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Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property; Final Rule

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 9636]

RIN 1545–BE18

Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations that provide guidance on the application of sections 162(a) and 263(a) of the Internal Revenue Code (Code) to amounts paid to acquire, produce, or improve tangible property. The final regulations clarify and expand the standards in the current regulations under sections 162(a) and 263(a). These final regulations replace and remove temporary regulations under sections 162(a) and 263(a) and withdraw proposed regulations that cross referenced the text of those temporary regulations. This document also contains final regulations under section 167 regarding accounting for and retirement of depreciable property and final regulations under section 168 regarding accounting for property under the Modified Accelerated Cost Recovery System (MACRS) other than general asset accounts. The final regulations will affect all taxpayers that acquire, produce, or improve tangible property. These final regulations do not finalize or remove the 2011 temporary regulations under section 168 regarding general asset accounts and disposition of property subject to section 168, which are addressed in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register**.

DATES: *Effective Date:* These regulations are effective on September 19, 2013.

Applicability Dates: In general, these final regulations apply to taxable years beginning on or after January 1, 2014. However, certain rules apply only to amounts paid or incurred in taxable years beginning on or after January 1, 2014. For dates of applicability of the final regulations, see §§ 1.162–3(j), 1.162–4(c), 1.162–11(b)(2), 1.165–2(d), 1.167(a)–4(b), 1.167(a)–7(f), 1.167(a)–8(h), 1.168(i)–7(e), 1.263(a)–1(h), 1.263(a)–2(j), 1.263(a)–3(r), 1.263(a)–6(c), 1.263A–1(l), and 1.1016–3(j).

FOR FURTHER INFORMATION CONTACT: Concerning §§ 1.162–3, 1.162–4, 1.162–11, 1.263(a)–1, 1.263(a)–2, 1.263(a)–3, and 1.263(a)–6, Merrill D. Feldstein or Alan S. Williams, Office of Associate Chief Counsel (Income Tax and Accounting), (202) 622–4950 (not a toll-free call); Concerning §§ 1.165–2, 1.167(a)–4, 1.167(a)–7, 1.167(a)–8, 1.168(i)–7, 1.263A–1, and 1.1016–3, Kathleen Reed or Patrick Clinton, Office Associate Chief Counsel (Income Tax and Accounting), (202) 622–4930 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this final regulation has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–2248. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

The collection of information in this regulation is in §§ 1.263(a)–1(f)(5), 1.263(a)–3(h)(6), and 1.263(a)–3(n)(2). This information is required in order for a taxpayer to elect to use the de minimis safe harbor, to elect to use the safe harbor for small taxpayers, and to elect to capitalize repair and maintenance costs. This information will inform the IRS that the taxpayer is electing to use these provisions, which allows taxpayers to obtain beneficial treatment for the amounts that qualify for these elections. The collection of information is voluntary to obtain a benefit under the final regulations. The likely respondents are business or other for-profit institutions, and small businesses or organizations.

Estimated total annual reporting burden: 1,100,000 hours.

Estimated annual burden hours per respondent varies from .25 hours to .5 hours, depending on individual circumstances, with an estimated average of .275 hours.

Estimated number of respondents: 4,000,000.

Estimated frequency of responses: Annually.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by section 6103.

Background

Section 263(a) provides that no deduction is allowed for (1) any amount paid out for new buildings or permanent improvements or betterments made to increase the value of any property or estate, or (2) any amount expended in restoring property or in making good the exhaustion thereof for which an allowance has been made. Final regulations previously issued under section 263(a) provided that capital expenditures included amounts paid or incurred to (1) add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or (2) adapt the property to a new or different use. However, those regulations also provided that amounts paid or incurred for incidental repairs and maintenance of property within the meaning of section 162 and § 1.162–4 of the Income Tax Regulations are not capital expenditures under § 1.263(a)–1.

