

DEPARTMENT OF THE TREASURY**Internal Revenue Service****26 CFR Part 1**

[REG-168745-03]

RIN 1545-BE18

Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking, a notice of public hearing, and withdrawal of previously proposed regulations.

SUMMARY: This document contains proposed regulations that explain how section 263(a) of the Internal Revenue Code (Code) applies to amounts paid to acquire, produce, or improve tangible property. The proposed regulations clarify and expand the standards in the current regulations under section 263(a), as well as provide some bright-line tests (for example, a de minimis rule for acquisitions). The proposed regulations will affect all taxpayers that acquire, produce, or improve tangible property. This document also provides a notice of public hearing on the proposed regulations and withdraws the proposed regulations published in the **Federal Register** on August 21, 2006 (71 FR 161).

DATES: Written or electronic comments must be received by June 9, 2008. Outlines of topics to be discussed at the public hearing scheduled for June 24, 2008, at 10 a.m., must be received by June 3, 2008.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-168745-03), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-168745-03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224, or sent electronically, via the Federal eRulemaking Portal at www.regulations.gov (IRS REG-168745-03). The public hearing will be held in the auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Merrill D. Feldstein or Mon L. Lam, (202) 622-4950; concerning submission of comments, the hearing, and/or to be

placed on the building access list to attend the hearing, Richard.A.Hurst@ircounsel.treas.gov.

SUPPLEMENTARY INFORMATION:**Background**

On August 21, 2006, the IRS and Treasury Department published in the **Federal Register** (71 FR 161) proposed amendments to the regulations under section 263(a) (2006 proposed regulations) relating to amounts paid to acquire, produce, or improve tangible property. The IRS and Treasury Department received numerous written comments. A public hearing was held on December 19, 2006. After considering the comment letters and the statements at the public hearing, the IRS and Treasury Department are withdrawing the 2006 proposed regulations and are proposing new regulations.

Summary of Comments and Explanation of Provisions**I. Overview**

These new proposed regulations include many of the provisions contained in the 2006 proposed regulations, including the proposed format changes in which § 1.263(a)-1 provides general rules for capital expenditures, § 1.263(a)-2 provides rules for amounts paid for the acquisition or production of tangible property, and § 1.263(a)-3 provides rules for amounts paid for the improvement of tangible property. However, these new proposed regulations provide many additional rules that were not included in the 2006 proposed regulations. For example, these new proposed regulations provide a definition of materials and supplies under § 1.162-3 (including a special 12-month rule and a \$100 de minimis rule), a book conformity de minimis rule for acquisitions of units of property under § 1.263(a)-2, a safe harbor for routine maintenance under § 1.263(a)-3, and an optional simplified method for regulated taxpayers under § 1.263(a)-3. Additionally, these new proposed regulations provide significant changes to the rules relating to unit of property, restorations, and allow for industry-specific repair allowance methods in future Internal Revenue Bulletin guidance. These new proposed regulations generally will apply to taxable years beginning on or after the date that final regulations are published in the **Federal Register**.

II. Withdrawal and Re-Proposal of Regulations

In addition to providing specific comments, many commentators suggested that, given the broad scope and effect of the regulations and the numerous comments received on the 2006 proposed regulations, consideration should be given to re-proposing the regulations in their entirety. This suggestion has been adopted and the 2006 proposed regulations are withdrawn and replaced with these new proposed regulations.

III. Materials and Supplies Under § 1.162-3

Various commentators thought that the 2006 proposed regulations failed to fully address the relationship between the rules for capitalization of tangible property under section 263(a) and the materials and supplies rules provided in § 1.162-3 of the current regulations because the 2006 proposed regulations did not provide special rules for the interaction between the two provisions. Specifically, commentators noted that under the 2006 proposed regulations, tangible property with a useful life of 12 months or less was not treated as a material and supply, which treatment was inconsistent with existing authorities, particularly with regard to the timing of when to deduct amounts paid to acquire the property with a useful life of 12 months or less. Commentators pointed out that the 2006 proposed regulations were inconsistent with § 1.162-3 and would create uncertainty with regard to which provision should be applied to which property. In response, the IRS and Treasury Department decided to revise §§ 1.162-3 and 1.263(a)-2 to provide clear and consistent treatment for those items that traditionally have been considered to be materials and supplies and to provide distinct, but coordinated, treatment for those items that should be addressed under section 263(a).

The new proposed regulations provide additional guidance under § 1.162-3 with respect to the definition of materials and supplies. Specifically, the proposed rules define a material and supply as tangible property that (a) is not a unit of property, (b) is a unit of property with an economic useful life of 12 months or less, (c) is a unit of property that costs \$100 or less, or (d) is identified as a material and supply in future guidance.

Under the existing regulations, the costs of non-incident materials and supplies are deducted as the materials and supplies are used or consumed, and the costs of incidental materials and

supplies are deducted as the costs are incurred. These new proposed regulations retain this treatment of materials and supplies, except with respect to rotatable and temporary spare parts. These new proposed regulations provide that rotatable or temporary spare parts treated as materials and supplies will be considered used or consumed in the taxable year in which the taxpayer disposes of the parts. This rule prevents taxpayers from prematurely deducting the cost of a unit of property by systematically replacing components with rotatable spare parts. The IRS and Treasury Department anticipate that taxpayers with rotatable or temporary spare parts that are not discarded after their original use generally will prefer to capitalize their costs and treat those parts as depreciable assets. These new proposed regulations provide for an election to capitalize these costs.

Taxpayers should recognize that the used or consumed standard for non-incidentals materials and supplies generally is met later than the placed in service standard used for depreciation. In addition, taxpayers are reminded that after a material or supply is used or consumed, capitalization of the material or supply cost to another property may be required. For example, amounts paid for materials and supplies used in the production of inventory or a self-constructed asset generally are required to be capitalized under section 263A. Similarly, amounts paid to produce materials and supplies generally are required to be capitalized as part of the production costs of the materials and supplies. Nothing in these new proposed regulations is intended to change this treatment.

First, these new proposed regulations provide that property that is not a unit of property as defined in § 1.263(a)-3 will be considered a material and supply. In general, this definition is intended to describe spare and replacement parts and is consistent with the current characterization of these items.

Second, these new proposed regulations provide that property that has an economic useful life of 12 months or less will be considered a material and supply. Commentators requested clarification concerning the application of the 12-month rule provided in the 2006 proposed regulations. For purposes of applying the 12-month rule, these new proposed regulations generally adopt the economic useful life definition in § 1.167(a)-1(b) and provide that, for purposes of these new proposed material and supplies regulations, the measurement period for economic

useful life begins when the item is first used or consumed in the taxpayer's trade or business. Therefore, the time prior to when an item is used or consumed is not taken into consideration in determining the economic useful life of the asset for these new proposed regulations, notwithstanding the fact that the item may have been placed in service (ready and available for its intended use) for depreciation.

In addition, these new proposed regulations provide a special economic useful life test under the 12-month rule for taxpayers with applicable financial statements (AFS). Under this rule, taxpayers with AFS are required to determine the economic useful life in a manner consistent with the economic useful life used for purposes of determining depreciation in the books and records supporting their AFS. An exception is provided if a taxpayer does not assign a useful life to certain property in its AFS (for example, the item is currently expensed in the taxpayer's AFS because it is considered *de minimis*).

The 2006 proposed regulations did not provide a *de minimis* rule for the acquisition or production of property but requested comments on whether a *de minimis* rule should be adopted. Commentators generally agreed that the regulations should include a *de minimis* rule but varied on how that rule should be structured.

Third, these new proposed regulations provide a \$100 *de minimis* rule within the definition of materials and supplies. Materials and supplies include a unit of property that has a production or acquisition cost of \$100 or less, without regard to the treatment of the item in the taxpayer's financial statements. Allowing small items to be treated as materials and supplies resolves uncertainty with respect to whether those items represent a depreciable asset or a material and supply, and \$100 is a low enough threshold to alleviate concerns about the potential distortion of income. However, treating a small unit of property as a material and supply may affect the timing of the deduction for the material and supply cost because expensing an amount paid for a non-incidentals material and supply will only occur in the period in which the item is used or consumed.

Various commentators pointed out that taxpayer burden may be reduced by allowing taxpayers to capitalize amounts paid for items that otherwise would qualify as materials and supplies and treat the items as depreciable assets. For example, many taxpayers currently

treat rotatable spare parts as capital expenditures depreciable over the life of the unit of property in which the rotatables are used. See Rev. Rul. 69-200 (1969-1 CB 60). See § 601.601(d)(2)(ii)(b).

Under these new proposed regulations, taxpayers may elect to treat an amount paid for a material and supply as a capital expenditure. In general, the election is made separately for each material and supply and is revocable only with the consent of the Commissioner. The election is made by capitalizing the cost of the material and supply in the year the cost is incurred and beginning depreciation of the item in the year it is placed in service.

IV. Repairs under § 1.162-4

The 2006 proposed regulations revised § 1.162-4 (the repair rules), to provide rules consistent with the improvement rules under § 1.263(a)-3 of the 2006 proposed regulations. Commentators expressed concern that the proposed changes would result in challenges to the deductibility of costs that the IRS has long agreed with taxpayers are deductible. The IRS and Treasury Department do not think that the proposed change to § 1.162-4 creates a burden of proof higher than that which exists under current law or requires capitalization of costs that are not required to be capitalized under current law. Therefore, these new proposed regulations do not propose any specific changes to the rules proposed in the 2006 proposed regulations. However, a routine maintenance safe harbor is provided in these new proposed regulations in § 1.263(a)-3.

V. Professional Expenses Under § 1.162-6

The existing regulations under § 1.162-6 provide rules for professional expenses. These new proposed regulations propose to remove § 1.162-6. In general, the treatment of the items listed in § 1.162-6 is adequately addressed in these new proposed regulations and other existing regulations. The proposed removal of § 1.162-6 is not intended to result in any substantive changes in the treatment of professional expenses.

VI. Capital Expenditures

A. Amounts Paid To Sell Property

The 2006 proposed regulations provided rules for the capitalization of selling expenses, except in the case of dealers, under § 1.263(a)-1. The 2006 proposed regulations included an example that required the capitalization

of advertising costs as a selling expense that must be offset against the sale proceeds. Various commentators questioned this treatment of advertising costs. In general, advertising costs are not capital expenditures. Therefore, these new proposed regulations retain the general rule but remove the references to advertising costs provided in the 2006 proposed regulations and update the examples accordingly.

B. Interests in Land

The 2006 proposed regulations did not provide a specific capitalization rule for amounts paid to acquire or create intangible interests in land. The 2006 proposed regulations specifically requested comments on this issue, but no comments were received. These new proposed regulations provide that amounts paid to acquire or create interests in land, such as easements, life estates, mineral interests, timber rights, zoning variances, or other interests in land, are examples of capital expenditures. Comments are specifically requested on this proposed rule.

VII. Amounts Paid To Acquire or Produce Tangible Property

The 2006 proposed regulations provided rules for the capitalization of amounts paid to acquire or produce tangible property under § 1.263(a)-2. These new proposed regulations generally retain the same format, but make some modifications to the 2006 proposed regulations. For example, modifications have been made to clarify the interaction of § 1.263(a)-2 of these new proposed regulations with the materials and supplies rules under § 1.162-3. Significant modifications and clarifications are discussed further in this preamble.

A. Definition of Produce

Commentators asked whether the term “produce” as used in the 2006 proposed regulations had the same meaning as the term “produce” under section 263A. These new proposed regulations clarify that the definition of the term produce for purposes of § 1.162-3 and § 1.263(a)-2 generally is the same as the definition of the term produce for section 263A purposes. The sole difference is that the term “improve” is not included in § 1.162-3 and § 1.263(a)-2 because “improve” under section 263A is specifically defined in § 1.263(a)-3 of these new proposed regulations, relating to the improvement of tangible property.

B. Transaction Costs

The 2006 proposed regulations generally required a taxpayer to

capitalize amounts paid to facilitate the acquisition of real or personal property, and included a list of typical transaction costs. Commentators suggested that with respect to the rules requiring the capitalization of facilitative transaction costs, an exception should be provided for transaction costs for pre-decisional investigatory costs, similar to the exception provided with respect to certain intangibles in § 1.263(a)-4(e)(1)(iii) (creation of certain contract rights) and § 1.263(a)-5(e) (acquisition of a trade or business). These new proposed regulations provide a general rule similar to the rules in the intangibles regulations requiring that taxpayers capitalize all costs that facilitate an acquisition of tangible property, including the costs of investigating the acquisition, but adopt the commentators’ suggestion in part by providing an exception for certain costs incurred in the investigation of real property acquisitions. The IRS and Treasury Department think it is appropriate to provide an exception for real property acquisitions because these types of transactions most often raise the issue of whether the investigatory costs are deductible business expansion costs rather than capital expenditures to acquire a specific asset. The exception provides that costs relating to activities performed in the process of determining whether to acquire real property and which real property to acquire generally are deductible pre-decisional costs. Under this exception, capitalization will not be required for certain pre-decisional investigative activities, such as marketing studies, that are not specifically identified in these regulations as being inherently facilitative. These new proposed regulations provide that inherently facilitative costs must be capitalized and list the costs, such as transportation and shipping costs, that are inherently facilitative.

A commentator pointed out that section 263A does not apply to acquisitions of property that are not intended for resale, and thus, taxpayers should not be required to capitalize overhead costs to this type of property. These new proposed regulations address this comment by providing a simplifying convention for employee compensation and overhead costs similar to the rules provided for intangible property. However, the new proposed regulations reiterate that section 263A does apply to the production of real or personal property. Section 263A contains rules for certain costs incurred prior to production.

Under current law, if a taxpayer engages in multiple separate and

distinct transactions, the taxpayer may allocate transaction costs to the separate transactions and recover the allocable transaction costs as each distinct transaction is abandoned. *Sibley, Lindsay & Curr Co. v. Commissioner*, 15 T.C. 106, 110 (1950), acq., 1951-1 CB 3. See § 601.601(d)(2)(ii)(b). However, if the transactions are viewed as alternatives, only one of which the taxpayer can complete, the courts have held that the taxpayer must capitalize all the transaction costs to the one transaction ultimately completed. *United Dairy Farmers, Inc. v. United States*, 267 F.3d 510 (6th Cir. 2001); *Nicolazzi v. Commissioner*, 79 T.C. 109 (1982), aff’d, 722 F.2d 324 (6th Cir. 1983). To avoid the difficulty inherent in administering this rule, including ascertaining the intent of the taxpayer, the new proposed regulations provide a more objective rule. This rule allows taxpayers to allocate inherently facilitative costs among the separate and distinct properties considered, regardless of the taxpayer’s ultimate intent or plan. The taxpayer capitalizes the allocable transaction costs to each property, including properties not acquired, and recovers the costs as appropriate under the applicable provision of the Code (for example, section 165, 167, or 168). Examples are provided to demonstrate the application of these rules.

In addition, a commentator noted that the rule contained in the 2006 proposed regulations with respect to costs incurred prior to placing property in service is really a rule for acquisition costs, not improvement costs. The IRS and Treasury Department agree that activities occurring prior to placing the property in service are conceptually more related to the acquisition of the property than to the improvement of property. Therefore, these new proposed regulations move to the acquisition cost section of these regulations the requirement to capitalize amounts paid for work performed prior to placing property in service.

C. De minimis rule

The 2006 proposed regulations did not provide a specific de minimis rule for the acquisition or production of property, but the preamble provided a detailed proposal of what might be an appropriate de minimis rule and requested comments from taxpayers on this issue. Numerous comments supported the adoption of a de minimis rule to the extent such a proposal would not alter the current understandings between taxpayers and examining agents with respect to what type of transactions are considered de minimis

on examination for purposes of evaluating risk. Therefore, to reduce burden and provide simplification, these new proposed regulations provide a de minimis rule. With respect to the concerns raised by commentators as to the adoption of a de minimis rule, the IRS and Treasury Department want to make clear that the adoption of such a rule is not intended to alter the general risk analysis currently employed by examining agents. Therefore, the de minimis rule proposed in these regulations should not affect any current understandings between examining agents and taxpayers with respect to the size and character of transactions that will be the focus of examinations.

The proposed de minimis rule is based primarily on a qualifying taxpayer's financial statement standards. A qualifying taxpayer is a taxpayer that: (a) Has an AFS, (b) has written accounting procedures for the expensing of de minimis items, and (c) recognizes de minimis costs as expenses on its AFS. Under the rule provided in these new proposed regulations, a qualifying taxpayer can use the de minimis standard adopted in its AFS to the extent the AFS de minimis standard does not result in a distortion of income. Although commentators varied regarding whether it is appropriate to require conformity with AFS to qualify for a de minimis rule, the IRS and Treasury Department think that it provides simplification and reduces burden only to allow deductions for de minimis amounts paid for property (other than the \$100 rule for materials and supplies) that are already being deducted for AFS purposes.

The primary concern with the adoption of a de minimis rule is that expensing items under a de minimis rule may not clearly reflect income under section 446, particularly for aggregate or bulk purchases of *de minimis* items. In general, the IRS and Treasury Department recognize that accounting for an item using generally accepted accounting principles will not result in a distortion of income. Nonetheless, a distortion of income standard has been adopted in an effort to avoid intentional manipulations of the de minimis rule. These new proposed regulations provide a safe harbor in which the use of an AFS de minimis standard will be deemed not to distort income. Specifically, the safe harbor provides that an amount deducted under the AFS de minimis rule for the taxable year will be deemed not to distort income if that amount, added to the amounts deducted in the taxable year as materials and supplies for units of property costing \$100 or

less, is less than or equal to the lesser of (i) 0.1 percent of the taxpayer's gross receipts for the taxable year, or (ii) 2 percent of the taxpayer's total depreciation and amortization for the taxable year as determined in its AFS. The safe harbor provided in these new proposed regulations is based upon percentages and comparisons provided in case law. See *Alacare Home Health Services, Inc. v. Commissioner*, T.C. Memo. 2001-149; *Cincinnati, New Orleans & Tex. Pac. Ry. Co. v. United States*, 424 F.2d 563 (Ct. Cl. 1970). This safe harbor is not intended to be used in other contexts as a bright-line rule of an amount that distorts income. Whether amounts above the safe harbor result in a distortion of income depends upon the taxpayer's facts and circumstances.

These new proposed regulations also provide that gain on the sale or disposition of property accounted for under the de minimis rule is not treated as gain resulting from the sale or disposition of a capital asset under section 1221 or as property used in the trade or business under section 1231. These new proposed regulations also clarify that property accounted for under the de minimis rule is not a material or supply under § 1.162-3.

Moreover, these new proposed regulations provide that taxpayers may elect to capitalize items that might otherwise be within the scope of the de minimis rule. In general, this election to capitalize is made separately for each asset by treating the amount paid as a capital expenditure on the tax return.

