance a separate and distinct intan-

gible asset within the meaning of paragraph (b)(3) of this section;

(iv) An amount paid to create or enhance a future benefit identified in published guidance in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter) as an intangible for which capitalization is required under this section; and

(v) An amount paid to facilitate (within the meaning of paragraph (e)(1) of this section) an acquisition or creation of an intangible described in paragraph (b)(1)(i), (ii), (iii) or (iv) of this section.

(2) *Published guidance.* Any published guidance identifying a future benefit as an intangible for which capitalization is required under paragraph (b)(1)(iv) of this section applies only to amounts paid on or after the date of publication of the guidance.

(3) *Separate and distinct intangible asset—(i) Definition.* The term *separate and distinct intangible asset* means a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable State, Federal or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged (ignoring any restrictions imposed on assignability) separate and apart from a trade or business. In addition, for purposes of this section, a fund (or similar account) is treated as a separate and distinct intangible asset of the taxpayer if amounts in the fund (or account) may revert to the taxpayer. The determination of whether a payment creates a separate and distinct intangible asset is made based on all of the facts and circumstances existing during the taxable year in which the payment is made.

(ii) *Creation or termination of contract rights.* Amounts paid to another party to create, originate, enter into, renew or renegotiate an agreement with that party that produces rights or benefits for the taxpayer (and amounts paid to facilitate the creation, origination, enhancement, renewal or renegotiation of such an agreement) are treated as