The determination of whether an expense may be deducted as a repair or must be capitalized generally requires an examination of all of a taxpayer's particular facts and circumstances. Moreover, the subjective nature of the existing standards described above has resulted in considerable controversy between taxpayers and the IRS over many years.

In 2006, in an effort to reduce the controversy in this area, the IRS and the Treasury Department published in the **Federal Register** August 21, 2006 (71 FR 48590) proposed amendments to the regulations under section 263(a) relating to amounts paid to acquire, produce, or improve tangible property. The IRS and the Treasury Department received numerous written comments in response to these proposed regulations. After considering these comments and the statements at the public hearing, in 2008 the IRS and the Treasury Department withdrew the 2006 proposed regulations and proposed new regulations in the **Federal Register** March 10, 2008 (73 FR 12838). The IRS and the Treasury Department also received many written comments and held a public hearing on the 2008 proposed regulations. On December 27, 2011, the IRS and the Treasury Department published temporary regulations in the **Federal Register** regarding the deduction and capitalization of expenditures related to tangible property (TD 9564; 76 FR 81060), withdrew the 2008 proposed regulations, and published new proposed regulations that cross referenced the text of the 2011 temporary regulations. The 2011 temporary regulations initially applied to taxable years beginning on or after January 1, 2012. The IRS and the Treasury Department received numerous written comments in response to the 2011 temporary and proposed regulations and held a public hearing on May 9, 2012. After considering these comments and the statements at the public hearing, the IRS and the Treasury Department published Notice 2012–73 (2012–51 IRB 713), on November 20, 2012, announcing that, to assist taxpayers in their transitions to the 2011 temporary regulations and final regulations, the IRS and the Treasury Department would change the applicability date of the 2011 temporary regulations to taxable years beginning on or after January 1, 2014, while permitting taxpayers to choose to apply the 2011 temporary regulations to taxable years beginning on or after January 1, 2012, and before the applicability date of the final regulations. The Notice also alerted taxpayers that the IRS and the Treasury Department intended to publish final regulations in 2013 and expected the final regulations to apply to taxable years beginning on or after January 1, 2014, but that the final regulations would permit taxpayers to apply its provisions to taxable years beginning on or after January 1, 2012. On December 17, 2012, the Treasury Department and the IRS published technical amendments to TD 9564, which amended the applicability date of the 2011 temporary regulations to taxable years beginning on or after January 1, 2014, while permitting taxpayers to choose to apply the 2011 temporary regulations to taxable years beginning on or after January 1, 2012, and before the applicability date of the final regulations. See **Federal Register** (77 FR 74583).

After considering all of the comments and the statements made at the public hearing on the 2011 temporary and proposed regulations, the IRS and the Treasury Department are removing the 2011 temporary regulations under sections 162, 165, 167, 263(a), 263A, 1016, and § 1.168(i)–7 and are issuing final regulations. The IRS and the Treasury Department are also removing the 2011 proposed regulations and are issuing new proposed regulations regarding the disposition of property subject to section 168. The proposed regulations are set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register**.

Explanation of Provisions

I. Overview

Section 263(a) generally requires the capitalization of amounts paid to acquire, produce, or improve tangible property. Section 162 allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including the costs of certain supplies, repairs, and maintenance. These final regulations provide a general framework for distinguishing capital expenditures from supplies, repairs, maintenance, and other deductible business expenses. The final regulations retain many of the provisions of the 2011 temporary and proposed regulations (2011 temporary regulations), which in many instances incorporated standards from case law and other existing authorities under sections 162 and 263(a). The final regulations also modify several sections of the 2011 temporary regulations in response to comments received and to clarify and simplify the rules while achieving results that are consistent with the case law. The final regulations adopt the same general format as the 2011 temporary regulations, where § 1.162–3 provides rules for materials and supplies, § 1.162–4 addresses repairs and maintenance, § 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, the final regulations refine and simplify some of the rules contained in the 2011 temporary regulations and create a number of new safe harbors. For example, the final regulations adopt a revised and simplified de minimis safe harbor under § 1.263(a)–1(f) and extend the safe harbor for routine maintenance under § 1.263(a)–3(i) to buildings. The final regulations also add a safe harbor for small taxpayers to the rules governing improvements to tangible property under § 1.263(a)–3. In addition, the final regulations refine several of the criteria for defining betterments and restorations to tangible property.