These new proposed regulations also make a conforming change to the regulations under section 263A to ensure that amounts paid for property produced by the taxpayer also qualify under the de minimis rule, because there is no basis for distinguishing between acquired and produced property for this purpose. This change is provided in § 1.263A-1(b)(14) of these new proposed regulations. The rule provides that the cost of property to which a taxpayer properly applies the de minimis rule contained in § 1.263(a)-2(d)(4) of these new proposed regulations (including the requirement that it not distort income) is not required to be capitalized under section 263A as a separate unit of property, but may be required to be capitalized as a cost incurred by reason of the production of other property. This change is necessary because without a conforming change to section 263A, property produced by the taxpayer that qualified under the de minimis rule would be capitalized under section

263A despite the de minimis rule under section 263(a).

These new proposed regulations do not impose any specific record keeping requirements for the use of the *de minimis* rule. However, under section 6001, taxpayers are required to keep books and records sufficient to establish their eligibility to use the de minimis rule. Specifically, taxpayers must maintain books and records reasonably sufficient to determine (1) the total amounts paid and deducted as materials and supplies pursuant to § 1.162-3(d)(1)(iii) of these new proposed regulations; (2) the total amounts paid and not capitalized pursuant to § 1.263(a)-2(d)(4)(i) of these new proposed regulations; (3) the computation of the safe harbor amount provided by § 1.263(a)-2(d)(4)(iii) of these new proposed regulations; (4) that income has not been distorted by the aggregate of the deductions under §§ 1.162-3(d)(1)(iii) and 1.263(a)-2(d)(4)(i) of these new proposed regulations if the aggregate amount exceeds the safe harbor amount determined pursuant to § 1.263(a)-2(d)(4)(iii) of these new proposed regulations; and (5) that the requirements of § 1.263(a)-2(d)(4)(i)(A)-(C) of these new proposed regulations have been met.

VIII. Improvements

In general, these proposed regulations are intended to reduce controversy and provide clarity on how to determine whether an amount paid must be capitalized under section 263(a) as an improvement cost. Consistent with that intent, the 2006 proposed regulations contained rules with respect to improvements, including rules to determine whether an amount paid results in a material increase in value or prolonged useful life. As described below, these regulations modify the rules set forth in the 2006 proposed regulations to reflect comments received. While these proposed regulations attempt to provide more certainty in an area of law that currently requires a subjective analysis, the IRS and Treasury Department request comments on whether the improvement rules in these regulations are consistent with the overriding goal of providing clarity and certainty in this area.

The IRS and Treasury Department received numerous comments regarding the improvement rules provided in the 2006 proposed regulations. Many of the comments received included a general request that consideration be given to providing more bright-line rules and clarifying definitions as well as providing greater consistency with other

provisions of the Code. The rules contained in these new proposed regulations attempt to address these concerns.

Section 1.263(a)-3 of the 2006 proposed regulations provided that taxpayers are required to capitalize amounts paid to improve a unit of property. Under the general rule in the 2006 proposed regulations, a unit of property is improved if the amounts paid (i) materially increase the value of the unit of property; or (ii) restore the unit of property. Under the 2006 proposed regulations, amounts paid to adapt a unit of property to a new or different use were considered to materially increase the value of a unit of property. The 2006 proposed regulations also contained rules for determining the appropriate unit of property.

These new proposed regulations remove the new or different use standard from the material increase in value rules and provide a separate category for new or different use. Additionally, the material increase in value standard has been renamed the "betterment" standard because the betterment standard more closely reflects the manner in which section 263(a) has been interpreted and applied under current law. Therefore, these new proposed regulations identify three categories of costs that result in an improvement to property. Taxpayers under the new proposed regulations must capitalize amounts paid that:

- (i) Result in a betterment to a unit of property;
- (ii) Restore a unit of property; or
- (iii) Adapt a unit of property to a new or different use.

These new proposed regulations continue to include rules for defining the unit of property to be used in making these determinations.

The 2006 proposed regulations did not prescribe a plan of rehabilitation doctrine as traditionally described in the case law. That judicially-created doctrine provides that a taxpayer must capitalize otherwise deductible repair costs if they are incurred as part of a general plan of rehabilitation to the property. See *Norwest Corp. v. Commissioner*, 108 T.C. 265 (1997); *Moss v. Commissioner*, 831 F.2d 833 (9th Cir. 1987); *United States v. Wehrli*, 400 F.2d 686 (10th Cir. 1968). Commentators requested that the regulations specifically state that the plan of rehabilitation doctrine either is eradicated or is limited to clearly defined circumstances.

Section 263A requires that all direct costs of an improvement and all indirect costs that directly benefit or are

incurred by reason of the improvement must be capitalized. See section 263A(b), which states that section 263A applies to real or tangible property produced by the taxpayer, and section 263A(g)(1), which states that the definition of "produce" includes improve. See also § 1.263A-1(e), which requires the capitalization of direct costs and of all indirect costs that directly benefit or are incurred by reason of the performance of production activities. Section 263A, therefore, requires a taxpayer to capitalize otherwise deductible repair costs as part of an improvement if the taxpayer improves a unit of property and the otherwise deductible repair costs directly benefit or are incurred by reason of the improvement to the property. Thus, section 263A has eliminated the need for a plan of rehabilitation doctrine to determine the allocable costs that must be capitalized as part of an improvement. Although some commentators requested that the circumstances in which otherwise deductible repair costs must be capitalized as part of an improvement be limited, for example, to property that is totally dysfunctional and unsuitable for its intended purpose, there is no authority for doing so because section 263A specifically applies to improvements. The legislative history to the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2085) also indicates that Congress intended section 263A to apply to improvements to property. See, for example, S. Rep. No. 99-313, 99th Cong., 2d Sess. 133-152 (1986), which states that the uniform capitalization rules will apply to assets or improvements to assets constructed by a taxpayer for its own use in a trade or business or in an activity engaged in for profit, and that the rules are not intended to apply to expenditures properly treated as repair costs under present law that do not relate to the manufacture, remanufacture, or production of property.

Section 263A does not require otherwise deductible repair costs to be capitalized if the repairs do not directly benefit or are not incurred by reason of a production activity (for example, an improvement). The judicially-created plan of rehabilitation doctrine, however, has been cited to require capitalization of otherwise deductible repair costs solely because the taxpayer has a plan (written or otherwise) to perform periodic repairs or maintenance, or solely because the taxpayer performs several repairs to the same property at one time even though the property is not improved. As stated in the preamble

to the 2006 proposed regulations, the IRS and Treasury Department do not think this characterization is appropriate. These new proposed regulations specifically provide that repairs that are made at the same time as an improvement, but that do not directly benefit or are not incurred by reason of the improvement, are not required to be capitalized under section 263(a). These new proposed regulations do not prescribe a plan of rehabilitation doctrine. Therefore, when these new proposed regulations are finalized, the judicially-created plan of rehabilitation doctrine will be obsolete, particularly with regard to the assertion that the doctrine transforms otherwise deductible repair costs into capital improvement costs solely because the repairs are performed at the same time as an improvement, or are pursuant to a maintenance plan, even though the repairs do not improve the property under § 1.263(a)-3. However, section 263A continues to require a taxpayer to capitalize otherwise deductible repair costs if the taxpayer improves a unit of property and the otherwise deductible repair costs directly benefit or are incurred by reason of the improvement to the property.

A. Unit of Property

The 2006 proposed regulations began with an initial unit of property determination of all components that are functionally interdependent to define the largest unit of property as a starting point for the analysis. Special rules applied to buildings and their structural components and to property used in certain regulated industries; network assets were excluded from the definition of unit of property. The unit of property determination for other personal property employed a facts and circumstances test based on the application of four exclusive factors—(1) marketplace treatment; (2) industry practice and financial accounting; (3) treatment as a rotatable spare part; and (4) functional use. An overriding rule required taxpayers to treat property as a unit of property for purposes of section 263 if the taxpayer did so for any other Federal income tax purpose.

The IRS and Treasury Department received multiple comments on the definition of a unit of property provided in the 2006 proposed regulations. The commentators generally expressed dissatisfaction with the unit of property rules provided in the 2006 proposed regulations, particularly with respect to the regulated industry rules and the rule for rotatable spare parts. Commentators generally agreed with the unit of property rules for a building, but raised

objections that the remaining rules provided in the 2006 proposed regulations were overly complex and ambiguous. Many commentators recommended that the determination of a unit of property be based primarily on the functional interdependence test, similar to that used for depreciation and section 263A purposes, with no further factors, while other commentators recommended that the determination be based on the factors used in *FedEx Corp. v. United States*, 291 F. Supp. 2d 699 (W.D. Tenn. 2003), *aff'd*, 412 F.3d 617 (6th Cir. 2005).

The IRS and Treasury Department think that most of the factors listed in the 2006 proposed regulations were the same as the factors used in *FedEx*. However, commentators generally criticized the manner in which the 2006 proposed regulations applied these factors. Nonetheless, the IRS and Treasury Department agree that some factors, such as the rotatable spare parts factor, may be overly burdensome, particularly for taxpayers that use small components in their businesses. Additionally, although some taxpayers in regulated industries favored the ability to conform to regulatory reporting, many that are not subject to regulatory accounting for all assets objected to the conformity rule as inappropriate and a potential source for uncertainty and controversy. Therefore, these new proposed regulations substantially modify the unit of property definition contained in the 2006 proposed regulations.

These new proposed regulations provide unit of property rules that generally are based on the functional interdependence standard, and include special rules for buildings, plant property, and network assets. Additional rules are provided that may require a smaller unit of property characterization in certain circumstances. Generally, improvements to a unit of property are not considered separate units of property even though the improvements are treated as separate assets for depreciation purposes.

These new proposed regulations generally provide the same rule for buildings as the 2006 proposed regulations. A building and its structural components are treated as a single unit of property. However, a special rule for condominiums and cooperatives is provided. Additionally, a leasehold improvement that is section 1250 property and is made by a lessee is a separate unit of property.

For property other than a building, these new proposed regulations provide that, in general, a single unit of property

includes all components that are functionally interdependent. However, a number of special rules are provided that may require a smaller unit of property to be considered. The IRS and Treasury Department do not think that applying solely a functional interdependence test results in the appropriate unit for all types of property. For some types of property, such as machinery and equipment in a manufacturing plant, the functional interdependence test often results in a very expansive unit of property. The IRS and Treasury Department think it is inappropriate to use such a large unit of property for making a determination regarding improvements.

These new proposed regulations provide a special rule for plant property, which is defined as “functionally interdependent machinery or equipment * * * used to perform an industrial process * * *.” This definition is not intended to include all types of property used in a taxpayer’s trade or business, but is intended only to capture the functionally interdependent machinery and equipment used in industrial processes like manufacturing, electric generation, distribution, warehousing, as well as equipment used in providing industrial services such as automated materials handling equipment. This special rule requires that the functionally interdependent machinery and equipment be separated into a component or a group of components that performs a discrete and major function or operation. These new proposed regulations provide various examples to illustrate activities that will constitute a discrete and major function.

These new proposed regulations provide the same definition of network assets as the 2006 proposed regulations and continue to reserve on providing a special rule for network assets. The IRS and Treasury Department think that in many situations, the unit of property for network assets should be smaller than the unit of property determined under the functional interdependence test. The IRS and Treasury Department generally think that the unit of property rules for network assets should be addressed on an industry by industry basis in Internal Revenue Bulletin guidance. Industries are invited to submit requests for guidance under the Industry Issue Resolution (IIR) program after these regulations are finalized.

These new proposed regulations also provide two additional rules that may require a smaller unit of property determination than that provided under the general rule. The first rule is triggered if the taxpayer has assigned different economic useful lives for

financial statement or regulatory purposes to components of a single unit of property at the time the unit of property is placed in service by the taxpayer. Simply accounting for components separately (for example, recording the property separately in depreciation or other asset-tracking books and records) does not trigger this rule. However, assigning a different economic useful life to components will require that the unit of property determination be limited to those components that have been assigned the same useful life for financial statement purposes. The second rule applies when components of a single unit of property are depreciated by the taxpayer under different MACRS classes (including a different MACRS class that results from a change in method of accounting). This second rule also applies if components of a single unit of property are depreciated by the taxpayer using different recovery methods (for example, double-declining balance versus unit-of-production). Again, simply recording various components separately in the taxpayer’s depreciation books and records will not trigger the rule.

These rules are intended to prevent overly broad unit of property determinations that are inconsistent with the taxpayer’s characterization of the unit of property for depreciation purposes. In general, the IRS and Treasury Department anticipate that these limiting rules will apply only in unique circumstances. The IRS and Treasury Department encourage taxpayers to provide comments on the application of these limiting rules and to identify situations (if any) in which the limiting rules may not operate as intended.

B. Routine Maintenance Safe Harbor

The 2006 proposed regulations did not contain a routine maintenance safe harbor. Various commentators requested that the regulations provide guidance to clarify when the cost of a routine maintenance activity will be considered a deductible expense. In addition, commentators expressed concern that under the rules provided in the 2006 proposed regulations, routine maintenance activities are required to be capitalized if performed near the end of the economic useful life of the property, regardless that identical activities were considered deductible if performed earlier in the useful life.

To address this concern, these new proposed regulations provide a routine maintenance safe harbor under which qualifying activities will be deemed to not improve the unit of property. Under

this safe harbor, routine maintenance activities include recurring activities that a taxpayer expects to perform more than once over the class life of the unit of property 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. Amounts paid for betterments do not keep the unit of property in an ordinarily efficient operating condition; however, the replacement of minor parts with improved but comparable parts generally does not result in a betterment. Thus, for example, the safe harbor includes amounts paid for replacement parts that the taxpayer expects to replace more than once during the class life of the unit of property, even if the replacement part is an improved but comparable part. As part of the safe harbor provisions, these new proposed regulations provide a list of relevant considerations to be taken into account in determining whether an amount is paid for routine maintenance. These considerations include the recurring nature of the activity, industry practice, manufacturer recommendations, taxpayer experience and the treatment of the activity on the taxpayer's AFS. The safe harbor maintenance rule specifically applies to maintenance activities performed on rotatable or temporary spare parts, but reminds taxpayers that under the rules proposed in § 1.162-3(b) of these new proposed regulations, the capitalized costs associated with rotatable and temporary spare parts (that is, acquisition costs) may be deducted only in the taxable year in which the rotatable or temporary spare part is discarded.

One concern with establishing a maintenance safe harbor that includes the costs of replacement parts is creating an incentive for taxpayers to componentize assets in an effort to recover basis upon the removal of a component while deducting the replacement cost as a repair or maintenance expense. Therefore, the safe harbor does not apply to the cost of replacement components in situations in which the taxpayer has taken into account the basis of the component being replaced in determining gain or loss resulting from a sale or exchange of the replacement component, has taken a loss related to the retirement of the component, or has taken a basis adjustment related to a casualty event under section 165.

The safe harbor is intended to operate only as a safe harbor in which qualifying costs will be deemed not to constitute an improvement. The IRS and Treasury Department recognize that many activities that do not qualify for

the safe harbor nonetheless may be activities that do not give rise to capitalization of costs under section 263(a). Additionally, costs deductible under the maintenance safe harbor may be required to be capitalized under section 263A to other property produced or acquired for resale.

C. Betterments

1. Overview

The 2006 proposed regulations used the term "material increase in value" to generally describe the concept of a betterment. In general, commentators agreed with the standards outlined in the 2006 proposed regulations to determine whether an amount paid materially increases the value of property. However, commentators differed on whether taxpayers should be allowed to override the material increase in value test by proving that the activity did not actually increase fair market value. Consistent with the preamble to the 2006 proposed regulations, the IRS and Treasury Department continue to think that whether an amount paid should be capitalized as a betterment to a unit of property depends upon the purpose, the physical nature, and the effect of the work for which the amounts were paid, and not upon an analysis of the fair market value of the property before and after the work. Therefore, to clarify this distinction, these new proposed regulations change the name of the material increase in value test to the betterment test. The general rule focuses on betterments to the condition of the property, the costs of which should be capitalized as an improvement if the betterment is material, regardless of whether the betterment increases the fair market value.

Commentators noted that the general concept of a betterment is difficult to apply and suggested that the language in the regulations better define what types of events would give rise to a betterment. Additionally, commentators pointed out that some of the betterment tests were redundant. The IRS and Treasury Department agree that the general concept of a betterment or improvement can be difficult to apply. In developing these new proposed regulations, consideration was given to retaining the rules provided in the current regulations without providing clarification of material increase in value, prolong useful life, and new or different use. The principal concern in providing detailed rules on the concept of an improvement is the potential to create controversy in areas where none currently exists, which would

undermine one of the primary purposes of the project.

Nonetheless, because commentators generally did not oppose the tests provided for material increase in value under the 2006 proposed regulations, these new proposed regulations continue to provide an exclusive list of tests that determine whether an amount paid results in a betterment in an attempt to further solicit comments in this area. The IRS and Treasury Department specifically request comments as to whether the exclusive list of tests with respect to improvements provides additional certainty in this area and if not, why. Given the continuing evaluation of this area, taxpayers should be particularly aware that no reliance should be placed on the rules provided in these new proposed regulations until such rules are finalized.

The tests included in the original proposed regulations have been reorganized in these new proposed regulations in an attempt to provide additional clarification. Under these new proposed regulations, an amount paid results in a betterment if it:

(i) Ameliorates a material condition or material defect that existed prior to the acquisition or arose during the production of the property,

(ii) Results in a material addition to the unit of property (including a physical enlargement, expansion, or extension), or

(iii) Results in a material increase in the capacity, productivity, efficiency, strength, or quality of the unit of property or its output.

2. Ameliorates a Material Condition or Defect

This rule generally follows the rule contained in the 2006 proposed regulations but clarifies, in response to comments received, that capitalization is only required to the extent the condition or defect is considered material. Commentators noted that a taxpayer may not know of a condition or defect that exists at the time property is acquired and that requiring capitalization of costs in this situation would create a hardship for those taxpayers. Although taxpayers may not be aware of defects that exist at the time of acquisition, the remedial activity being performed necessarily results in a betterment, regardless of whether the activity actually increases the fair market value of the property. The rule provided in these proposed regulations is consistent with established case law. See *United Dairy Farmers, Inc. v. United States*, 267 F.3d 510 (6th Cir. 2001);

Dominion Resources, Inc. v. United States, 219 F.3d 359 (4th Cir. 2000).

Moreover, adopting a rule based on a taxpayer's knowledge at the time of acquisition or production would be difficult to administer. The IRS and Treasury Department recognize that application of this rule to used property acquired by a taxpayer will result in some costs that would otherwise be deductible as repair costs being capitalized the first time the repairs are performed (if the condition or defect is material) if the nature of the activities is to correct the effects of wear and tear that was not caused by the taxpayer's use of the property. This result is consistent with the routine maintenance safe harbor, which requires the activities under that safe harbor to be performed as a result of the taxpayer's own use of the property.