In addition, these regulations finalize certain temporary regulations under section 167 regarding accounting for and retirement of depreciable property and section 168 regarding accounting for MACRS property, other than general asset accounts. However, these regulations do not finalize the rules under § 1.168(i)–1T or § 1.168(i)–8T addressing the definition of disposition for property subject to section 168. Instead, to address significant changes in this area, revised regulations under section 168 are being proposed concurrently with these final regulations (and appear in the Proposed Rules section of this issue of the **Federal Register**).

II. Materials and Supplies Under § 1.162–3

Responding to generally favorable comments on the treatment of materials and supplies in the 2011 temporary regulations, the final regulations retain the framework and many of the rules set forth in the 2011 temporary regulations. In response to comments, however, the final regulations expand the definition of materials and supplies to include property that has an acquisition or production cost of $200 or less (increased from $100 or less), clarify application of the optional method of accounting for rotable and temporary spare parts, and simplify the application of the de minimis safe harbor of § 1.263(a)–1(f) to materials and supplies. The final regulations also define standby emergency spare parts and limit the application of the election to capitalize materials and supplies to only rotable, temporary, and standby emergency spare parts.

A. Definition of Materials and Supplies

Commenters requested that the dollar threshold for characterizing a unit of property as a material or supply be increased from property with an acquisition cost of $100 or less to property with an acquisition cost of $500 or $1,000. Specifically, commenters were concerned that the low $100 threshold would not capture many common supplies such as calculators and coffee makers. Balancing concerns over distortions to income that could result from increasing the acquisition cost to $500 (or more) with the need to include the typical materials and supplies ordinarily used by many taxpayers, the final regulations increase the $100 threshold to $200. In addition, the final regulations retain the language providing the IRS and the Treasury Department with the authority to change the amount of this threshold through published guidance.

Commenters also continued to question the effect of the 2011 temporary regulations on the treatment of standby emergency spare parts under Rev. Rul. 81–185 (1981–2 CB 59). To resolve questions in this area, the final regulations generally incorporate the definition of standby emergency spare parts provided in Rev. Rul. 81–185 into the definition of materials and supplies and provide that these parts are eligible for the optional election to capitalize certain materials and supplies provided in § 1.162–3(d).

B. Election To Capitalize Certain Materials and Supplies

The 2011 temporary regulations retained the rule from the 2008 proposed regulations permitting a taxpayer to elect to capitalize and depreciate amounts paid for certain materials and supplies. Several comments noted that the requirement to elect to capitalize certain material and supply costs continued to be inconsistent with prior IRS pronouncements that distinguished certain depreciable property from materials and supplies. See, for example, Rev. Rul. 2003–37 (2003–1 CB 717) (permitting taxpayers to treat certain rotable spare parts used in a service business as depreciable assets); Rev. Rul. 81–185 (1981–2 CB 59) (concluding that major standby emergency spare parts are depreciable property); Rev. Rul. 69–201 (1969–1 CB 60) (holding that standby replacement parts used in pit mining business are items for which depreciation is allowable); Rev. Rul. 69–200 (1969–1 CB 60) (holding that flight equipment rotable spare parts and assemblies are tangible property for which depreciation is allowable while expendable flight equipment spare parts are materials and supplies); Rev. Proc. 2007–48 (2007–2 CB 110) (providing a safe harbor method of accounting to treat certain rotable spare parts as depreciable assets). In addition, several comments noted that the rule under the 2011 temporary regulations could lead to problematic results, such as permitting a component acquired to improve a unit of tangible property owned by the taxpayer to be treated as an asset and depreciated over a recovery period different from the unit of tangible property intended to be improved.

To address these concerns, the final regulations retain the rule permitting a taxpayer to elect to capitalize and depreciate amounts paid for certain materials and supplies but provide that this rule is only applicable to rotable, temporary, or standby emergency spare parts. By limiting the application of the rule to rotable, temporary, or standby emergency spare parts, the final regulations resolve the potentially problematic results arising in the 2011 temporary regulations. And while the final rule modifies Rev. Rul. 2003–37, Rev. Rul. 81–185, Rev. Rul. 69–200, and Rev. Rul. 69–201 to the extent that the regulations characterize certain tangible properties addressed in these rulings as materials and supplies, the treatment is consistent with the holdings of the revenue rulings, which permit taxpayers to treat rotable, temporary, or standby emergency spare parts as assets subject to the allowance for depreciation.

The final regulations also clarify the procedure for a taxpayer that wants to revoke the election to capitalize and depreciate certain materials and supplies. The taxpayer may revoke this election by filing a request for a letter ruling and obtaining the consent of the Commissioner of Internal Revenue to revoke this election. The Commissioner may grant a request to revoke this election if the taxpayer acted reasonably and in good faith, and the revocation will not prejudice the interests of the Government. In deciding whether to grant such a request, the Commissioner anticipates applying standards similar to the standards under § 301.9100–3 of this chapter for granting extensions of time for making regulatory elections.

Finally, one commenter requested that the rules governing materials and supplies be modified to address the cost of acquiring or producing rotable spare parts that a taxpayer leases to customers in the ordinary course of the taxpayer's leasing business. This commenter requested that the final regulations clarify that these leased rotable spare parts are included in the definition of rotable and temporary spare parts and that a taxpayer may elect to capitalize and depreciate these leased rotable spare parts under the materials and supplies rules. Under the 2011 temporary regulations, the definition of rotable and temporary spare parts includes only components acquired to maintain, repair, or improve a unit of property owned, leased, or serviced by the taxpayer. This definition of rotable and temporary spare parts does not include components that the taxpayer leases to its customers and that are unrelated to other property owned, leased to other parties, or serviced by the taxpayer. The final regulations do not expand the definition of rotable and temporary spare parts to include leased rotable spare parts. The IRS and the Treasury Department believe that these parts are outside the scope of regulations governing materials and supplies.

C. Optional Method for Rotable and Temporary Spare Parts

One commenter requested that the final regulations remove the requirement that the optional method for rotable and temporary spare parts, if elected, be used for all of a taxpayer's rotable and temporary spare parts in the same trade or business. Recognizing that taxpayers may have pools of rotable or temporary parts that are treated differently for financial statement purposes, the final regulations modify this rule. The final regulations provide that a taxpayer that uses the optional method for rotable and temporary spare parts for Federal tax purposes must use the optional method for all of the pools of rotable and temporary spare parts used in the same trade or business for which the optional method is used for the taxpayer's books and records. Thus, a taxpayer generally is not required to use the optional method for those pools of rotable or temporary spare parts for which it does not use the optional method in its books and records for the trade or business. However, if a taxpayer chooses to use the optional method for any pool of rotable or temporary spare parts for which the taxpayer does not use the optional method in its books and records for the trade or business, then the taxpayer must use the optional method for all its pools of rotable and temporary spare parts in that trade or business.

Commenters also requested that the optional method for rotable and temporary spare parts be treated as the default method of accounting for rotable and temporary spare parts, instead of treating rotable and temporary spare parts as used and consumed in the taxable year when disposed. Many taxpayers do not use the optional method of accounting for rotable and temporary spare parts, and that method requires a degree of record keeping that would be overly burdensome for all taxpayers. Therefore, the final regulations do not adopt this suggestion and continue to generally treat rotable and temporary spare parts as materials and supplies that are used and consumed in the taxable year when disposed of by the taxpayer, unless the taxpayer chooses a different treatment under § 1.162–3.