The IRS and Treasury Department understand that certain cases exist in which a taxpayer contaminates property during its operations, the taxpayer disposes of the property, and the taxpayer reacquires the property to clean up the contamination. Under the proposed rule, a taxpayer would be required to capitalize the costs incurred to clean up the property even though it was the taxpayer's own activities that contaminated the property. The IRS and Treasury Department request comments regarding the appropriate treatment of environmental remediation costs in these circumstances, considering that the remediation is performed as a result of the taxpayer's own use of the property. The IRS and Treasury Department also request comments regarding how to determine whether the contamination was due solely to the taxpayer's prior operations or, if an interim owner may have added to the contamination, how to determine the appropriate treatment of remediation costs in that circumstance.

3. Results in a Material Increase in the Capacity, etc.

This rule applies both to material increases in the capacity, efficiency, strength, or quality of the unit of property itself as well as to material increases in the capacity, efficiency, strength, or quality of the output of the unit of property.

4. Application of Betterments Rule

Commentators requested that, to the extent possible, additional guidance be provided with respect to how the betterments rules, including materiality, should be applied. The IRS and Treasury Department considered various possible bright-line rules with respect to materiality, but determined

that each rule was inappropriate under certain circumstances. For example, the IRS and Treasury Department considered a rule that presumed materiality if the amounts paid are capitalized in the taxpayer's financial statements as a permanent improvement, that is, the betterment is capitalized in the taxpayer's financial statements over the remaining economic useful life of the unit of property or longer. The IRS and Treasury Department think that financial statement treatment is an important factor in determining materiality, because if the activity is material enough to treat as an improvement for financial statements, then generally it should be a material improvement for tax purposes. However, this bright-line rule was not adopted because the IRS and Treasury Department recognize that the standards used for financial statement purposes for capitalization of improvements do not coincide with the rules for capitalization of improvements in these proposed regulations. For example, some taxpayers may defer major maintenance expenses and amortize the expenses over the period until the next maintenance cycle rather than immediately expensing the costs for financial statement purposes. The taxpayer's reason for not immediately expensing the cost for financial statement purposes (that is, treating the cost as a deferred expense or as a material capital expenditure) may not be readily apparent to the IRS, creating administrative burden and a potential source of controversy. Therefore, under these new proposed regulations, materiality will be based upon the facts and circumstances in each case. Examples are provided to illustrate to the application of materiality.

5. Appropriate Comparison for Betterments

The 2006 proposed regulations specifically provided that the appropriate comparison for determining whether an amount paid results in a betterment is made by comparing the condition of the unit of property immediately after the expenditure with the condition of the property prior to the circumstances necessitating the expenditure. These new proposed regulations retain the same comparison test.

D. Restorations

1. Overview

The 2006 proposed regulations provided that, consistent with section 263(a)(2), a taxpayer must capitalize amounts paid that restore a unit of

property. The 2006 proposed regulations provided that amounts paid restore a unit of property only if they substantially prolong the economic useful life of the unit of property, and provided four rules for making that determination. The restoration of property rules contained in the 2006 proposed regulations were criticized by commentators as being overbroad and difficult to apply. In particular, the AFS definition of economic useful life and the bright-line one-year rule were denounced as providing inappropriate results. In response, these new proposed regulations make numerous modifications to the 2006 proposed regulations.

These new proposed regulations continue to require a taxpayer to capitalize amounts paid to restore a unit of property. However, the one-year rule and the AFS conformity requirement for economic useful life have been removed. These new proposed regulations provide a series of bright-line rules to determine when an amount paid is deemed to restore property. Although some commentators criticized rules that deem the cost of certain activities to be capitalized as restorations, the IRS and Treasury Department think that bright lines under this test will reduce controversy and help ease administration. These rules also expand on the rules provided in the 2006 proposed regulations with regard to the restoration of property after a casualty loss.

Section 263(a)(2) states that no deduction is allowed for any amount paid in restoring property or in making good the exhaustion thereof for which an allowance is or has been made. The IRS and Treasury Department think that this language requires capitalization of a replacement component if the taxpayer removes the basis of the replaced component from its books and records and takes the basis of the replaced component into account in its tax return. If a taxpayer takes into account the basis of a replaced component in its tax return, then the replacement of that component "makes good the exhaustion thereof for which an allowance has been made." Therefore, these new proposed regulations provide that if the taxpayer has properly taken a portion of the existing adjusted basis of the restored asset into account in the computation of gain or loss on a sale or exchange, or as a retirement loss or other loss under the Code, the replacement of that component will be deemed to restore the unit of property.

2. Restoration of Property Destroyed In a Casualty

The 2006 proposed regulations required a taxpayer to capitalize amounts paid to repair property if the taxpayer properly deducted a casualty loss under section 165 with respect to a unit of property and the amounts paid restore the unit of property to a condition that is the same or better than before the casualty. The casualty loss rule provided in the 2006 proposed regulations was criticized. In general, commentators thought there should be no link between the recognition of a casualty loss under section 165 and the determination of whether the cost to replace the property destroyed (in part or in whole) after a casualty event constitutes a capital expenditure. However, significant authority implies that a casualty-type event generally may only be characterized either as an extraordinary event (thus giving rise to a "loss" under section 165), or as an ordinary and necessary event in the operation of a trade or business (thus giving rise to an ordinary and necessary deduction under section 162). See, e.g., *R. R. Hensler, Inc. v. Commissioner*, 73 T.C. 168, 179 (1979), acq., (1980–2 CB 1); *Hubinger v. Commissioner*, 36 F.2d 724, 726 (2d Cir. 1929), cert. denied, 281 U.S. 741 (1930). Thus, a casualty is not an ordinary event, and the cost to repair property damaged by a casualty is not an ordinary expense. Stated differently, a loss under section 165 represents a destruction of property necessitating a replacement, which is capital, while an ordinary event generally represents damage to property necessitating a repair, which may or may not be capital. Because the restoration cost resulting from a loss is not ordinary, it is not allowed as an ordinary and necessary expense under section 162, but is treated as a capital expenditure under section 263(a). Although it is clear that a casualty event generally results in two economic costs to the taxpayer (the destruction of the previously invested capital and the costs to replace the destruction), the event giving rise to both of these costs is the same.

These new proposed regulations generally require consistent characterization of all costs arising from a single event. Therefore, under the rules provided in these new proposed regulations, a taxpayer that experiences an extraordinary loss event sufficiently destructive to invoke the provisions of section 165 will be required to treat the resulting restoration costs as a capitalized replacement of the destroyed property. This rule is required to ensure consistency in tax treatment among

similarly situated taxpayers. For example, a taxpayer whose property is completely destroyed by a casualty event is required to capitalize the restoration of the loss because the restoration results in the replacement of the destroyed property with an entirely new unit of property. However, without a consistency rule, a taxpayer who experiences the same casualty event but only has part of a unit of property destroyed might argue that the cost to replace the destroyed portion of the unit of property is deductible because it simply returns the unit of property as a whole to its pre-casualty state. Allowing this type of disparity in tax treatment would provide an incentive to characterize destructions of property as partial destructions in order to leave open the position that a deduction may be taken for both the destruction of property resulting from the casualty event, as well as the ordinary and necessary expense of replacing the destroyed property. This rule also eliminates the dual characterization of minor costs incurred for items such as broken windows or blown-off shingles as both a casualty loss under section 165 and an ordinary and necessary expense under section 162.

Commentators noted that a rule requiring the capitalization of restoration costs following the recognition of a casualty loss would unfairly burden taxpayers that routinely experience extraordinary loss events in their trade or business. However, it should be noted that under these new proposed regulations, capitalization is required only if a loss or basis adjustment to the property is recognized by the taxpayer with respect to the event.

Various judicial authorities have held that events that generally are viewed as extraordinary loss events may nonetheless be considered ordinary occurrences in a particular industry. See *Atlantic Greyhound Corp. v. United States*, 111 F. Supp. 953 (Ct. Cl. 1953). In this situation, the costs to replace property destroyed in what would normally be characterized as a casualty event may result in an ordinary and necessary expenditure under section 162 rather than a loss under section 165. In this regard, the IRS and Treasury Department will consider providing guidance on what types of events may be considered ordinary in a particular industry. Taxpayers are encouraged to provide comments on this issue.

Commentators also noted that the rule provided in the 2006 proposed regulations created a disparity between taxpayers that recognized a loss under section 165 and taxpayers that received

untaxed insurance proceeds as a result of a casualty event and adjusted the basis of the damaged asset accordingly. These new proposed regulations eliminate this disparity.

3. Other Restorations

Similar to the 2006 proposed regulations, these new proposed regulations provide additional circumstances in which a restoration is deemed to occur. Capitalization is required for 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 can no longer function for its intended purpose. The IRS and Treasury Department anticipate that these types of restorations will occur either as a result of lack of maintenance by the taxpayer or after the end of the property's useful life. A unit of property that is damaged by a casualty is not considered to be deteriorated to a state of disrepair.

These new proposed regulations also require capitalization of amounts paid to rebuild a unit of property to a like-new condition after the end of its economic useful life. The IRS and Treasury Department anticipate that this standard will apply to the traditional rebuilding of a unit of property to return it to a like-new condition. In general, a restoration under this rule will not result from routine maintenance activities, even if performed near the end of the useful life of the property, but instead represents a fundamental renewal of the economic useful life of the asset.

Similar to the 2006 proposed regulations, the new proposed regulations require capitalization of amounts paid to replace a major component or substantial structural part of a unit of property. In response to comments regarding the uncertainty in applying this standard, these new proposed regulations define the term "major component or substantial structural part." Specifically, these new proposed regulations provide that the replacement of a major component or substantial structural part will be deemed to occur only if (a) the replacement costs constitute 50 percent or more of the replacement cost of the unit of property or (b) the replacement part or parts constitute 50 percent or more of the physical structure of the unit of property. These 50 percent thresholds apply solely for purposes of the restoration rules and are not intended to be applied to the betterment or new or different use rules.

E. New or Different Use

In general, these new proposed regulations contain the rules set forth in the 2006 proposed regulations with respect to the capitalization of amounts paid to adapt property to a new or different use. However, these new proposed regulations remove the parenthetical contained in the 2006 proposed regulations relating to "structural alterations to the unit of property." Commentators noted that, although permanent structural alterations may result in adapting property to a new or different use, those alterations also could result in betterments to the unit of property and, in certain circumstances, could constitute routine maintenance. Commentators also noted that adapting property to a new or different use does not necessarily make the property better or increase its value, but nevertheless is a capital expenditure. Therefore, the new or different use rules are provided separately from the betterment rules in these new proposed regulations.

These new proposed regulations also clarify that amounts paid will be deemed to adapt property to a new or different use only if the new use is not consistent with the taxpayer's intended use of the property at the time the property is placed in service by the taxpayer. Additional examples have been added to clarify the application of this rule.

F. Repair Allowance

The 2006 proposed regulations provided a repair allowance similar to the CLADR repair allowance, but did not specify different repair allowance percentages for different industries. Commentators generally favored the idea of a repair allowance; however, they widely criticized the lack of percentages tailored to specific industries. Some commentators in regulated industries requested that they be allowed to determine their deductible repair costs and their capital improvement costs for tax purposes based on conformity with regulatory accounting reporting.

These new proposed regulations adopt the request by certain regulated industries to conform the tax treatment of amounts paid to maintain, repair, or improve tangible property to their regulatory accounting treatment. An optional regulatory accounting method is proposed for amounts paid to maintain, repair, or improve tangible property subject to regulatory accounting. For purposes of this method, regulated accounting industries include industries regulated by the

Federal Energy Regulatory Commission (FERC), the Federal Communications Commission (FCC), and the Surface Transportation Board (STB). The IRS and Treasury Department recognize that conformity with the regulatory accounting rules in these industries frequently may result in the overcapitalization of costs, and sometimes the undercapitalization of costs, as compared to the general rules for improvements under these new proposed regulations. The regulatory accounting method is not intended to be used as a definitive test of what should be capitalized for taxpayers that do not elect to use the method.

These new proposed regulations do not propose a detailed repair allowance like the one that was provided in the 2006 proposed regulations. Some commentators stated that very large taxpayers will want to have a repair allowance, because applying the general rules asset-by-asset is too burdensome because of their numerous assets. The commentators made clear, however, that taxpayers would not widely use a one-size-fits-all approach and that any repair allowance must be tailored to individual industries. Therefore, these new proposed regulations provide authority for issuing industry-specific repair allowance guidance in the future.

IX. Accounting Method Changes

These new proposed regulations do not provide any specific rules for changes in method of accounting. Because these proposed regulations are not effective until they are published as final regulations, taxpayers may not change their accounting method to conform to a method of accounting provided in these proposed regulations. Generally, a taxpayer's treatment of an amount paid to conform with these proposed regulations will be a change in method of accounting under section 446(e). For example, a change to the routine maintenance safe harbor in § 1.263(a)–3(e) of these proposed regulations or to the optional regulatory accounting method in § 1.263(a)–3(i) of these proposed regulations is a change in method of accounting. The IRS and Treasury Department request comments on whether a change to or from the use of the de minimis rule in § 1.263(a)–2(d)(4) of these proposed regulations is a change in method of accounting under section 446(e).

Proposed Effective Date

These regulations are proposed to apply to taxable years beginning on or after the date the final regulations are published in the **Federal Register**. The final regulations will provide rules

applicable to taxpayers that seek to change a method of accounting to comply with the rules contained in the final regulations. Taxpayers may not change a method of accounting in reliance upon the rules contained in these new proposed regulations until the rules are published as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f), this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before the proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. Comments are requested on all aspects of the proposed regulations. In addition, the IRS and Treasury Department specifically request comments on the clarity of the proposed rules and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for June 24, 2008, at 10 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments by June 9, 2008 and an outline of the topics to be discussed and

the time to be devoted to each topic (signed original and eight (8) copies) by June 3, 2008. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Merrill D. Feldstein, Office of the Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

Withdrawal of Proposed Amendments to the Regulations

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking (REG-168745-03) published in the **Federal Register** on August 21, 2006, (71 FR 161) is withdrawn.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.162-3 is revised to read as follows:

§ 1.162-3 Materials and supplies.

(a) *In general*—(1) *Non-incident materials and supplies.* Amounts paid to acquire or produce materials and supplies are deductible in the taxable year in which the materials and supplies are used or consumed in the taxpayer's operations.

(2) *Incidental materials and supplies.* Amounts paid to acquire or produce incidental materials and supplies that are carried on hand and for which no record of consumption is kept or physical inventories at the beginning and end of the year are not taken, are deductible in the taxable year in which these amounts are paid, provided taxable income is clearly reflected.

(b) *Rotable and temporary spare parts.* For purposes of this section, rotable spare parts are parts that are removable from the unit of property, generally repaired or improved, and

either reinstalled on other property, or stored for later installation. Temporary spare parts are parts that are used temporarily until a new or repaired part can be installed, and then removed and stored for later (emergency or temporary) installation. For purposes of paragraph (a)(1) of this section, rotable and temporary spare parts are used or consumed in the taxpayer's business in the taxable year in which the taxpayer disposes of the parts.

(c) *Coordination with other provisions of the Internal Revenue Code.* Nothing in this section changes the treatment of any amount that is specifically provided for under any provision of the Internal Revenue Code (Code) or regulations other than section 162(a) or section 212 and the regulations under those sections. For example, see section § 1.263(a)-3, which requires taxpayers to capitalize amounts paid to improve units of property and section 263A and the regulations under section 263A, which require taxpayers to capitalize the direct and allocable indirect costs, including the cost of materials and supplies, to property produced or to property acquired for resale.

(d) *Definitions*—(1) *Materials and supplies.* For purposes of this section, *materials and supplies* means tangible property that is used or consumed in the taxpayer's operations and that—

(i) Is not a unit of property (as determined under § 1.263(a)-3(d)(2)) and is not acquired as part of a single unit of property; or

(ii) Is a unit of property (as determined under § 1.263(a)-3(d)(2)) that has an economic useful life of 12 months or less, beginning when the property is used or consumed in the taxpayer's operations; or

(iii) Is a unit of property (as determined under § 1.263(a)-3(d)(2)) that has an acquisition cost or production cost (as determined under section 263A) of \$100 or less; or

(iv) Is identified in published guidance in the **Federal Register** or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter) as materials and supplies for which treatment is permitted under this section.

(2) *Economic useful life*—(i) *General rule.* The economic useful life of a unit of property is not necessarily the useful life inherent in the property but is the period over which the property may reasonably be expected to be useful to the taxpayer or, if the taxpayer is engaged in a trade or business or an activity for the production of income, the period over which the property may reasonably be expected to be useful to the taxpayer in its trade or business or

for the production of income, as applicable. See § 1.167(a)-1(b) for the factors to be considered in determining this period.

(ii) *Taxpayers with an applicable financial statement.* For taxpayers with an applicable financial statement (as defined in paragraph (d)(2)(iii) of this section), the economic useful life of a unit of property, solely for the purposes of applying the provisions of paragraph (d)(1)(ii) of this section, is the useful life initially used by the taxpayer for purposes of determining depreciation in its applicable financial statement, regardless of any salvage value of the property. If a taxpayer does not have an applicable financial statement for the taxable year in which the property was originally acquired or produced, the economic useful life of the unit of property must be determined under paragraph (d)(2)(i) of this section.

Further, if a taxpayer treats amounts paid for a unit of property as an expense in its applicable financial statement on a basis other than the useful life of the property or if a taxpayer does not depreciate the unit of property on its applicable financial statement, the economic useful life of the unit of property must be determined under paragraph (d)(2)(i) of this section. For example, if a taxpayer has a policy of treating as an expense on its applicable financial statement amounts paid for property costing less than a certain dollar amount, notwithstanding that the property has a useful life of more than one year, the economic useful life of the property must be determined under paragraph (d)(2)(i) of this section.

(iii) *Definition of applicable financial statement.* The taxpayer's applicable financial statement is the taxpayer's financial statement listed in paragraphs (d)(2)(iii)(A) through (C) of this section that has the highest priority (including within paragraph (d)(2)(iii)(B) of this section). The financial statements are, in descending priority—

(A) A financial statement required to be filed with the Securities and Exchange Commission (SEC) (the 10-K or the Annual Statement to Shareholders);

(B) A certified audited financial statement that is accompanied by the report of an independent CPA (or in the case of a foreign entity, by the report of a similarly qualified independent professional), that is used for—

(1) Credit purposes;

(2) Reporting to shareholders, partners, or similar persons; or

(3) Any other substantial non-tax purpose; or

(C) A financial statement (other than a tax return) required to be provided to

the Federal or a state government or any Federal or state agencies (other than the SEC or the Internal Revenue Service).