D. Materials and Supplies Under the de Minimis Safe Harbor

There were numerous comments on the application of the de minimis rule provided in the 2011 temporary regulations to materials and supplies under §§ 1.162–3T(f) (election to apply de minimis rule to materials and supplies) and 1.263(a)–2T(g) (general de minimis rule) and the interaction between the two sections. In response to these comments, the final regulations more clearly coordinate the two provisions as addressed below in the discussion of the de minimis safe harbor.

E. Property Treated as Materials and Supplies in Published Guidance

Several commenters questioned the effect of the 2011 temporary regulations on prior published guidance that permits taxpayers to treat certain property as materials and supplies. For example, Rev. Proc. 2002–12 (2002–1 CB 374) allows a taxpayer to treat smallwares as materials and supplies that are not incidental under § 1.162–3. Similarly, Rev. Proc. 2002–28 (2002–1 CB 815) allows a qualifying small business taxpayer to treat certain inventoriable items in the same manner as materials and supplies that are not incidental under § 1.162–3. The final regulations do not supersede, obsolete, or replace these revenue procedures to the extent they deem certain property to constitute materials and supplies under § 1.162–3. This designated property continues to qualify as materials and supplies under the final regulations, because the definition of material and supplies includes property that is identified as materials and supplies in published guidance.

III. Repairs Under § 1.162–4

The 2011 temporary regulations provided that 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. The IRS and the Treasury Department received no comments on this regulation. The final regulations retain the rule from the 2011 temporary regulations. In addition, the final regulations add a cross reference to § 1.263(a)–3(n), the new election to capitalize amounts paid for repair and maintenance consistent with the taxpayer's books and records, discussed later in this preamble.

IV. De Minimis Safe Harbor Under §§ 1.263(a)–1(f) and 1.162–3(f)

A. De Minimis Safe Harbor Ceiling

The 2011 temporary regulations required a taxpayer to capitalize amounts paid to acquire or produce a unit of real or personal property, including the related transaction costs. However, § 1.263(a)–2T(g) provided a de minimis exception permitting a taxpayer to deduct certain amounts paid for tangible property if the taxpayer had an applicable financial statement, had written accounting procedures for expensing amounts paid for such property under specified dollar amounts, and treated such amounts as expenses on its applicable financial statement. Under § 1.263(a)–2T(g)(1)(iv), a taxpayer's de minimis deduction for the taxable year was limited to a ceiling: the greater of (1) 0.1 percent of the taxpayer's gross receipts for the taxable year as determined for Federal income tax purposes, or (2) 2 percent of the taxpayer's total depreciation and amortization expense for the taxable year as determined on the taxpayer's applicable financial statement.

The IRS and the Treasury Department received a significant number of comments addressing the de minimis safe harbor provided in § 1.263(a)–2T(g). Nearly all comments raised concerns about the administrative burden the ceiling would place on taxpayers, noting that taxpayers would be required to keep detailed accounts of amounts that they generally do not track because such amounts are expensed under their financial accounting capitalization policies. Thus, while the ceiling itself could be calculated relatively simply, the financial accounting systems employed by most taxpayers would not allow them to easily determine which costs the de minimis rule applied to and, therefore, whether or not applicable costs exceeded the ceiling. Commenters also pointed out that the operation of the ceiling requirement did not allow taxpayers to anticipate when they had reached the gross receipts or depreciation limitation or to identify assets that would be excluded under the de minimis rule during a taxable year, because the ceiling amount could only be calculated after the end of a taxable year. Commenters also highlighted the complexities inherent in the application of the ceiling requirement for consolidated groups. In many cases, commenters suggested that the administrative burden imposed would outweigh any potential tax benefit. Many commenters suggested that this problem be resolved by removing the ceiling altogether and permitting taxpayers to deduct for Federal income tax purposes amounts properly expensed under their financial accounting policies.

The final regulations adopt commenters' suggestions that the ceiling in the de minimis rule in the 2011 temporary regulations be eliminated and that amounts properly expensed under a taxpayer's financial accounting policies be deductible for tax purposes. To both address taxpayers' concerns and ensure that the de minimis safe harbor in the final regulations requires taxpayers to use a reasonable, consistent methodology that clearly reflects income for Federal income tax purposes, the ceiling in § 1.263(a)–2T(g)(1)(iv) has been replaced with a new safe harbor determined at the invoice or item level and based on the policies that the taxpayer utilizes for its financial accounting books and records. A taxpayer with an applicable financial statement may rely on the de minimis safe harbor under § 1.263(a)–1(f) of the final regulations only if the amount paid for property does not exceed $5,000 per invoice, or per item as substantiated by the invoice. The final regulations provide the IRS and the Treasury Department with the authority to change the safe harbor amount through published guidance.

Commenters also asked that the de minimis safe harbor be expanded to include not only amounts paid for property costing less than a certain dollar amount but also amounts paid for property having a useful life less than a certain period of time. The final regulations adopt this suggestion and provide that the de minimis safe harbor also applies to a financial accounting procedure that expenses amounts paid for property with an economic useful life of 12 months or less as long as the amount per invoice (or item) does not exceed $5,000. Such amounts are deductible under the de minims rule whether this financial accounting procedure applies in isolation or in combination with a financial accounting procedure for expensing amounts paid for property that does not exceed a specified dollar amount. Under either procedure, if the cost exceeds $5,000 per invoice (or item), then the amounts paid for the property will not fall within the de minimis safe harbor. In addition, an anti-abuse rule is provided to aggregate costs that are improperly split among multiple invoices.

B. Taxpayers Without an Applicable Financial Statement

The 2011 temporary regulations did not provide a de minimis safe harbor for taxpayers without an applicable financial statement, but the preamble requested comments addressing alternatives that would provide the IRS and the Treasury Department with assurance that a taxpayer is using a reasonable, consistent methodology that clearly reflects income. One commenter suggested that the definition of applicable financial statement be expanded to include financial statements subject to a compliance review under the rules of the American Institute of Certified Public Accountants' (AICPA) Statement of Standards for Accounting and Review Services. Numerous comments also requested that the de minimis rule be generally expanded to taxpayers without an applicable financial statement.

The final regulations include a de minimis rule for taxpayers without an applicable financial statement. While careful consideration was given to the suggestion of relying on reviewed financial statements as defined in the AICPA's Statement of Standards for Accounting and Review Services, the final regulations do not adopt this standard. While the AICPA standard for reviewed financial statements ensures that the taxpayer's policies comply with the applicable financial accounting framework, the standard does not contemplate a review of the taxpayer's internal control, fraud risk, or accounting records. Thus, the standard does not provide sufficient assurance to the IRS that such policies are being followed and, accordingly, that the taxpayer is using a reasonable, consistent methodology that clearly reflects its income. However, the final regulations do provide a de minimis safe harbor for taxpayers without an applicable financial statement if accounting procedures are in place to deduct amounts paid for property costing less than a specified dollar amount or amounts paid for property with an economic useful life of 12 months or less. The de minimis safe harbor for taxpayers without an applicable financial statement provides a reduced per invoice (or item) threshold because there is less assurance that the accounting procedures clearly reflect income. A taxpayer without an applicable financial statement may rely on the de minimis safe harbor only if the amount paid for property does not exceed $500 per invoice, or per item as substantiated by the invoice. If the cost exceeds $500 per invoice (or item), then no portion of the cost of the property will fall within the de minimis safe harbor. Similar to the safe harbor for a taxpayer with an applicable financial statement, this provision provides the IRS and the Treasury Department with the authority to change the safe harbor amount through published guidance. In addition, an anti-abuse rule is provided to aggregate costs that are improperly split among multiple invoices.