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

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

(e) *Election to capitalize.* A taxpayer may elect to treat as a capital expenditure the cost of any material or supply as defined in paragraph (d)(1) of this section, unless the material or supply is a component of a unit of property as described in paragraph (d)(1)(i) of this section, and the unit of property is a material or supply under paragraph (d)(1)(ii)-(iv) of this section, rather than a capital expenditure. An election made under this paragraph (e) applies to amounts paid during the taxable year to acquire or produce any material or supply to which paragraph (a) of this section would apply (but for the election under this paragraph (e)). A taxpayer makes the election by capitalizing the amounts paid to acquire or produce a material or supply in the taxable year the amounts are paid and by recovering the costs when the material or supply is placed in service by the taxpayer for the purposes of determining depreciation under the applicable Code and regulation provisions. A taxpayer must make this election in its timely filed original Federal income tax return (including extensions) for the taxable year the material or supply is placed in service by the taxpayer for purposes of determining depreciation. See § 1.263(a)-2 for the treatment of amounts paid to acquire or produce real or personal tangible property. In the case of a pass-through entity, the election is made by the pass-through entity, and not by the shareholders, partners, etc. An election must be made for each material and/or supply. A taxpayer may revoke an election made under this paragraph (e) with respect to

a material or supply only by filing a request for a private letter ruling and obtaining the Commissioner's consent to revoke the election. An election may not be made or revoked through the filing of an application for change in accounting method or by an amended Federal income tax return. A taxpayer that revokes an election may not re-elect to capitalize the material or supply for a period of at least 60 months, beginning with the taxable year of revocation.

(f) *Examples.* The rules of this section are illustrated by the following examples, in which it is assumed (unless otherwise stated) that the property is not an incidental material or supply, that the taxpayer is a calendar year, accrual method taxpayer, and that the taxpayer has not elected to capitalize under paragraph (e) of this section.

Example 1. Not a unit of property; component of personal property. X operates a fleet of aircraft. In 2008, X purchases a stock of spare parts, which it uses to maintain and repair its aircraft. The spare parts are not units of property as determined under § 1.263(a)-3(d)(2) and are not rotatable or temporary spare parts. In 2009, X uses the spare parts in a repair and maintenance activity that does not improve the property under § 1.263(a)-3. Under paragraph (a)(1) of this section, the amounts paid for the spare parts are deductible as materials and supplies in 2009, the taxable year in which the spare parts are used to repair and maintain the aircraft.

Example 2. Not a unit of property; rotatable spare parts. X operates a fleet of specialized vehicles that it uses in its service business. At the time that it acquires a new type of vehicle, X also acquires a substantial number of rotatable spare parts that will be kept on hand to quickly replace similar parts in X's vehicles as those parts break down or wear out. These rotatable replacement parts are not units of property as determined under § 1.263(a)-3(d)(2), are removable from the vehicles, and are repaired or reconditioned, so that they can be reinstalled on the same or similar vehicles. In 2008, X acquires several vehicles and associated rotatable spare parts. In 2009, X makes repairs to several vehicles by using these rotatable spare parts to replace worn or damaged parts. In 2010, X removes these rotatable spare parts from its vehicles, repairs them and reinstalls them on other similar vehicles. In 2012, X can no longer use the rotatable parts it acquired in 2008 and disposes of them as scrap. Under paragraph (d)(1) of this section, the rotatable spare parts acquired in 2008 are materials and supplies. However, under paragraph (b) of this section, these parts are not used or consumed until the taxable year in which X disposes of the parts. Therefore, under paragraph (a)(1) of this section, X may deduct the amounts paid for the rotatable spare parts in 2012, the taxable year in which X disposes of the parts.

Example 3. Not a unit of property; part of a single unit of real property. X owns an

apartment building and discovers that a window in one of the apartments is broken. In 2008, X pays for the acquisition, delivery, and installation of a new window to replace the broken window. In the same year, the new window is installed. The window is not a unit of property as determined under § 1.263(a)-3(d)(2), and the replacement of the window does not improve the property under § 1.263(a)-3. Under paragraph (a)(1) of this section, the amounts paid for the acquisition, delivery, and installation of the window are deductible as materials and supplies in 2008, the taxable year in which the window is installed in the apartment building.

Example 4. Economic useful life of 12 months or less. X operates a fleet of aircraft that carries freight for its customers. X owns a storage tank on its premises, which can hold a one-month supply of jet fuel for its aircraft. On December 31, 2008, X purchases a one-month supply of jet fuel. In 2009, X uses the jet fuel purchased on December 31, 2008, to fuel the aircraft used in its business. Under paragraph (a)(1) of this section, the amounts paid for the jet fuel are deductible as materials and supplies in 2009, the taxable year in which the jet fuel is used or consumed in the operation of X's aircraft.

Example 5. Unit of property that costs \$100 or less. X operates a rental business that rents out a variety of small individual items to customers (rental items). X maintains a supply of rental items on hand to replace worn or damaged items. In 2008, X purchases a large quantity of rental items to use in its rental business. Each of these rental items is a unit of property that costs \$100 or less. In 2009, X begins using all of the rental items purchased in 2008 by providing them to customers of its rental business. X does not sell or exchange these items on established retail markets at any time after the items are used in the rental business. Under paragraph (a)(1) of this section, the amounts paid for the rental items are deductible as materials and supplies in 2009, the taxable year in which the rental items are used in X's business.

Example 6. Unit of property that costs \$100 or less. X provides billing services to its customers. In 2008, X incurs costs to purchase 50 facsimile machines to be used by its employees. Each facsimile machine is a unit of property that costs less than \$100. In 2008, X's employees begin using 35 of the facsimile machines, and X stores the remaining 15 machines for use in a later taxable year. Under paragraph (a)(1) of this section, the amounts paid for 35 of the facsimile machines are deductible as materials and supplies in 2008, the taxable year in which X uses those machines. The amounts paid for each of the remaining 15 machines are deductible in the taxable year in which each machine is used.

Example 7. Materials and supplies used in improvements; coordination with § 1.263(a)-3. X owns various machines that are used in its business. In 2008, X purchases a supply of spare parts for its machines. The spare parts are not units of property as determined under § 1.263(a)-3(d)(2) and are not rotatable or temporary spare parts. The spare parts may be used by X in the repair or maintenance of a machine under § 1.162-4 or in the improvement of a machine under

§ 1.263(a)–3. In 2009, X uses all of these spare parts in an activity that improves the unit of property under § 1.263(a)–3. Under paragraph (d)(1)(i) of this section, the spare parts purchased by X in 2008 are materials and supplies. Under paragraph (a)(1) of this section, the amounts paid for the spare parts are otherwise deductible as materials and supplies in 2009, the taxable year in which X uses those parts. However, because these materials and supplies are used to improve X's property, X is required to capitalize the amounts paid for those spare parts under § 1.263(a)–3. See also section 263A requiring taxpayers to capitalize the direct and allocable indirect costs of property produced or acquired for resale.

Example 8. Cost of producing materials and supplies; coordination with section 263A. X is a manufacturer that produces liquid waste as part of its operations. X determines that its current liquid waste disposal process is inadequate. To remedy the problem, in 2008, X constructs a leaching pit to provide a draining area for the liquid waste. The leaching pit has an economic useful life of less than 12 months, starting on the date that X begins to use the leaching pit as a draining area. At the end of this period, X's factory will be connected to the local sewer system. In 2009, X starts using the leaching pit in its operations. The amounts paid to construct the leaching pit (including the direct and allocable indirect costs of property produced under section 263A) are amounts paid for a material or supply under paragraph (d)(1)(ii) of this section. Under paragraph (a)(1) of this section, the amounts paid for the leaching pit are otherwise deductible as materials and supplies in 2009, the taxable year in which X uses the leaching pit. However, because the amounts paid to construct the leaching pit are incurred by reason of X's manufacturing operations, X is required to capitalize the amounts paid to construct the leaching pit to X's property produced. See § 1.263A–1(e)(3)(ii)(E).

Example 9. Costs of acquiring materials and supplies for production of property; coordination with section 263A. In 2008, X purchases jigs, dies, molds, and patterns for use in the manufacture of X's products. The economic useful life of each jig, die, mold, and pattern is 12 months or less, beginning when each item is used in the manufacturing process. X begins using the purchased items in 2009 to manufacture its products. These items are materials and supplies under paragraph (d)(1)(ii) of this section. Under paragraph (a)(1) of this section, the amounts paid for the items are otherwise deductible as materials and supplies in 2009, the taxable year in which X uses those items. However, because the amounts paid for these materials and supplies directly benefit or are incurred by reason of the taxpayer's production activities, X is required to capitalize the amounts paid for these items to X's property produced. See § 1.263A–1(e)(3)(ii)(E).

Example 10. Election to capitalize. X operates a rental business that rents out a variety of items (rental items) to its customers, each of which is a separate unit of property as determined under § 1.263(a)–3(d)(2). X does not sell or exchange these items on established retail markets at any

time after the items are used in the rental business. In 2008, X incurs costs to purchase various rental items, all of which cost less than \$100 or have an economic useful life of less than 12 months, beginning when used or consumed. X begins using the rental items in its business in 2008. Under paragraph (a)(1) of this section, the amounts paid for each rental item purchased in 2008 are deductible as a material or supply in the taxable year in which the item is used. However, for administrative reasons, X would prefer to treat all of its rental items as capital expenditures subject to depreciation. Under paragraph (e) of this section, X may elect not to apply the rule contained in paragraph (a)(1) of this section to the rental items. X makes this election by capitalizing the amounts paid for each rental item in the taxable year the costs are incurred and by beginning to recover the costs of each item on its timely filed Federal income tax return for the taxable year that the item is placed in service by X for purposes of determining depreciation under the applicable Code and regulation provisions. See § 1.263(a)–2(e) for the treatment of capital expenditures.

Example 11. Election to capitalize. X is an electric utility. In 2008, X acquires certain temporary spare parts, which it keeps on hand to avoid operational time loss in the event it must make emergency repairs to a unit of property that is subject to depreciation. These parts are not units of property as determined under § 1.263(a)–3(d)(2) and are not used to improve property under § 1.263(a)–3(d)(1). These temporary spare parts are used until a new or repaired part can be installed, and then removed and stored for later emergency installation. Under paragraphs (a)(1) and (b) of this section, the amounts paid for the temporary spare parts are deductible as materials and supplies in the taxable year in which they are disposed of by the taxpayer. However, because it is unlikely that the temporary spare parts will be disposed of in the near future, X would prefer to treat the spare parts as capital expenditures subject to depreciation. Accordingly, X may elect under paragraph (e) of this section not to apply the rule contained in paragraph (a)(1) of this section to each of its temporary spare parts. X makes this election by capitalizing the amounts paid for each spare part in the taxable year the costs are incurred and by beginning to recover the costs of each part on its timely filed Federal income tax return for the taxable year that the part is placed in service by X for purposes of determining depreciation under the applicable Code and regulation provisions. See § 1.263(a)–2(e) for the treatment of capital expenditures and section 263A requiring taxpayers to capitalize the direct and allocable indirect costs of property produced or acquired for resale.

Par. 3. Section 1.162–4 is revised to read as follows:

§ 1.162–4 Repairs.

Amounts paid for repairs and maintenance to tangible property are deductible if the amounts paid are not required to be capitalized under § 1.263(a)–3.

§ 1.162–6 [Removed]

Par. 4. Section 1.162–6 is removed.

Par. 5. Section 1.263(a)–0 is amended by revising the entries for §§ 1.263(a)–1, 1.263(a)–2 and 1.263(a)–3 to read as follows:

§ 1.263(a)–0 Table of contents.

* * * * *

§ 1.263(a)–1 Capital expenditures; in general.

- (a) General rule for capital expenditures.
- (b) Coordination with section 263A.
- (c) Examples of capital expenditures.
- (d) Amounts paid to sell property.
 - (1) In general.
 - (2) Treatment of capitalized amount.
 - (3) Examples.
- (e) Amount paid.
- (f) [Reserved]
- (g) Effective/applicability date.

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

- (a) Overview.
- (b) Definitions.
 - (1) Amount paid.
 - (2) Personal property.
 - (3) Real property.
 - (4) Produce.
 - (c) Coordination with other provisions of the Internal Revenue Code.
 - (1) In general.
 - (2) Materials and supplies.
 - (d) Acquired or produced tangible property.
 - (1) In general.
 - (i) Requirement of capitalization.
 - (ii) Examples.
 - (2) Defense or perfection of title to property.
 - (i) In general.
 - (ii) Examples.
 - (3) Transaction costs.
 - (i) In general.
 - (ii) Scope of facilitate.
 - (A) In general.
 - (B) Inherently facilitative amounts.
 - (C) Special rule for acquisitions of real property.
 - (D) Employee compensation and overhead costs.
 - (1) In general.
 - (2) Election to capitalize.
 - (iii) Treatment of transaction costs.
 - (iv) Examples.
 - (4) De minimis rule.
 - (i) In general.
 - (ii) Exceptions to de minimis rule.
 - (iii) Safe harbor.
 - (iv) Additional rules.
 - (v) Election to capitalize.
 - (vi) Definition of applicable financial statement.
 - (vii) Examples.
 - (e) Treatment of capital expenditures.
 - (f) Recovery of capitalized amounts.
 - (1) In general.
 - (2) Examples.
 - (g) [Reserved]
 - (h) Effective/applicability date.

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

- (a) Overview.

paid to appraise the truck and, in 2009, is required to offset the amount paid against the amount realized from the sale of the truck.

Example 6. Costs of abandoned sale of personal property not used in a trade or business. Assume the same facts as in *Example 5*, except that, instead of selling the truck on February 15, 2009, X decides on that date not to sell the truck and takes the truck off the market. X is required to capitalize in 2008 the amount paid to appraise the truck. Although the sale is abandoned in 2009, X may not treat the amount paid to appraise the truck as a loss under section 165 because the truck was not used in X's trade or business or in a transaction entered into for profit.

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

(f) [Reserved]

(g) *Effective/applicability date.* The rules in this section apply to taxable years beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Par. 7. Section 1.263(a)-2 is revised to read as follows:

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

(a) *Overview.* This section provides rules for applying section 263(a) to amounts paid to acquire or produce a unit of real or personal property. Paragraph (b) of this section contains definitions. Paragraph (c) of this section contains the rules for coordinating this section with other provisions of the Internal Revenue Code (Code). Paragraph (d) of this section provides the rules for determining the treatment of amounts paid to acquire or produce a unit of real or personal property, including amounts paid to defend or perfect title to real or personal property and amounts paid to facilitate the acquisition of property. Paragraph (d) also provides a *de minimis* rule.

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

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

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

(3) *Real property* means land and improvements thereto, such as buildings

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

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

(c) *Coordination with other provisions of the Internal Revenue 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 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 certain indirect costs of producing property or acquiring property for resale.

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

(d) *Acquired or produced tangible property—(1) In general—(i) Requirement of capitalization.* Except as provided in paragraph (d)(4) of this section (relating to the *de minimis* rule) and in § 1.162-3(d)(1)(ii), (iii), and (iv) (relating to certain materials and supplies), a taxpayer must capitalize amounts paid to acquire or produce a unit of real or personal property (as determined under § 1.263(a)-3(d)(2)), including leasehold improvement property, land and land improvements, buildings, machinery and equipment, and furniture and fixtures. Amounts paid to acquire or produce a unit of real or personal property include the invoice price, transaction costs as determined under paragraph (d)(3) of this section, and costs for work performed prior to the date that the unit of property is placed in service by the taxpayer (without regard to any applicable convention under section 168(d)). A taxpayer also must capitalize amounts paid to acquire real or personal property for resale and to produce real or personal property. See section 263A for the costs required to be capitalized to

property produced by the taxpayer or to property acquired for resale.

(ii) *Examples.* The rules of this section are illustrated by the following examples, in which it is assumed that the taxpayer does not apply the *de minimis* rule under paragraph (d)(4) of this section:

Example 1. Acquisition of personal property. In 2008, X purchases new cash registers for use in its retail store located in leased space in a shopping mall. Assume each cash register is a unit of property as determined under § 1.263(a)-3(d)(2), and is not a material or supply under § 1.162-3. X must capitalize under this paragraph (d)(1) the amount paid to purchase each cash register.

Example 2. Relocation of personal property. Assume the same facts as in *Example 1*, except that X's lease expires in 2009 and X decides to relocate its retail store to a different building. In addition to various other costs, X pays \$5,000 to move the cash registers. X is not required to capitalize under this paragraph (d)(1) the \$5,000 amount paid for moving the cash registers.

Example 3. Acquisition of personal property that is not a unit of property; coordination with § 1.162-3. X operates a fleet of aircraft. In 2008, X purchases a stock of spare parts, which it uses to maintain and repair its aircraft. Assume that the spare parts are not units of property as determined under § 1.263(a)-3(d)(2). X does not make elections under § 1.162-3(e) to treat the materials and supplies as capital expenditures. In 2009, X uses the spare parts in a repair and maintenance activity that does not improve the property under § 1.263(a)-3. Because the parts are not units of property, X is not required to capitalize the amounts paid for the parts under this paragraph (d)(1). Rather, X must apply the rules in § 1.162-3, governing the treatment of materials and supplies, to determine the treatment of these amounts.

Example 4. Acquisition of unit of personal property; coordination with § 1.162-3. X operates a rental business that rents out a variety of small individual items to customers (rental items). X maintains a supply of rental items on hand to replace worn or damaged items. In 2008, X purchases a large quantity of rental items to be used in its business. Assume that each of these items is a unit of property under § 1.263(a)-3(d)(2) and that several of these rental items are materials and supplies under the definition provided in § 1.162-3(d). Therefore, X must apply the rules in § 1.162-3 to determine the treatment of the amounts paid to acquire rental items that are materials and supplies. Under this paragraph (d)(1), X must capitalize the amounts paid for the rental items that are units of property and do not otherwise qualify as materials and supplies under § 1.162-3(d).

Example 5. Acquisition or production cost. X purchases or produces jigs, dies, molds, and patterns for use in the manufacture of X's products. Assume that each of these items is a unit of property as determined under § 1.263(a)-3(d)(2), and is not a material and supply under § 1.162-3(d). X is required to

capitalize under this paragraph (d)(1) the amounts paid to produce or purchase the jigs, dies, molds, and patterns. See section 263A for the costs to be capitalized to property produced by X.

Example 6. Acquisition of land. X purchases a parcel of undeveloped real estate. X must capitalize under this paragraph (d)(1) the amount paid to acquire the real estate. See § 1.263(a)–2(d)(3) for the treatment of amounts paid to facilitate the acquisition of real property.

Example 7. Acquisition of building. X purchases a building. X must capitalize under this paragraph (d)(1) the amount paid to acquire the building. See § 1.263(a)–2(d)(3) for the treatment of amounts paid to facilitate the acquisition of real property.

Example 8. Acquisition of property for resale. X purchases goods for resale. X must capitalize under this paragraph (d)(1) the amounts paid to acquire the goods. See section 263A for the costs to be capitalized to property acquired for resale.

Example 9. Production of property for sale. X produces goods for sale. X must capitalize under this paragraph (d)(1) the amount paid to produce the goods. See section 263A for the costs to be capitalized to property produced by X.