Finally, for both taxpayers with applicable financial statements and taxpayers without applicable financial statements, the de minimis safe harbor is not intended to prevent a taxpayer from reaching an agreement with its IRS examining agents that, as an administrative matter, based on risk analysis or materiality, the IRS examining agents will not review certain items. It is not intended that examining agents must now revise their materiality thresholds in accordance with the de minimis safe harbor limitations provided in the final regulation. Thus, if examining agents and a taxpayer agree that certain amounts in excess of the de minimis safe harbor limitations are not material or otherwise should not be subject to review, that agreement should be respected, notwithstanding the requirements of the de minimis safe harbor. However, a taxpayer that seeks a deduction for amounts in excess of the amount allowed by the safe harbor has the burden of showing that such treatment clearly reflects income.

C. Safe Harbor Election

Commenters asked whether the de minimis rule in the 2011 temporary regulations was mandatory or elective and, if mandatory, requested a change to make the safe harbor elective. The final regulations adopt these suggestions and provide that the de minimis rule is a safe harbor, elected annually by including a statement on the taxpayer's timely filed original Federal tax return for the year elected. The final regulations provide that, if elected, the de minimis safe harbor must be applied to all amounts paid in the taxable year for tangible property that meet the requirements of the de minimis safe harbor, including amounts paid for materials and supplies that meet the requirements. In addition, the final regulations provide that a taxpayer may not revoke an election to use the de minimis safe harbor. An election to use the de minimis safe harbor may not be made through the filing of an application for change in accounting method.

D. Written Accounting Procedures

The 2011 temporary regulations required that to utilize the de minimis safe harbor, a taxpayer must have written accounting procedures in place at the beginning of the taxable year treating the amounts paid for property costing less than a certain dollar amount as an expense for financial accounting purposes. Commenters suggested that transition guidance be issued for taxpayers that did not have written accounting procedures in place at the beginning of 2012. Alternatively, one commenter suggested that taxpayers be allowed to make the drafting of a written accounting procedure retroactive to the beginning of 2012.

The final regulations do not adopt these suggestions for transition relief. Although the publication of the 2011 temporary regulations late in the calendar year (December 27, 2011) likely prevented taxpayers without written accounting procedures at that time from implementing such procedures prior to the beginning of the 2012 taxable year, the provisions of the 2011 temporary regulations are elective for taxable years beginning prior to January 1, 2014. In addition, the final regulations are not applicable until taxable years beginning on or after January 1, 2014. Therefore, taxpayers without written accounting procedures that choose to elect the de minimis safe harbor for their 2014 taxable years should have sufficient time to consider and draft appropriate procedures prior to the applicability date of the final regulations. Moreover, the de minimis safe harbor is intended to provide recordkeeping simplicity to taxpayers by allowing them to follow an established financial accounting policy for federal tax purposes, and allowing retroactive application is inconsistent with such purpose.

E. Application to Consolidated Group Members

Several comments noted that the rule for use of a consolidated group's applicable financial statement failed to consider situations in which taxpayers are included on a consolidated applicable financial statement but are not members in an underlying consolidated group for Federal income tax purposes. Comments requested that taxpayers in this situation be permitted to rely on the financial policies of the group that apply to them as well as the group's consolidated applicable financial statement to satisfy the requirements of the de minimis rule. The final regulations adopt this suggestion and provide that if a taxpayer's financial results are reported on the applicable financial statement for a group of entities, then the group's applicable financial statement may be treated as the applicable financial statement of the taxpayer. Furthermore, in this situation, the written accounting procedures provided for the group and utilized for the group's applicable financial statement may be treated as the written accounting procedures of the taxpayer.