Example 10. Production of building. X constructs a building. X must capitalize under this paragraph (d)(1) the amount paid to construct the building. See section 263A for the costs to be capitalized to real property produced by X.

Example 11. Acquisition of assets constituting a trade or business. Y owns tangible and intangible assets that constitute a trade or business. X purchases all the assets of Y in a taxable transaction. X must capitalize under this paragraph (d)(1) the amount paid for the tangible assets of Y. See § 1.263(a)–4 for the treatment of amounts paid to acquire intangibles and § 1.263(a)–5 for the treatment of amounts paid to facilitate the acquisition of assets that constitute a trade or business. See section 1060 for special allocation rules for certain asset acquisitions.

Example 12. Work performed prior to placing the property in service. In 2008, X purchases a building for use as a business office. The building is in a state of disrepair. Prior to placing the building in service, X incurs costs to repair cement steps, shore up parts of the first and second floors, replace electrical wiring, remove and replace old plumbing, and paint the outside and inside of the building. All the work was performed on the building or its structural components. In 2010, X places the building in service and begins using the building as its business office. Assume the building and its structural components is the unit of property. The amounts paid must be capitalized as costs of acquiring the building because they were for work performed prior to X's placing the building in service.

Example 13. Work performed prior to placing the property in service. In January 2008, X purchases a new machine for use in an existing production line of its manufacturing business. Assume that the machine is a unit of property under § 1.263(a)–3(d)(2). After the machine is

installed, X performs critical testing on the machine to ensure that it is operational. On November 1, 2008, the critical testing is complete and X places the machine in service on the production line. X continues to perform testing for quality control. The amounts paid for the installation and critical testing must be capitalized as costs of acquiring the machine because they were for work performed prior to X's placing the machine in service. However, amounts paid for quality control testing after the machine is placed in service by X are not required to be capitalized as a cost of acquiring the machine.

(2) *Defense or perfection of title to property*—(i) *In general.* Amounts paid to defend or perfect title to real or personal property are amounts paid to acquire or produce property within the meaning of this section and must be capitalized. See section 263A for the costs required to be capitalized to property produced by the taxpayer or to property acquired for resale.

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

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

Example 2. Amounts paid to invalidate ordinance. X is in the business of quarrying and supplying for sale sand and stone in a certain municipality. Several years after X establishes its business, the municipality in which it is located passes an ordinance that prohibits the operation of X's business. X incurs attorney's fees in a successful prosecution of a suit to invalidate the municipal ordinance. X prosecutes the suit to preserve its business activities and not to defend X's title in the property. Therefore, attorney's fees paid by X are not required to be capitalized under this paragraph (d)(2). However, under section 263A, all indirect costs, including otherwise deductible costs, that directly benefit or are incurred by reason of the taxpayer's production activities must be capitalized to the property produced for sale. See § 1.263A–1(e)(3)(i). Therefore, because the amounts paid to invalidate the ordinance are incurred by reason of X's production activities, the amounts paid must be capitalized under section 263A to the property produced for sale by X.

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

(3) *Transaction costs*—(i) *In general.* A taxpayer must capitalize amounts

paid to facilitate the acquisition or production of real or personal property. See section 263A for the costs required to be capitalized to property produced by the taxpayer or to property acquired for resale. See § 1.263(a)–5 for the treatment of amounts paid to facilitate the acquisition of assets that constitute a trade or business.

(ii) *Scope of facilitate*—(A) *In general.* Except as otherwise provided in this section, an amount is paid to facilitate the acquisition of real or personal property if the amount is paid in the process of investigating or otherwise pursuing the acquisition. Whether an amount is paid in the process of investigating or otherwise pursuing the acquisition is determined based on all of the facts and circumstances. In determining whether an amount is paid to facilitate an acquisition, the fact that the amount would (or would not) have been paid but for the acquisition is relevant, but is not determinative. These amounts include, but are not limited to, inherently facilitative amounts specified in paragraph (d)(3)(ii)(B) of this section.

(B) *Inherently facilitative amounts.*

An amount paid in the process of investigating or otherwise pursuing the acquisition of real or personal property facilitates the acquisition if the amount is inherently facilitative. An amount is inherently facilitative if the amount is paid for—

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

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

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

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

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

(6) Examining and evaluating the title of property;

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

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

(9) Finders' fees or brokers' commissions, including amounts paid that are contingent on the successful closing of the acquisition;

(10) Architectural, geological, engineering, environmental or inspection services pertaining to particular properties; and

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

(C) *Special rule for acquisitions of real property.* Except as provided in paragraph (d)(3)(ii)(B) of this section (relating to inherently facilitative amounts), an amount paid by the taxpayer in the process of investigating or otherwise pursuing the acquisition of real property does not facilitate the acquisition if it relates to activities performed in the process of determining whether to acquire real property and which real property to acquire.

(D) *Employee compensation and overhead costs—(1) In general.* For purposes of this paragraph (d)(3), amounts paid for employee compensation (within the meaning of § 1.263(a)–4(e)(4)(ii)) and overhead are treated as amounts that do not facilitate the acquisition of real or personal property. See section 263A for the treatment of employee compensation and overhead costs required to be capitalized to property produced by the taxpayer or to property acquired for resale.

(2) *Election to capitalize.* A taxpayer may elect to treat amounts paid for employee compensation or overhead as amounts that facilitate the acquisition of property. The election is made separately for each acquisition and applies to employee compensation or overhead, or both. For example, a taxpayer may elect to treat overhead, but not employee compensation, as amounts that facilitate the acquisition of property. A taxpayer makes the election by treating the amounts to which the election applies as amounts that facilitate the acquisition in the taxpayer's timely filed original Federal income tax return (including extensions) for the taxable year during which the amounts are paid. In the case of an S corporation or partnership, the election is made by the S corporation or by the partnership, and not by the shareholders or partners. A taxpayer may revoke an election made under this paragraph (d)(3)(ii)(D)(2) with respect to each acquisition only by filing a request for a private letter ruling and obtaining the Commissioner's consent to revoke the election. An election may not be made or revoked through the filing of an application for change in accounting method or by an amended Federal income tax return.

(iii) *Treatment of transaction costs.* All amounts paid to facilitate the acquisition or production of real or personal property are capital expenditures. Inherently facilitative amounts allocable to real or personal property are capital expenditures

related to such property even if the property is not eventually acquired or produced. Facilitative amounts allocable to real or personal property actually acquired or produced must be included in the basis of the property acquired or produced. See paragraph (f) of this section for the recovery of capitalized amounts.

(iv) *Examples.* The following examples illustrate the rules of this paragraph (d)(3):

Example 1. Broker's fees to facilitate an acquisition. X decides to purchase a building in which to relocate its offices and hires a real estate broker to find a suitable building. X pays fees to the broker to find property for X to acquire. Under paragraph (d)(3)(i) of this section, X must capitalize the amounts paid to the broker because these costs are inherently facilitative of the acquisition of real property.

Example 2. Inspection and survey costs to facilitate an acquisition. X decides to purchase building A and pays amounts to third-party contractors for a termite inspection and an environmental survey of building A. Under paragraph (d)(3)(i) of this section, X must capitalize the amounts paid for the inspection and the survey of the building because these costs are inherently facilitative of the acquisition of real property.

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

Example 4. Scope of facilitate. X is in the business of providing legal services to clients. X is interested in acquiring a new conference table for its office. X hires and incurs fees for an interior designer to shop for, evaluate, and make recommendations to X regarding which new table to acquire. Under paragraph (d)(3)(i) of this section, X must capitalize the amounts paid to the interior designer to provide these services because they are paid in the process of investigating or otherwise pursuing the acquisition of personal property.

Example 5. Transaction costs allocable to other property. X, a retailer, wants to acquire land for the purpose of building a new distribution facility for its products. X considers various properties on highway A in state B. In evaluating the feasibility of several sites, X incurs fees for the services of an architect to advise and prepare preliminary plans for a facility that X is reasonably likely to construct at one of the sites. The architect's fees are not inherently facilitative to the acquisition of land, but are inherently facilitative to the acquisition of a building under paragraph (d)(3)(ii)(B)(10) of this section. In addition, these costs are allocable as construction costs of the building under section 263A. Therefore, X does not capitalize these fees as amounts to acquire the building under paragraph (d)(3)(ii)(B) of

this section, but instead must capitalize these costs as indirect costs allocable to the production of property under section 263A.

Example 6. Special rule for acquisitions of real property. X owns several retail stores. X decides to examine the feasibility of opening a new store in City A. In October 2008, X hires and incurs costs for a development consulting firm to study City A and perform market surveys, evaluate zoning and environmental requirements, and make preliminary reports and recommendations as to areas that X should consider for purposes of locating a new store. In December 2008, X continues to consider whether to purchase real property in City A and which property to acquire. X hires, and incurs fees for, an appraiser to perform appraisals on two different sites to determine a fair offering price for each site. In March 2009, X decides to acquire one of these two sites for the location of its new store. At the same time, X determines not to acquire the other site. Under paragraph (d)(3)(ii)(C) of this section, X is not required to capitalize amounts paid to the development consultant in 2008 because the amounts relate to activities performed in the process of determining whether to acquire real property and which real property to acquire and the amounts are not inherently facilitative costs under paragraph (d)(3)(ii)(B) of this section. However, X must capitalize amounts paid to the appraiser in 2008 because the appraisal costs are inherently facilitative costs under paragraph (d)(3)(ii)(B)(2) of this section. In 2009, X must include the appraisal costs allocable to property acquired in the basis of the property acquired and may recover the appraisal costs allocable to the property not acquired in accordance with paragraph (f) of this section.

Example 7. Employee compensation and overhead. X, a freight carrier, maintains an acquisition department whose sole function is to arrange for the purchase of vehicles and aircraft from manufacturers or other parties to be used in its freight carrying business. As provided in paragraph (d)(3)(ii)(D)(1) of this section, X is not required to capitalize any portion of the compensation paid to employees in its acquisition department or any portion of its overhead allocable to its acquisition department. However, under paragraph (d)(3)(ii)(D)(2) of this section, X may elect to capitalize the compensation and overhead costs allocable to the acquisition of a vehicle or aircraft by treating these amounts as costs that facilitate the acquisition of that property in its timely filed original Federal income tax return for the year the amounts are paid.

(4) *De minimis rule—(i) In general.* Except as otherwise provided in this paragraph (d)(4), a taxpayer is not required to capitalize under paragraph (d) of this section amounts paid for the acquisition or production (including any amounts paid to facilitate the acquisition or production) of a unit of property (as determined under § 1.263(a)–3(d)(2)) if—

(A) The taxpayer has an applicable financial statement (as defined in § 1.263(a)–2(d)(4)(vi));

(B) The taxpayer has at the beginning of the taxable year, written accounting procedures treating as an expense for non-tax purposes the amounts paid for property costing less than a certain dollar amount;

(C) The taxpayer treats the amounts paid during the taxable year as an expense on its applicable financial statement in accordance with its written accounting procedures; and

(D) The total aggregate of amounts paid and not capitalized under paragraphs (d)(4)(i)(A), (B), and (C) of this section for the taxable year do not distort the taxpayer's income for the taxable year.

(ii) *Exceptions to de minimis rule.* The de minimis rule in paragraph (d)(4)(i) of this section does not apply to the following:

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

(B) Amounts paid for property that is or is intended to be included in property produced or acquired for resale.

(C) Amounts paid for land.

(iii) *Safe harbor.* The total aggregate amount that is not required to be capitalized under the de minimis rule of paragraphs (d)(4)(i)(A), (B) and (C) of this section for the taxable year is deemed to not distort the taxpayer's income under paragraph (d)(4)(i)(D) of this section if this amount, added to the amount the taxpayer deducts in the taxable year as materials and supplies under the definition provided under § 1.162-3(d)(1)(iii) (relating to certain property costing \$100 or less), is less than or equal to the lesser of—

(A) 0.1 percent of the taxpayer's gross receipts for the taxable year; or

(B) 2 percent of the taxpayer's total depreciation and amortization expense for the taxable year as determined in its applicable financial statement.

(iv) *Additional rules.* Property to which a taxpayer applies the de minimis rule contained in paragraph (d)(4) of this section is not treated upon sale or disposition as a capital asset under section 1221 or as property used in the trade or business under section 1231. Property to which a taxpayer applies the de minimis rule contained in paragraph (d)(4) of this section is not a material or supply under § 1.162-3. The cost of property to which a taxpayer properly applies the de minimis rule contained in paragraph (d)(4) of this section is not required to be capitalized under section 263A to a separate unit of property, but may be required to be capitalized as a cost of other property if incurred by reason of the production of the other property. See, for example, § 1.263A-1(e)(3)(ii)(O) requiring

taxpayers to capitalize repair and maintenance costs allocable to property produced or acquired for resale.

(v) *Election to capitalize.* A taxpayer may elect not to apply the de minimis rule contained in paragraph (d)(4)(i) of this section. An election made under this paragraph (d)(4)(v) applies to any unit of property during the taxable year to which paragraphs (d)(4)(i)(A), (B), and (C) of this section would apply (but for the election under this paragraph (d)(4)(v)). A taxpayer makes the election by treating the amount paid as a capital expenditure in its timely filed original Federal income tax return (including extensions) for the taxable year in which the amount is paid. In the case of an S corporation or partnership, the election is made by the S corporation or by the partnership, and not by the shareholders or partners. A taxpayer may revoke an election made under this paragraph (d)(4)(v) with respect to a unit of property only by filing a request for a private letter ruling and obtaining the Commissioner's consent to revoke the election. An election may not be made or revoked through the filing of an application for change in accounting method or by an amended Federal income tax return.

(vi) *Definition of applicable financial statement.* For purposes of this paragraph (d)(4), the taxpayer's applicable financial statement is the taxpayer's financial statement listed in paragraphs (d)(4)(vi)(A) through (C) of this section that has the highest priority (including within paragraph (d)(4)(iv)(B) of this section). The financial statements are, in descending priority—

(A) A financial statement required to be filed with the Securities and Exchange Commission (SEC) (the 10-K or the Annual Statement to Shareholders);

(B) A certified audited financial statement that is accompanied by the report of an independent CPA (or in the case of a foreign entity, by the report of a similarly qualified independent professional), that is used for—

(1) Credit purposes;

(2) Reporting to shareholders, partners, or similar persons; or

(3) Any other substantial non-tax purpose; or

(C) A financial statement (other than a tax return) required to be provided to the Federal or a state government or any Federal or state agencies (other than the SEC or the Internal Revenue Service).

(vii) *Examples.* The following examples illustrate the rule of this paragraph (d)(4):

Example 1. De minimis rule. X purchases 10 printers at \$200 each for a total cost of

\$2000. Assume that each printer is a unit of property under § 1.263(a)-3(d)(2). X has an applicable financial statement. X has a written policy at the beginning of the taxable year to expense amounts paid for property costing less than \$500. X treats the amounts paid for the printers as an expense on its applicable financial statement. Assuming the total aggregate amounts not capitalized under the de minimis rule for the taxable year do not distort the taxpayer's income, X is not required to capitalize the amounts paid for the printers.

Example 2. De minimis rule safe harbor not met. X is a member of an affiliated group that files a consolidated return. In 2008, X purchases 300 computers at \$400 each for a total cost of \$120,000. Assume that each computer is a unit of property under § 1.263(a)-3(d)(2). X has a written policy at the beginning of the taxable year to expense amounts paid for property costing less than \$500. X treats the amounts paid for the computers as an expense on its applicable financial statement. In addition, in 2008 X purchases 300 desk chairs for \$50 each for a total cost of \$15,000. X intends to deduct the amounts paid for the desk chairs when used or consumed as non-incidentals materials and supplies under § 1.162-3(a)(1) and § 1.162-3(d)(1)(iii) because they are units of property costing less than \$100. For its 2008 taxable year, X has gross receipts of \$125,000,000 and reports \$7,000,000 of depreciation and amortization on its applicable financial statement. Thus, in order to meet the de minimis rule safe harbor for 2008, the sum of the amounts not required to be capitalized under the de minimis rule for 2008 (\$120,000) plus the amounts X intends to deduct as materials and supplies under § 1.162-3(a)(1) and § 1.162-3(d)(1)(iii) for 2008 (\$15,000), must be less than or equal to \$125,000 (0.1% of X's total gross receipts of \$125,000,000), which is less than \$140,000 (2% of X's total depreciation and amortization of \$7,000,000). Because \$135,000 (\$120,000 + \$15,000) exceeds \$125,000, X will not meet the de minimis rule safe harbor for its 2008 taxable year. As a result, to apply the de minimis rule to the \$120,000 paid to acquire the computers, X will have to otherwise establish that this amount does not distort the taxpayer's income in 2008.

Example 3. De minimis rule safe harbor met. Assume the same facts as in *Example 2*, except X makes an election under paragraph (d)(4)(v) of this section to capitalize the \$10,000 paid to acquire 25 of the 300 computers at \$400 each. In this case, X is not required to capitalize the \$110,000 paid to acquire the remaining 275 computers under paragraph (d)(4)(i) because this amount, when added to the \$15,000 that X intends to deduct in 2008 as materials and supplies under § 1.162-3(a)(1) and § 1.162-3(d)(1)(iii), does not exceed the de minimis rule safe harbor of \$125,000 for 2008.

Example 4. De minimis rule safe harbor; election to capitalize. Assume the same facts as in *Example 2*, except X does not otherwise establish that the deduction of amounts in excess of the \$125,000 safe harbor do not distort X's income in 2008. Rather, X makes an election under § 1.162-3(d) to capitalize

\$10,000 paid to acquire 200 of the 300 desk chairs at \$50 each. In this case, X is not required to capitalize the \$120,000 paid to acquire the 300 computers under paragraph (d)(4)(i) of this section because this amount, when added to the \$5000 (the remaining 100 desk chairs at \$50 each) that X intends to deduct in 2008 as materials and supplies under § 1.162-3(a)(1) and § 1.162-3(d)(1)(iii), does not exceed the de minimis rule safe harbor of \$125,000 for 2008.

(e) *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. See section 263A for the treatment of amounts referred to in this section as well as other amounts paid in connection with the production of real property and personal property, including films, sound recordings, video tapes, books, or similar properties.

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

(2) *Examples.* The following examples illustrate the rule of this paragraph (f)(1). Assume that X does not apply the de minimis rule under paragraph (d)(4) of this section.

Example 1. Recovery when property placed in service. X owns a 10-unit apartment building. The refrigerator in one of the apartments stops functioning and X purchases a new refrigerator to replace the old one. X pays for the acquisition, delivery, and installation of the new refrigerator to replace the old refrigerator. Assume that the refrigerator is the unit of property, as determined under § 1.263(a)-3(d)(2), and is not a material or supply under § 1.162-3. Under paragraph (d) of this section, X is required to capitalize the amounts paid for the acquisition, delivery, and installation of the refrigerator. Under this paragraph (f), the capitalized amounts are recovered through depreciation when the refrigerator is placed in service by X.

Example 2. Recovery when property used in the production of property. X operates a plant where it manufactures widgets. X 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(d)(2), and is not a material or supply under § 1.162-3. Under paragraph (d) of this section, X is required to capitalize the amounts paid to

acquire the tractor/loader. Under this paragraph (f), the capitalized amounts are recovered through depreciation when the tractor/loader is placed in service by X. However, because the tractor/loader is used in the production of property, under section 263A the cost recovery (that is, the depreciation) on the capitalized amounts must be capitalized to X's property produced, and consequently, recovered through cost of goods sold. See § 1.263A-1(e)(3)(ii)(I).

(g) [Reserved]

(h) *Effective/applicability date.* The rules in this section apply to taxable years beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Par. 8. Section 1.263(a)-3 is revised to read as follows:

§ 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 rules for determining the treatment of amounts paid to improve tangible property, including rules for determining the appropriate unit of property. Paragraph (e) of this section provides a safe harbor for routine maintenance costs. Paragraph (f) of this section provides rules for determining whether amounts paid result in betterments to the unit of property. Paragraph (g) of this section provides rules for determining whether amounts paid restore the unit of property. Paragraph (h) of this section provides rules for amounts paid to adapt the unit of property to a new or different use. Paragraph (i) of this section provides an optional regulatory accounting method safe harbor. Paragraph (j) of this section provides an optional repair allowance. Paragraphs (k) through (m) of this section provide additional rules related to these provisions. Paragraph (n) of this section provides the applicability date of 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) *Applicable financial statement.* The *applicable financial statement* is the taxpayer's financial statement listed in paragraphs (b)(4)(i) through (iii) of this section that has the highest priority (including within paragraph (b)(4)(ii) of this section). The financial statements are, in descending priority—

(i) A financial statement required to be filed with the Securities and Exchange Commission (SEC) (the 10-K or the Annual Statement to Shareholders);

(ii) A certified audited financial statement that is accompanied by the report of an independent CPA (or in the case of a foreign entity, by the report of a similarly qualified independent professional), that is used for—

(A) Credit purposes,
(B) Reporting to shareholders, partners, or similar persons; or
(C) Any other substantial non-tax purpose; or

(iii) A financial statement (other than a tax return) required to be provided to the Federal or a state government or any Federal or state agencies (other than the SEC or the Internal Revenue Service).

(c) *Coordination with other provisions of the Internal Revenue 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 regulations (other than section 162(a) or section 212 and the regulations under those sections). See, for example, § 1.263A-1(e)(3), requiring taxpayers to capitalize costs that directly benefit or are incurred by reason of the performance of the production or resale activities, including repair and maintenance costs allocable to property produced or acquired for resale.

(2) *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) *Improved property*—(1) *Capitalization rule.* Except as provided in the optional regulatory accounting method in paragraph (i) of this section or under any repair allowance method published in accordance with paragraph (j) of this section, a taxpayer must capitalize the aggregate of related amounts paid to improve a unit of property, whether the improvements are made by the taxpayer or by a third party, and whether the taxpayer is an owner or lessee of the property. For purposes of this section, a unit of property includes units of property for which the acquisition or production costs were deducted as materials and supplies under § 1.162-3(a)(1) or under the de minimis rule in § 1.263(a)-2(d)(4). See section 263A for the costs required to be capitalized to property produced by the taxpayer or to property acquired for resale; section 1016 for adding capitalized amounts to the basis of the unit of property; and section 168 for 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—

(i) Result in a betterment to the unit of property (see paragraph (f) of this section); or

(ii) Restore the unit of property (see paragraph (g) of this section); or

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

(2) *Determining the appropriate unit of property*—(i) *In general.* The unit of property rules in this paragraph (d)(2) 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(d). In general, the unit of property determination is based upon the functional interdependence standard provided in paragraph (d)(2)(iii)(A) of this section. However, special rules are provided for buildings (see paragraph (d)(2)(ii) of this section), plant property (see paragraph (d)(2)(iii)(B) of this section), and network assets (see paragraph (d)(2)(iii)(C) of this section). Additional rules are provided if a taxpayer has assigned different financial statement economic useful lives or MACRS classes or depreciation methods to components of property (see paragraph (d)(2)(iii)(D) of this section). Property that is aggregated and 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. In addition, an improvement to a unit of property as determined under this section, other than a leasehold improvement, is not a unit of property separate from the unit of property improved.

(ii) *Buildings and structural components.* In the case of a building (as defined in § 1.48-1(e)(1)), the building and its structural components (as defined in § 1.48-1(e)(2)) are a single unit of property. In the case of a leasehold improvement made by a lessee and that is section 1250 property, the leasehold improvement is a separate unit of property. In the case of a taxpayer that owns or occupies an individual unit in a building with multiple units (such as a condominium or cooperative), the unit of property is the individual unit owned and/or occupied by the taxpayer.

(iii) *Property other than buildings*—(A) *In general.* Except as provided in paragraph (d)(2)(iii)(B), (C) and (D) of this section, in the case of real or personal property other than property described in paragraph (d)(2)(ii) 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.

(B) *Plant property*—(1) *Definition.* For purposes of this paragraph (d)(2) of this section, 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.

(2) *Unit of property for plant property.* In the case of plant property, a unit of property is comprised of each component (or group of components) within the unit of property determined under the general rule of paragraph (d)(2)(iii)(A) of this section that performs a discrete and major function or operation within the functionally interdependent machinery or equipment.

(C) *Network assets*—(1) *Definition.* For purposes of this paragraph (d)(2), 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 a structural component of a building under paragraph (d)(2)(ii) 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.

(2) [Reserved]

(D) *Additional rules.* Notwithstanding the unit of property determination under paragraphs (d)(2)(iii)(A), (B), and (C) of this section, a component (or a group of components) of a unit property must be treated as a separate unit of property if—

(1) At the time the unit of property (as determined under paragraph (d)(2)(iii)(A), (B), and (C) of this section) is placed in service by the taxpayer (without regard to subsequent improvements), the taxpayer has recorded on its books and records for financial or regulatory accounting purposes an economic useful life for the component that is different from the economic useful life of the unit of property of which the component is a part; or

(2) 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, at the time the component was placed in service by the taxpayer, has properly depreciated the component using a different depreciation method under section 167 or section 168 than the depreciation method of the unit of property of which the component is a part.

(iv) *Examples.* The rules of this paragraph (d)(2) are illustrated by the following examples, in which it is assumed that the taxpayer has not made a general asset account election with regard to property or accounted for property in a multiple asset account.

Example 1. Buildings and structural components; plant property. X owns a building containing various types of manufacturing equipment that are not structural components of the building. Because the property is a building, as defined in § 1.48-1(e)(1), the unit of property for the building must be determined under paragraph (d)(2)(ii) of this section. Under the rules of that paragraph, X must treat the building and all its structural components as a single unit of property. In addition, because the manufacturing equipment contained within the building constitutes property other than a building, the units of property for the manufacturing equipment are initially determined under the general rule in paragraph (d)(2)(iii)(A) of this section and are therefore comprised of all the components that are functionally interdependent. Moreover, because the manufacturing equipment is plant property, under

paragraph (d)(2)(iii)(B) of this section, the units of property under the general rule are further divided into smaller units of property by determining the components (or groups of components) that perform discrete and major functions within the plant. Finally, X must apply the additional rules in paragraph (d)(2)(iii)(D) of this section to determine whether any of the units of property determined under paragraphs (d)(2)(iii)(A) and (B) of this section contain components that must be treated as separate units of property.

Example 2. Buildings and structural components; property other than plants. X, a manufacturer, owns a building adjacent to its manufacturing facility that contains office space and related facilities for X's employees that manage and administer X's manufacturing operations. The office building contains equipment, such as desks, chairs, computers, telephones, and bookshelves, that are not structural components of the building. Because the office building is a building, as defined in § 1.48-1(e)(1), the unit of property for the building must be determined under paragraph (d)(2)(ii) of this section. Under the rules of that paragraph, X must treat the office building and all its structural components as a single unit of property. In addition, because the equipment contained within the office building constitutes property other than a building, the units of property for the office equipment are initially determined under the general rule in paragraph (d)(2)(iii)(A) of this section and are comprised of the groups of components that are functionally interdependent. X then must apply the additional rules in paragraph (d)(2)(iii)(D) of this section to determine whether any of the units of property determined under paragraph (d)(2)(iii)(A) of this section contain components that must be treated as separate units of property.

Example 3. Plant property; discrete and major function. X 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), four pulverizers that grind coal, one 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. When X placed the plant into service, X recorded all the components of the plant as having the same economic useful life on its books and records for financial and regulatory accounting purposes. X also treated all the components of the plant as being within the same class of property under section 168(e) and has depreciated all the components using the same depreciation methods. 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 (d)(2)(iii)(A) 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 (d)(2)(iii)(B) 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, X must treat the structure, the boiler, the turbine, and the generator each as a separate unit of property, and each of the four pulverizers as a separate unit of property because each of these components performs a discrete and major function within the power plant. X is not required to 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 4. Plant property; discrete and major function. X is engaged in a uniform and linen rental business that operates a plant to treat and launder items used in its business. Within the plant X utilizes an assembly line-like process that incorporates many different machines and equipment to launder and prepare the items to be returned to customers. X 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 several sorters, boilers, washers, dryers, ironers, folders, and waste water treatment systems. Because the laundering equipment contained within the plant is personal property, the unit of property for the laundering equipment is initially determined under the general rule in paragraph (d)(2)(iii)(A) 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 (d)(2)(iii)(B) of this section, the initial units of property are further divided into smaller units of property by determining the components (or groups of components) that perform discrete and major functions within the line. Under paragraph (d)(2)(iii)(B) of this section, X 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. Finally, X must apply the additional rules in paragraph (d)(2)(iii)(D) of this section to determine whether any of the units of property determined under paragraph (d)(2)(iii)(B) of this section contain components that must be treated as separate units of property.

Example 5. Plant property; industrial process. X operates a restaurant that prepares and serves food to retail customers. Within its restaurant, X has a large piece of equipment that uses an assembly line-like process to prepare and cook tortillas that X serves to its customers. Because the tortilla-making equipment is personal property, the unit of property for the equipment is initially determined under the general rule in

paragraph (d)(2)(iii)(A) 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. Although the equipment is used to perform a manufacturing process, the equipment is not being used in an industrial process, as it performs a small-scale function as part of X's retail restaurant operations. Therefore, the equipment is not plant property under paragraph (d)(2)(iii)(B) of this section. Finally, X must apply the additional rules in paragraph (d)(2)(iii)(D) of this section to determine whether the equipment contains components that must be treated as separate units of property.

Example 6. Personal property. X owns locomotives that it uses in its railroad business. Each locomotive consists of various components, such as an engine, generators, batteries and trucks. X acquired a locomotive with all its components and recorded all the components as having the same economic useful life on its books and records for financial and regulatory accounting. X also treated all the components of the locomotive as being within the same class of property under section 168(e) and has depreciated all the components using the same depreciation methods. Because X's locomotive is property other than a building, the initial unit of property is determined under paragraph (d)(2)(iii)(A) of this section. Under this paragraph, the locomotive is a single unit of property because it consists entirely of components that are functionally interdependent. Because the additional rules under paragraph (d)(2)(iii)(D) of this section do not apply under these facts, the locomotive is a single unit of property.

Example 7. Personal property. X is engaged in the business of transporting freight throughout the United States. To conduct its business, X owns a fleet of tractors and trailers. Each tractor and trailer is comprised of various components, including tires. X purchases a truck trailer with all of its components, including 16 tires. At the time the trailer was placed in service by X, X treated the trailer and the tires as being within the same class of property under section 168(e) and has depreciated all the components using the same depreciation methods. However, on its books and records for financial accounting purposes, X recorded economic useful lives for the tires that were different from the economic useful life that it recorded for the trailer. Because X's trailer is property other than a building, the initial units of property for the trailer are determined under the general rule in paragraph (d)(2)(iii)(A) of this section and are comprised of all the components that are functionally interdependent. Under this rule, the truck trailer, including its 16 tires, is a single unit of property because the trailer and the tires are functionally interdependent (that is, the placing in service of the tires is dependent upon the placing in service of the trailer). X then must apply the additional rules in paragraph (d)(2)(iii)(D) of this section to determine whether the initial unit of property determined under paragraph

(d)(2)(iii)(A) of this section contains components that must be treated as separate units of property. Under paragraph (d)(2)(iii)(D)(1) of this section, because X recorded on its books and records economic useful lives for the tires that are different from the economic useful lives that it recorded for the trailer, the tires must be treated as separate units of property.

Example 8. Personal property. X provides legal services to customers. X purchased a laptop computer and a printer to be used by its employees in providing services. When X placed the computer and printer into service, X recorded both items and all their components as having the same economic useful life on its books and records for financial accounting purposes. X also treated the computer and printer and all their components as being within the same class of property under section 168(e) and has depreciated all the components using the same depreciation methods. Because the computer and printer are property other than a building, the initial units of property are determined under the general rule in paragraph (d)(2)(iii)(A) of this section and are comprised of the components that are functionally interdependent. Under this paragraph (d)(2)(iii)(A), 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). The additional rules in paragraph (d)(2)(iii)(D) of this section do not apply under these facts. Accordingly, the computer and the printer each constitute separate units of property.

(3) *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.

(4) *Repairs and maintenance performed during an improvement—(i) In general.* A taxpayer must capitalize all the direct costs of an improvement and all the indirect costs (including otherwise deductible repair costs) that directly benefit or are incurred by reason of an improvement in accordance with the rules under section 263A. 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.

(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 substantial capital improvements to property not used in the taxpayer's trade or business

or for the production of income if the repairs are done as part of a remodeling of the taxpayer's residence.

(5) *Aggregate of related amounts.* For purposes of paragraph (d)(1) of this section, the aggregate of related amounts paid to improve a unit of property may be incurred 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 and whether the costs are incurred by reason of a single improvement or directly benefit a single improvement.

(e) *Safe harbor for routine maintenance—(1) In general.* An amount paid for routine maintenance performed on a unit of property is deemed to not improve that unit of property. Routine maintenance 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 parts of the unit of property with comparable and commercially available and reasonable replacement parts. 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 (e)(4) of this section) of the unit of property. Among the factors to be considered in determining whether a taxpayer is performing routine maintenance are the recurring nature of the activity, industry practice, manufacturers' recommendations, the taxpayer's experience, and the taxpayer's treatment of the activity on its applicable financial statement (as defined in paragraph (b)(4) of this section). 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) *Exceptions.* Routine maintenance does not include the following—

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

(ii) Amounts paid for the replacement of a component of a unit of property if 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) Amounts paid for the repair of damage to a unit of property for which the taxpayer has taken a basis adjustment as a result of a casualty loss under section 165 or relating to a casualty event described in section 165; and

(iv) Amounts paid to 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.

(3) *Rotable or temporary spare parts.* For purposes of paragraph (e)(1) of this section, amounts paid for routine maintenance include routine maintenance performed on (and with regard to) rotable and temporary spare parts. But see § 1.162-3(b), which provides that rotable and temporary spare parts are used or consumed by the taxpayer in the taxable year in which the taxpayer disposes of the part.

(4) *Class life.* The class life of a unit of property is the recovery period prescribed for the property under section 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 paragraph (e), section 168(g)(3)(A) (relating to tax-exempt use property subject to lease) does not apply.

(5) *Examples.* The following examples illustrate the rules of this paragraph (e).

Example 1. Routine maintenance on rotable component. (i) X is a commercial airline engaged in the business of transporting passengers and freight throughout the United States and abroad. To conduct its business, X owns or leases various types of aircraft. As a condition of maintaining its airworthiness certification for these aircraft, X is required by the Federal Aviation Administration (FAA) to establish and adhere to a continuous maintenance program for each aircraft within its fleet. These programs, which are designed by X and the aircraft's manufacturer and approved by the FAA, are incorporated into each aircraft's maintenance manual. The maintenance manuals require a variety of periodic maintenance visits at various intervals. One type of maintenance visit is an engine shop visit (ESV), which X expects to perform on its aircraft engines approximately every 4 years in order to keep its aircraft in its ordinarily efficient operating condition. In 2004, X purchased a new aircraft and four new engines to use in that aircraft and later, in other aircraft in its fleet. The aircraft engines are rotable spare parts because they are removable from the aircraft, and repaired and reinstalled on other aircraft or stored for later installation on other aircraft. See § 1.162-3(b) (treatment of materials and supplies). In 2008, X 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 X's maintenance program, the part is repaired, or if necessary, replaced with a comparable and commercially available and reasonable replacement part. After the ESVs the engines are returned to X to be reinstalled on another aircraft or stored for later installation. Assume the unit of property for X's aircraft is the entire aircraft, including the aircraft engines, and that the class life for X's aircraft is 12 years. Assume that none of the exceptions set out in paragraph (e)(2) of this section applies to the costs of performing the ESVs.

(ii) Because the ESVs involve the recurring activities that X 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 X expects to perform more than once during the 12 year class life of the aircraft, X's ESVs are within the routine maintenance safe harbor under paragraph (e) of this section. Accordingly, the amounts paid by X for the ESVs are deemed not to improve the aircraft and are not required to be capitalized under paragraph (d)(1) of this section. For the treatment of costs to acquire the engines, see § 1.162-3.

Example 2. Routine maintenance after economic useful life. Assume the same facts as in *Example 1*, except that X incurs costs to perform an ESV on one of its aircraft engines in 2024, after the end of the economic useful life that X anticipated for 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 (e) of this section. Accordingly, the amounts paid by X for this ESV, even though performed after the economic useful life of the aircraft, are deemed not to improve the aircraft and are not required to be capitalized under paragraph (d)(1) of this section.

Example 3. Routine maintenance resulting from prior owner's use. (i) In January 2008, X 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. The machine is fully operational at the time it is purchased by X and is immediately placed in service in X's business. At the time it is placed in service by X, X 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 and reasonable replacement parts. At the time the machine is purchased, it is approaching the end of a three-year scheduled maintenance period. As a result, in February 2008, X incurs costs to perform the manufacturer recommended scheduled maintenance. Assume that none of the exceptions set out in paragraph (e)(2) of

this section apply to the amounts paid for the scheduled maintenance.

(ii) The majority of the costs incurred by X do not qualify under the routine maintenance safe harbor in paragraph (e) of this section because the costs were primarily incurred as a result of the prior owner's use of the property and not X's use. The condition of the machine at the time that it was placed in service by X was that of a machine nearing the end of a scheduled maintenance period. Accordingly, the amounts paid by X for the scheduled maintenance resulting from the prior owner's use of the property must be capitalized if those amounts result in a betterment under paragraph (f) of this section, including the amelioration of a material condition or defect, or otherwise result in an improvement under paragraph (d)(1) of this section. See also section 263A requiring taxpayers to capitalize the direct and allocable share of indirect costs of property produced or acquired for resale.

Example 4. Routine maintenance resulting from new owner's use. Assume the same facts as in *Example 3*, except that after X incurs costs for the maintenance in 2008, X continues to operate the machine in its manufacturing business. In 2011, X incurs costs 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 3* and that none of the exceptions set out in paragraph (e)(2) of this section apply to the amounts paid for the scheduled maintenance. Because the scheduled maintenance performed in 2011 involves the recurring activities that X 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 X expects to perform more than once during the 10 year class life of the machine, X's scheduled maintenance costs are within the routine maintenance safe harbor under paragraph (e) of this section. Accordingly, the amounts paid by X for the scheduled maintenance in 2011 are deemed not to improve the machine and are not required to be capitalized under paragraph (d)(1) of this section. However, because the amounts paid for the scheduled maintenance are incurred by reason of X's manufacturing operations, X is required to capitalize the amounts paid for the maintenance to products produced by X. See § 1.263A-1(e)(3)(ii).

Example 5. Routine maintenance; replacement of substantial structural part. X is in the business of producing commercial products for sale. As part of the production process, X places raw materials into lined containers in which a chemical reaction is used to convert raw materials into the finished product. The lining is a substantial structural part of the container, and comprises 60% of the total physical structure 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 X placed the container into service, X was aware that approximately every three years, X would be required to replace the lining in the container with

comparable and commercially available and reasonable replacement materials. At the end of that period, 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 2003, X acquired 10 new containers and placed them into service. In 2006, 2009, 2011, and 2014, X pays amounts to replace the containers' linings with comparable and commercially available and reasonable replacement parts. Assume that none of the exceptions set out in paragraph (e)(2) of this section apply to the amounts paid for the replacement linings. Because the replacement of the linings involves recurring activities that X 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 X expects to perform more than once during the 12 year class lives of the containers, X's lining replacement costs are within the routine maintenance safe harbor under paragraph (e) of this section. Accordingly, the amounts paid by X for the replacement of the container linings are deemed not to improve the containers and are not required to be capitalized under paragraph (d)(1) of this section. However, because the amounts paid to replace the container linings are incurred by reason of X's manufacturing operations, X is required to capitalize the amounts paid for the replacements to products produced by X. See § 1.263A-1(e)(3)(ii).

Example 6. Routine maintenance once during class life. X 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 X places a freight car into service, X expects to perform cyclical reconditioning to the car every 8 to 10 years in order to keep the freight car in ordinarily efficient operating condition. During this reconditioning, X incurs costs to disassemble, inspect, and recondition and/or replace components of the freight car with comparable and commercially available and reasonable replacement parts. Ten years after the freight car is placed in service by X, X incurs costs to perform a cyclical reconditioning on the car. Because X expects to perform the reconditioning only once during the 14 year class life of the freight car, the costs incurred for reconditioning do not qualify for the routine maintenance safe harbor under paragraph (e) of this section. Accordingly, X must capitalize the amounts paid for the reconditioning of the freight car if these amounts result in an improvement under paragraph (d)(1) of this section.

Example 7. Routine maintenance on non-rotatable part. X 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 X places its towboats into service, X is aware that approximately every three to four years, X 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 and reasonable replacement parts. Assume the towboat engines are not rotatable spare parts under § 1.162-3(b). In 2005, X acquired a new towboat, including its two engines, and placed the towboat into service. In 2009, X incurs amounts to perform scheduled maintenance on both engines in the towboat. Assume that none of the exceptions set out in paragraph (e)(2) of this section apply to the scheduled maintenance costs. Because the scheduled maintenance involves recurring activities that X expects to perform more than once during the 18 year class life of the towboat. This maintenance results from X's use of the towboat, and is performed to keep the towboat in an ordinarily efficient operating condition, the scheduled maintenance on X's towboat is within the routine maintenance safe harbor under paragraph (e) of this section. Accordingly, the amounts paid by X for the scheduled maintenance to its towboat engines in 2009 are deemed not to improve the towboat and are not required to be capitalized under paragraph (d)(1) of this section.

Example 8. Routine maintenance with betterments. Assume the same facts as *Example 7*, except that in 2013, X's towboat engines are due for another scheduled maintenance visit. At this time X decides to upgrade the engines to increase their horsepower and propulsion, which would permit the towboats to tow heavier loads. Accordingly, in 2013 X incurs costs 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, X incurs costs to upgrade certain engine parts to increase the towing capacity of the boats in excess of the capacity when the boats were placed in service by X. Both the scheduled maintenance procedures and the replacement of parts with new and upgraded parts are necessary to increase the horsepower of the engines and the towing capacity of the boat. Thus, the work done on the engines encompasses more than the recurring activities that X 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. In addition, the scheduled maintenance procedures directly benefit and are incurred by reason of the upgrades. Therefore, the amounts paid by X in 2013 for the maintenance and upgrade of the engines do not qualify for the routine maintenance safe harbor described under paragraph (e) of this section. These amounts must be capitalized if they result in a betterment under paragraph (f) of this section, including a material increase in the capacity of the towboat, or otherwise result

in an improvement under paragraph (d)(1) of this section. See also section 263A requiring taxpayers to capitalize all the direct costs of an improvement to property and all the indirect costs that directly benefit or are incurred by reason of an improvement to property.

Example 9. Exceptions to routine maintenance. X 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. When X placed the canals into service, X expected to have to perform major maintenance on the canals every 3 years to keep the canals in their ordinarily efficient operating condition. This maintenance included draining the canals, and then cleaning, inspecting, repairing, reconditioning or replacing parts of the canal with comparable and commercially available and reasonable replacement parts. X placed the canals into service in 2005 and did not perform any maintenance on the canals until 2010. At that time, the canals had fallen into a state of disrepair and no longer functioned for irrigation. In 2010, X paid amounts to drain the canals, and do extensive cleaning, repairing, reconditioning and replacing parts of the canals with comparable and commercially available and reasonable replacement parts. Although the work performed on X's canals was similar to the activities that X 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 (e)(2)(iv) of this section, routine maintenance does not include amounts paid to return a unit of property to its former ordinary efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use. Accordingly, amounts paid by X for work performed on the canals in 2010 must be capitalized if they result in improvements under paragraph (d)(1) of this section (for example, restorations under paragraph (g) of this section).

(f) *Capitalization of betterments—(1) In general.* A taxpayer must capitalize amounts paid that result in the betterment of a unit of property. An amount paid results in the betterment of 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) Results in a material addition (including a physical enlargement, expansion, or extension) to the unit of property; or

(iii) Results in a material increase in capacity (including additional cubic or square space), productivity, efficiency, strength, or quality of the unit of property or the output of the unit of property.

(2) *Application of general rule—(i) Facts and circumstances.* To determine whether an amount paid results in a betterment described in paragraph (f)(1) of this section, it is appropriate to consider all the facts and circumstances including, but not limited to, the purpose of the expenditure, the physical nature of the work performed, the effect of the expenditure on the unit of property, and the taxpayer's treatment of the expenditure on its applicable financial statement (as described in paragraph (b)(4) of this section).

(ii) *Unavailability of replacement parts.* If a taxpayer needs to replace part of a unit of property that cannot practicably 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.

(iii) *Appropriate comparison—(A) In general.* In cases in which a particular event necessitates an expenditure, the determination of whether an expenditure results in a betterment of the unit of property is made by comparing the condition of the property immediately after the expenditure with the condition of the property immediately prior to the circumstances necessitating the expenditure.

(B) *Normal wear and tear.* If the expenditure is made to correct the effects of normal wear and tear to the unit of property (including the amelioration of a condition or defect that existed prior to the taxpayer's acquisition of the unit of property resulting from normal wear and tear), 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) *Particular event.* If the expenditure is made as a result of a particular event, the condition of the property immediately prior to the circumstances necessitating the expenditure is the condition of the property immediately prior to the particular event.

(3) *Examples.* The following examples illustrate solely the rules of this paragraph (f). Even if capitalization is not required in an example under this paragraph (f), the amounts paid in the example may be subject to capitalization

under a different provision of this section.

Example 1. Amelioration of pre-existing material condition or defect. In 2008, X purchases a store located on a parcel of land that contained underground gasoline storage tanks left by prior occupants. Assume that the parcel of land is the unit of property. The tanks had leaked, causing soil contamination. X is not aware of the contamination at the time of purchase. In 2009, X discovers the contamination and incurs costs to remediate the soil. The remediation costs incurred by X result in a betterment to the land under paragraph (f)(1)(i) of this section because the costs were incurred to ameliorate a material condition or defect that existed prior to the taxpayer's acquisition of the land.

Example 2. Not amelioration of pre-existing condition or defect. X owned a building that was constructed with insulation that contained asbestos. The health dangers of asbestos were not widely known when the building was constructed. In 2008, X determined that certain areas of asbestos-containing insulation had begun to deteriorate and could eventually pose a health risk to employees. Therefore, X decided to remove the asbestos-containing insulation from the building and replace it with new insulation that was safer to employees, but no more efficient or effective than the asbestos insulation. Assume the building and its structural components (including the asbestos insulation) is the unit of property. The amounts paid to remove and replace the asbestos insulation are not required to be capitalized as a betterment under paragraphs (f)(1)(i) and (f)(2)(i) of this section because the asbestos, although later determined to be unsafe under certain circumstances, was not an inherent and material defect to the property. In addition, the removal and replacement of the asbestos did not result in any material additions to the building or material increases in capacity, productivity, efficiency, strength or quality of the building or the output of the building under paragraphs (f)(1)(ii) and (f)(1)(iii) of this section.

Example 3. Not amelioration of pre-existing material condition or defect. (i) In January 2008, X purchases a used machine for use in its manufacturing operations. Assume that the machine is a unit of property and it has a class life of 10 years. The machine is fully operational at the time it is purchased by X and is immediately placed in service in X's business. At the time it is placed in service by X, X expects to perform manufacturer recommended scheduled maintenance on the machine 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 and reasonable replacement parts. The scheduled maintenance does not result in any material additions or material increases in capacity, productivity, efficiency, strength or quality of the machine or the output of the machine. At the time the machine is purchased, it is approaching the end of a three-year scheduled maintenance period. As a result,

in February 2008, X incurs costs to perform the manufacturer recommended scheduled maintenance to keep the machine in its ordinarily efficient operating condition.

(ii) The majority of the costs incurred by X do not qualify under the routine maintenance safe harbor in paragraph (e) of this section because the costs were primarily incurred as a result of the prior owner's use of the property and not the taxpayer's use. The condition of the machine at the time that it was placed in service by X was that of a machine nearing the end of a scheduled maintenance period. Accordingly, the amounts paid by X for the scheduled maintenance resulting from the prior owner's use of the property ameliorate conditions or defects that existed prior to X's ownership of the machine. Nevertheless, considering the facts and circumstances under paragraph (f)(2)(i) of this section, including the purpose and minor nature of the work performed, those amounts do not ameliorate a material condition or defect under paragraph (f)(1)(i) of this section and accordingly do not result in a betterment that must be capitalized under this paragraph (f).

Example 4. Not amelioration of pre-existing material condition or defect. In 2008, X purchases a used ice resurfacing machine for use in the operation of its ice skating rink. To comply with local regulations, X is required to routinely monitor the air quality in the ice skating rink. One week after X places the machine into service, during a routine air quality check, X discovers that the operation of the machine is adversely affecting the air quality in the skating rink. As a result, X incurs costs to inspect and retune the machine, which includes replacing minor components of the engine, which had worn out prior to X's acquisition of the machine. Assume the resurfacing machine, including the engine, is the unit of property. The routine maintenance safe harbor in paragraph (e) of this section does not apply to the amounts paid because the activities performed do more than return the machine to the condition that existed at the time it was placed in service by X. The amounts paid by X to inspect, retune, and replace minor components of the ice resurfacing machine ameliorated a condition or defect that existed prior to X's acquisition of the equipment. Nevertheless, considering the facts and circumstances under paragraph (f)(2)(i) of this section, including the purpose and minor nature of the work performed, these amounts do not ameliorate a material condition or defect under paragraph (f)(1)(i) of this section, result in a material addition to the machine under paragraph (f)(1)(ii) of this section, or result in a material increase in the capacity, productivity, efficiency, strength or quality of the machine or the output of the machine. Accordingly, the amounts paid by X to inspect, retune, and replace minor components of the machine do not result in a betterment that must be capitalized under this paragraph (f).

Example 5. Amelioration of material condition or defect; increase in quality. (i) In January 2009, X 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, X is aware that the building is in a condition that is below the standards that X requires for facilities used in its business. Beginning in 2009 and over the next two years, while X continues to use the building as an assisted living facility, X incurs costs for repairs, maintenance, and the acquisition of new property to bring the facility into the high-quality condition for which X's facilities are known. The work includes repainting; replacing flooring materials, windows, and tiling and fixtures in bathrooms; replacing window treatments, furniture, and cabinets; and repairing or replacing roofing materials, heating and cooling systems. On its applicable financial statements, X capitalizes the costs of the repairs, maintenance, and acquisitions over the remaining economic useful life recorded for the building. Assume that the building, including its structural components, is a single unit of property and that each section 1245 property is a separate unit of property.

(ii) Considering the facts and circumstances under paragraph (f)(2)(i) of this section, including the purpose of the expenditures, the effect of the expenditures on the building, and the treatment of the expenditures in X's applicable financial statements, the amounts paid by X for repairs and maintenance to the building and its structural components ameliorated material conditions and defects that existed prior to X's acquisition of the building. In addition, these amounts materially increased the quality of the building as compared to the condition of the building when it was placed in service by X. Accordingly, the amounts paid by X for repairs and maintenance to the building and its structural components (that is, repainting, replacing windows, replacing bathroom fixtures, repairing and replacing roofing materials and heating and cooling systems) result in betterments that must be capitalized under this paragraph (f). Moreover, X is required to capitalize the amounts paid to acquire and install each section 1245 property, including the flooring materials, tiling, each window treatment, each item of furniture, and each cabinet, in accordance with § 1.263(a)-2(d).

Example 6. Not a betterment. X owns a nationwide chain of retail stores that sell a wide variety of items. To remain competitive in the industry, X periodically changes the layout and appearance of its stores. These changes include the reconfiguration of the stores to provide better exposure of the merchandise and cosmetic alterations to keep the store modern and attractive to customers. The work is not undertaken for the purpose of repairing damaged property but rather to renew the appearance of the property. X incurs costs to update 50 stores during the taxable year. In its applicable financial statement, X capitalizes all the costs of the updates over a 5-year period until which X anticipates it would have to update again. Assume that each store building, including its structural components, is a unit of property and that each section 1245 property within the store is a separate unit of property. Also assume that the work performed did not ameliorate any material conditions or defects that existed when X acquired the store

buildings or result in any material additions to the store buildings.

(ii) Considering the facts and circumstances under paragraph (f)(2)(i) of this section, including the purpose of the expenditure, the nature of the work performed, and the treatment of the work on X's applicable financial statements, the amounts paid by X for updates to its store buildings (including their structural components) do not result in material increases in capacity, productivity, efficiency, strength or quality of the store buildings. Accordingly, the amounts paid by X for the updates on the store buildings (including their structural components) do not result in betterments that must be capitalized under this paragraph (f). However, X is required to capitalize the amounts paid to acquire and install each section 1245 property in accordance with § 1.263(a)–2(d).

Example 7. Betterment; regulatory requirement. X owns a hotel in City that includes five foot high unreinforced terra cotta and concrete parapets with overhanging cornices around the entire roof perimeter. The parapets and cornices are in good condition. In 2008, City passes an ordinance setting higher safety standards for parapets and cornices because of the hazardous conditions caused by earthquakes. To comply with the ordinance, X replaces the old parapets and cornices with new ones made of glass fiber reinforced concrete, which makes them lighter and stronger than the original ones. They are attached to the hotel using welded connections instead of wire supports, making them more resistant to damage from lateral movement. Assume the hotel building and its structural components are the unit of property. The event necessitating the expenditure was the 2008 City ordinance. Prior to the ordinance, the old parapets and cornices were in good condition, but were determined by City to create a potential hazard. After the expenditure, the new parapets and cornices materially increased the structural soundness (that is, the strength) of the hotel building. Therefore, the amounts paid by X to replace the parapets and cornices must be capitalized because they resulted in a betterment to the hotel. City's requirement that X correct the potential hazard to continue operating the hotel is not relevant in determining whether the amount paid improved the hotel. See paragraph (d)(3) of this section.

Example 8. Not a betterment; regulatory requirement. X owns a meat processing plant. In 2008, X discovers that oil was seeping through the concrete walls of the plant, creating a fire hazard. Federal meat inspectors advise X that it must correct the seepage problem or shut down its plant. To correct the problem, X incurs costs 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. Assume the plant building and its structural components are the unit of property. The event necessitating the expenditure was the seepage of the oil. Prior to the seepage, the plant did not leak and was functioning for its intended use. The expenditure did not result in a material addition or material increase in

capacity, productivity, efficiency, strength or quality of the plant or its output of compared to the condition of the plant prior to the seepage of the oil. Therefore, the amounts paid by X to correct the seepage do not result in a betterment to the plant. X is not required to capitalize as an improvement under this paragraph (f) amounts paid to correct the seepage problem. The Federal meat inspectors' requirement that X correct the seepage to continue operating the plant is not relevant in determining whether the amount paid improved the plant. See paragraph (d)(3) of this section.

Example 9. Not a betterment; replacement with same part. X owns a small retail shop. In 2008, a storm damages the roof of X's shop by displacing numerous wooden shingles. X decides to replace all the wooden shingles on the roof and hires a contractor to replace all the shingles on the roof with new wooden shingles. Assume the shop building and its structural components are the unit of property. The event necessitating the expenditure was the storm. Prior to the storm, the retail shop was functioning for its intended use. The expenditure did not result in a material addition, or material increase in the capacity, productivity, efficiency, strength or quality of the shop or the output of the shop compared to the condition of the shop prior to the storm. Therefore, the amounts paid by X to reshingle the roof with wooden shingles do not result in betterment to the shop building. X is not required to capitalize as an improvement under this paragraph (f) amounts paid to replace the shingles.

Example 10. Not a betterment; replacement with comparable part. Assume the same facts as in *Example 9*, except that wooden shingles are not available on the market. X decides to replace all the wooden shingles with comparable asphalt shingles. The amounts paid by X to reshingle the roof with asphalt shingles do not result in a betterment to the shop, even though the asphalt shingles may be stronger than the wooden shingles. Because the wooden shingles could not practically be replaced with new wooden shingles, the replacement of the old shingles with comparable asphalt shingles does not, by itself, result in an improvement to the shop. X is not required to capitalize as an improvement under this paragraph (f) amounts paid to replace the shingles.

Example 11. Betterment; replacement with improved parts. Assume the same facts as in *Example 9*, except that, instead of replacing the wooden shingles with asphalt shingles, X decides to replace all the wooden shingles with shingles made of lightweight composite materials that are maintenance-free and do not absorb moisture. The new shingles have a 50-year warranty and a Class A fire rating. The expenditure for these shingles resulted in a material increase in the quality of the shop building as compared to the condition of the shop building prior to the storm. X must capitalize amounts paid to reshingle the roof as an improvement under this paragraph (f) because they result in a betterment to the shop.

Example 12. Material increase in capacity. X owns a factory building with a storage area on the second floor. In 2008, X replaces 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. Assume the factory building and its structural components are the unit of property. X must capitalize as an improvement amounts paid for the columns and girders because they result in a material increase in the load-carrying capacity of the building. The comparison rule in paragraph (f)(2)(iii) of this section does not apply to these amounts paid because the expenditure was not necessitated by a particular event.

Example 13. Material increase in capacity. In 2008, X purchases 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 is 150 feet wide, 1,000 feet long, and 10 feet deep. To allow for ingress and egress and for the unloading of its barges, X needs to deepen the channel to a depth of 20 feet. X hires a contractor to dredge the channel to the required depth. Assume the channel is the unit of property. X must capitalize as an improvement amounts paid for the dredging because it resulted in a material increase in the capacity of the channel. The comparison rule in paragraph (f)(2)(iii) of this section does not apply to these amounts paid because the expenditure was not necessitated by a particular event.

Example 14. Not a material increase in capacity. Assume the same facts as in *Example 13*, except that the channel was susceptible to siltation and, by 2009, the channel depth had been reduced to 18 feet. X hired a contractor to redredge the channel to a depth of 20 feet. The event necessitating the expenditure was the siltation of the channel. Both prior to the siltation and after the redredging, the depth of the channel was 20 feet. Therefore, the amounts paid by X for redredging the channel did not result in a material addition to the unit of property or a material increase in the capacity, productivity, efficiency, strength or quality of the unit of property or the output of the unit of property. X is not required to capitalize as a betterment under paragraph (f) of this section amounts paid to redredge the channel.

Example 15. Not a material increase in capacity. X owns a building used in its trade or business. The first floor has a drop-ceiling. X decides to remove the drop-ceiling and repaint the original ceiling. Assume the building and its structural components are the unit of property. The removal of the drop-ceiling does not create additional capacity in the building that was not there prior to the removal. Therefore, the amounts paid by X to remove the drop-ceiling and repaint the original ceiling did not result in a material addition or a material increase to the capacity, productivity, efficiency, strength or quality of the unit of property or output of the unit of property. X is not required to capitalize as a betterment under this paragraph (f) amounts paid related to removing the drop-ceiling. The comparison rule in paragraph (f)(2)(iii) of this section does not apply to these amounts paid because the expenditure was not necessitated by a particular event.

(g) *Capitalization of restorations*—(1) *In general.* A taxpayer must capitalize amounts paid to restore a unit of property, including amounts paid in making good the exhaustion for which an allowance is or has been made. An amount is paid to restore a unit of property if it—

(i) Is for the replacement of a component of a unit of property and 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 and 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 repair of damage to a unit of property for which the taxpayer has properly taken a basis adjustment as a result of a casualty loss under section 165, or relating to a casualty event described in section 165;

(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 after the end of its economic useful life (see paragraph (g)(2) of this section); or

(vi) Is for the replacement of a major component or a substantial structural part of the unit of property (see paragraph (g)(3) of this section).

(2) *Rebuild to like-new condition*—(i) *In general.* For purposes of paragraph (g)(1)(v) of this section, the following definitions apply:

(1) *Like-new condition.* A unit of property is rebuilt to a like-new condition if it is brought to the status of new, rebuilt, remanufactured, or similar status under the terms of any Federal regulatory guideline or the manufacturer's original specifications.

(2) *Economic useful life.* The economic useful life of a unit of property is not necessarily the useful life inherent in the property but is the period over which the property may reasonably be expected to be useful to the taxpayer or, if the taxpayer is engaged in a trade or business or an activity for the production of income, the period over which the property may reasonably be expected to be useful to the taxpayer in its trade or business or for the production of income, as applicable. See § 1.167(a)-1(b) for the factors to be considered in determining this period.

(ii) *Exception.* An amount paid is not required to be capitalized under paragraph (g)(1)(v) of this section if it is

paid during the recovery period prescribed in section 168(c) (taking into account the applicable convention) for the property, regardless of whether the property is depreciated under section 168(a).

(3) *Replacement of a major component or a substantial structural part*—(i) *In general.* For purposes of paragraph (g)(1)(vi) of this section, the replacement of a major component or a substantial structural part means the replacement of—

(1) A part or a combination of parts of the unit of property, the cost of which comprises 50 percent or more of the replacement cost of the unit of property; or

(2) A part or a combination of parts of the unit of property that comprise 50 percent or more of the physical structure of the unit of property.

(ii) *Exception.* An amount paid is not required to be capitalized under paragraph (g)(1)(vi) of this section if it is paid during the recovery period prescribed in section 168(c) (taking into account the applicable convention) for the property, regardless of whether the property is depreciated under section 168(a).

(4) *Examples.* The following examples illustrate solely the rules of this paragraph (g). Even if capitalization is not required in an example under the cited subparagraph under this paragraph (g), the amounts paid in the example may be subject to capitalization under a different provision of this section, or under a different subparagraph in this paragraph (g).

Example 1. Replacement of loss component. X owns a manufacturing building containing various types of manufacturing equipment. X does a cost segregation study of the manufacturing building and properly determines that a walk-in freezer in the manufacturing equipment is section 1245 property as defined in section 1245(a)(3). The freezer is not part of the HVAC system that relates to the general operation or maintenance of the building. The components of the walk-in freezer cease to function and X decides to replace them. X abandons the freezer components and properly recognizes a loss from the abandonment of the components. X replaces the abandoned freezer components with new components and incurs costs to acquire and install the new components. Under paragraph (g)(1)(i) of this section, X must capitalize the amounts paid to acquire and install the new freezer components because X 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 X did not abandon the components, but instead sold them to another party and properly recognized a loss on the sale. Under paragraph (g)(1)(ii) of this

section, X must capitalize the amounts paid to acquire and install the new freezer components because X replaced components for which it had property 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. X 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. X 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. X hires a contractor to repair the damage to the building and pays the contractor \$50,000 for the work. Under paragraph (g)(1)(iii) of this section, X must capitalize the \$50,000 amount paid to the contractor because X properly adjusted its basis as a result of a casualty loss under section 165.

Example 4. Restoration after casualty event. Assume the same facts as in *Example 3*, except that X receives insurance proceeds of \$50,000 after the casualty to compensate for its loss. X cannot deduct a casualty loss under section 165 because its loss was compensated by insurance. However, X properly reduces its basis in the property by the amount of the insurance proceeds. Under paragraph (g)(1)(iii) of this section, X must capitalize the \$50,000 amount paid to the contractor because X has properly taken a basis adjustment relating to a casualty event described in section 165.

Example 5. Restoration of property in a state of disrepair. X owns and operates a farm with several barns and outbuildings. One of the outbuildings is not used or maintained by X on a regular basis and falls 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. X decides to restore the outbuilding and incurs costs to shore up the walls and replace the siding. Under paragraph (g)(1)(iv) of this section, X must capitalize the amounts paid to restore the outbuilding because they return the outbuilding to its ordinarily efficient operating condition after it had deteriorated to a state of disrepair and was no longer functional for its intended use.

Example 6. Rebuild of property to like-new condition before end of economic useful life. X is a Class I railroad that owns a fleet of freight cars. Freight cars have a recovery period of 7 years under section 168(c) and an economic useful life of 30 years. Every 8 to 10 years, X rebuilds its freight cars. Ten years after the freight car is placed in service by X, X performs a rebuild, which includes a complete disassembly, inspection, and reconditioning and/or replacement of components of the suspension and draft systems, trailer hitches, and other special equipment. X modifies the car to upgrade various components to the latest engineering standards. The freight car essentially 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 rebuilt condition under the manufacturer's specifications. Assume the freight car is the unit of property. X is not required to capitalize under paragraph (g)(1)(v) of this section the amounts paid to rebuild the freight car because, although the amounts paid restore the freight car to like-new condition, the amounts were not paid after the end of the economic useful life of the freight car.

Example 7. Rebuild of property to like-new condition after end of economic useful life. Assume the same facts as in *Example 6*, except that X rebuilds the freight car 40 years after it is placed in service by X. Under paragraph (g)(1)(v) of this section, X must 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 economic useful life of the freight car.

Example 8. Replacement of major component. X is a common carrier that owns a fleet of petroleum hauling trucks. X replaces the existing engine, cab, and petroleum tank with a new engine, cab, and tank. The new engine and cab cost \$25,000; the new tank costs \$10,000. The cost of a new tractor is \$50,000 and the cost of a new trailer is \$30,000. Assume the tractor of the truck (which includes the cab and the engine) is a separate unit of property from the rest of the truck, and that the trailer (which contains the petroleum tank) is a separate unit of property from the rest of the truck. Also assume that X replaced the components after the end of the recovery periods under section 168(c) for the tractor and the trailer. The amounts paid for the new engine and cab comprise 50% of the cost of a new tractor and must be capitalized under paragraph (g)(1)(vi) of this section. The amounts paid for the new petroleum tank do not comprise 50% or more of the cost of a new trailer; however, the tank comprises more than 50% of the physical structure of the trailer. Therefore, the amounts paid for the new tank also must be capitalized under paragraph (g)(1)(vi) of this section.

Example 9. Repair performed during a restoration. Assume the same facts as in *Example 8*, except that, at the same time the engine and cab of the tractor are replaced, X paints the cab of the tractor with its company logo and fixes 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 (d)(4)(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 in accordance with the rules under section 263A. 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. Therefore, all amounts paid that directly benefit or are incurred by reason of the tractor restoration must be

capitalized, including amounts paid for activities that usually would be deductible maintenance expenses, such as the painting of the cab. Amounts paid to repair the broken taillight, however, are not incurred by reason of the restoration of the tractor, nor do the amounts paid directly benefit the tractor restoration, despite that the repair was performed at the same time as the restoration. Thus, X must capitalize to the restoration of the tractor the amounts paid to paint the cab, but X is not required to capitalize to the restoration of the tractor the amounts paid to repair the broken taillight.

Example 10. Not a replacement of substantial structural part. X owns a large retail store. X discovers a leak in the roof of the store and hires a contractor to inspect and fix the roof. The contractor discovers that a major portion of the sheathing and rafters has rotted, and recommends the replacement of the entire roof. X pays the contractor to replace the roof. Assume the store and its structural components are the unit of property and that the roof does not comprise 50% or more of the physical structure of the store. Also assume the cost of the roof does not comprise 50% or more of the cost to acquire a new store. Consequently, the new roof is not a major component or substantial structural part of the store. Therefore, X is not required to capitalize under paragraph (g)(1)(vi) of this section the amounts paid to replace the roof.

Example 11. Related amounts to replace major component. (i) X 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 machinery used in the immediate retail sale of gas. To comply with regulations issued by the Environmental Protection Agency, X is required to remove and replace leaking USTs. In 2008, X 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. Assume the new tanks comprise 50% or more of the physical structure of the gasoline distribution system. X also is required to pay a permit fee to the county to undertake the installation of the new tanks.

(ii) X pays the permit fee to the county on October 15, 2008. The contractor performs all of the required work and, on November 1, 2008, bills X for the costs of removing the old USTs. On November 15, 2008, the contractor bills X for the remainder of the work. Assume the gasoline distribution system is the unit of

property. The USTs are major components of the gasoline distribution system. Therefore, under paragraphs (d)(5) and (g)(1)(vi) of this section, X must capitalize as an improvement to the distribution system the aggregate of related amounts paid to replace the USTs, which related amounts include the amount paid to the county, the amount paid to remove the old USTs, and the amount paid to install the new USTs (regardless that the amounts were separately invoiced and paid to two different parties).

Example 12. Minor part replacement; coordination with section 263A. X is in the business of smelting aluminum. X's aluminum smelting facility includes a plant where molten aluminum is poured into molds and allowed to solidify. Because of the potential of fire from a molten metal explosion, the plant's roof must be made of fire-resistant material. The roof must also be without leaks because rain water hitting the molten aluminum could cause an explosion. During 2008, X removed and replaced a major portion of the plant's roof decking and roofing material. Assume the plant building and its structural components are the unit of property and that the portion of the roof that is replaced is not a major component or substantial structural part of the building. X is not required to capitalize under paragraph (g)(1)(vi) of this section the amounts paid to remove and replace the roof decking and materials. However, under section 263A, all direct and indirect costs, including otherwise deductible costs, that directly benefit or are incurred by reason of X's manufacturing activities must be capitalized to the property produced by X. Therefore, because the amounts paid for the roof decking and materials are incurred by reason of X's manufacturing operations, the amounts paid must be capitalized under section 263A to the property produced by X.

(h) **Capitalization of amounts to adapt property to a new or different use—(1) In general.** Taxpayers must capitalize amounts 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 intended ordinary use of the unit of property at the time originally placed in service by the taxpayer.

(2) **Examples.** The following examples illustrate solely the rules of this paragraph (h). Even if capitalization is not required in an example under this paragraph (h), the amounts paid in the example may be subject to capitalization under a different provision of this section.

Example 1. New or different use. X is a manufacturer and owns a manufacturing facility that it has used for manufacturing since 1970, when it was placed in service by X. Assume the manufacturing facility is a unit of property. In 2008, X incurred costs to convert its manufacturing facility into a showroom for its business. To convert the facility, X replaces various structural components to provide a better layout for the

showroom and its offices. X also rewires and repaints the building as part of the conversion. None of the materials used, such as the wiring, are better than existing materials in the building. Under this paragraph (h), the amounts paid by X to convert the manufacturing facility into a showroom are paid to adapt the building to a new or different use because the conversion is not consistent with X's intended ordinary use of the property at the time it was placed in service. Therefore, X is required to capitalize these amounts under paragraph (h)(1) of this section.

Example 2. Not a new or different use. X owns a building, which is a unit of property, consisting of twenty retail spaces. The space was designed to be reconfigured; that is, adjoining spaces could be combined into one space. In 2008, one of the tenants expanded its occupancy to include two adjoining retail spaces. To facilitate the new lease, X incurred costs to remove the walls between the three retail spaces. Under this paragraph (h), the amounts paid by X to convert three retail spaces into one larger space for an existing tenant do not adapt X's building to a new or different use because the combination of retail spaces is consistent with X's intended, ordinary use of the building. Therefore, the costs are not required by this paragraph (h) to be capitalized.

Example 3. Not a new or different use. X owns a building, which is a unit of property, consisting of twenty retail spaces. X decides to sell the building. In anticipation of selling the building, X repaints the interior walls and refinishes the hardwood floors. Preparing the building for sale does not constitute a new or different use for the building. Therefore, amounts paid in preparing the building for sale are not required by this paragraph (h) to be capitalized.

Example 4. New or different use. Since 1930, X has owned 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 X's operation of the manufacturing facility, the land became contaminated with wastes from its manufacturing processes. In 1995, X discontinued manufacturing operations at the site. In 2008, X decides to sell the property to a developer that intends to use the property for residential housing. In anticipation of selling the land, X pays amounts to cleanup the land to a standard that is required for the land to be used for residential purposes. In addition, X pays amounts to regrade the land so that it can be used for residential purposes. Amounts paid by X to cleanup wastes that were discharged in the course of X's manufacturing operations do not adapt the land to a new or different use, regardless of the extent to which the land was cleaned. However, amounts 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 X's intended ordinary use of the property at the time it was placed in service. Accordingly, the amounts paid by X to regrade the land must be capitalized under paragraph (h)(1) of this section.

(i) *Optional regulatory accounting method—(1) In general.* This paragraph (i) 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 elects to use the regulatory accounting method described in paragraph (i)(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 § 1.263(a)-3(d) (and the routine maintenance safe harbor described in paragraph (e) of this section) do not apply to amounts paid to repair, maintain, or improve property subject to regulatory accounting by taxpayers that elect to use the regulatory accounting method under this paragraph (i). However, section 263A continues to apply to costs required to be capitalized to property produced by the taxpayer or to property acquired for resale.

(2) *Eligibility for regulatory accounting method.* A taxpayer that is engaged in a trade or business in a regulated industry may use the regulatory accounting method under this paragraph (i). For purposes of this paragraph (i), a taxpayer in a regulated industry is a taxpayer that 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 its method of accounting for regulatory accounting purposes in determining whether an amount paid 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 must 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.

(4) [Reserved]

(5) *Examples.* The rules of this paragraph (i) are illustrated by the following examples.

Example 1. Taxpayer subject to regulatory accounting rules of FERC. X is an electric utility company that operates a power plant to generate electricity. X is subject to the regulatory accounting rules of FERC and X chooses to use the regulatory accounting method under this paragraph (i). X does not capitalize on its books and records for regulatory accounting purposes the cost of repairs made to its turbines. Under the regulatory accounting method, X must not capitalize for Federal income tax purposes amounts paid for repairs made to its turbines.

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, for various reasons, X is no longer required to use FERC's regulatory accounting rules. X cannot use the regulatory accounting method provided in this paragraph (i).

Example 3. Taxpayer subject to regulatory accounting rules of FCC. X is a telecommunications company that is subject to the regulatory accounting rules of the FCC. X chooses to use the regulatory accounting method under this paragraph (i). The assets of X include a telephone central office switching center, which contains numerous switches and various switching equipment. X capitalizes on its books and records for regulatory accounting purposes the cost of replacing each switch. Under the regulatory accounting method, X 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. X is a Class I railroad that is subject to the regulatory accounting rules of the STB. X chooses to use the regulatory accounting method under this paragraph (i). X capitalizes on its books and records for regulatory accounting purposes the cost of locomotive rebuilds. Under the regulatory accounting method, X is required to capitalize for Federal income tax purposes amounts paid to rebuild its locomotives.

(j) *Repair allowance.* A taxpayer may use a repair allowance method of accounting that is identified in published guidance in the **Federal Register** or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter).

(k) *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. See section 263A for the treatment of amounts referred to in this section as well as other amounts paid in connection with the production of real property and personal property,

including films, sound recordings, video tapes, books, or similar properties.

(l) *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.

(m) [Reserved]

(n) *Effective/applicability date.* The rules in this section apply to taxable

years beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Par. 9. Section 1.263A-1 is amended by adding paragraph (b)(14) as follows:

§ 1.263A-1 Uniform capitalization of costs.

* * * * *

(b) * * *

(14) *Property subject to de minimis rule.* Section 263A does not apply to the costs of property produced by a taxpayer to which the taxpayer properly applies the de minimis rule under § 1.263(a)-2(d)(4). However, the cost of

property to which a taxpayer properly applies the de minimis rule under § 1.263(a)-2(d)(4) may be required to be capitalized to other property as a cost incurred by reason of the production of the other property that is subject to section 263A.

* * * * *

Linda E. Stiff,

Deputy Commissioner for Services and Enforcement.

[FR Doc. E8-4466 Filed 3-7-08; 8:45 am]

BILLING CODE 4830-01-P