F. Transaction and Other Additional Costs

The preamble to the 2011 temporary regulations provided that the de minimis rule did not apply to amounts paid for labor and overhead incurred in repairing or improving property. Commenters pointed out that the preamble did not provide any policy reason for excluding labor and overhead costs from the de minimis rule and that the exclusion would require rules to allocate additional invoice costs, such as freight and installation costs, between tangible property costs and labor and overhead costs, requiring additional recordkeeping by taxpayers. Additionally, one commenter pointed out that the de minimis rule in the 2011 temporary regulations did not expressly provide for an exclusion of labor and overhead costs. Commenters requested that additional costs included on an invoice for tangible property be included within the scope of the de minimis rule.

The final regulations adopt the commenters' suggestions, in part, and clarify the treatment under the de minimis safe harbor of transaction costs and other additional costs of acquiring and producing property subject to the safe harbor. To simplify the application of the de minimis rule to tangible property, the final regulations provide that a taxpayer electing to apply the de minimis safe harbor is not required to include in the cost of the tangible property the additional costs of acquiring or producing such property if these costs are not included in the same invoice as the tangible property. However, the final regulations also provide that a taxpayer electing to apply the de minimis safe harbor must include in the cost of such property all additional costs (for example, delivery fees, installation services, or similar costs) of acquiring or producing such property if these costs are included on the same invoice with the tangible property. If an invoice includes amounts paid for multiple tangible properties and the invoice includes additional invoice costs related to the multiple properties, then the taxpayer must allocate the additional invoice costs to each property using a reasonable method. The final regulations specify that a reasonable allocation method includes, but is not limited to, specific identification, a pro rata allocation, or a weighted average method based on each property's relative cost. The final regulations also clarify that additional costs consist of the transaction costs (that is, the facilitative costs under § 1.263(a)–2(f)) of acquiring or producing the property and the costs under § 1.263(a)–2(d) for work performed prior to the date that the unit of tangible property is placed in service.

G. Materials and Supplies

The IRS and Treasury Department received numerous comments on the application of the de minimis rule to materials and supplies under § 1.162–3T of the 2011 temporary regulations. Under the 2011 temporary regulations, taxpayers were permitted to select materials and supplies to be expensed under the de minimis rule provided that these materials and supplies satisfied all requirements of the de minimis rule, including the ceiling. Many comments raised concerns about the administrative burdens associated with identifying and allocating materials and supplies between the de minimis rule and the general rules for materials and supplies in a manner that would not exceed the de minimis rule ceiling. In many cases, commenters suggested that the administrative burden imposed would outweigh any potential tax benefit. Thus, commenters requested revisions to the de minimis rule to reduce taxpayers' administrative burden of complying with the 2011 temporary regulations.

To simplify application of the de minimis safe harbor, the final regulations require that the de minimis safe harbor be applied to all eligible materials and supplies (other than rotable, temporary, and standby emergency spare parts subject to the election to capitalize or rotable and temporary spare parts subject to the optional method of accounting for such parts) if the taxpayer elects the de minimis safe harbor under § 1.263(a)-1(f). Unlike the 2011 temporary regulations rule permitting taxpayers to select materials and supplies for application of the de minimis safe harbor, the requirement in the final regulations to apply the de minimis safe harbor, if elected, to all eligible materials and supplies simplifies the application of the de minimis rule and reduces the administrative burden on the IRS. Taxpayers that do not elect the de minimis safe harbor provided in the final regulations for the taxable year must treat their amounts paid for materials and supplies in accordance with the rules provided in § 1.162–3.

H. Coordination With Section 263A

Commenters asked for clarification on the interaction of the de minimis rule with section 263A. Several comments asked whether the application of the de minimis rule resulted in property with an unadjusted basis of zero, which would then be subject to section 263A, or, alternatively, whether section 263A required taxpayers to capitalize the cost of property subject to section 263A, regardless of whether the de minimis rule applied.

The final regulations clarify the interaction between the two provisions. The final regulations provide that amounts paid for tangible property eligible for the de minimis safe harbor may, nonetheless, be subject to capitalization under section 263A if the amounts paid for this tangible property comprise the direct or allocable indirect costs of other property produced by the taxpayer or property acquired for resale.

In general, under section 263A, if property is held for future production, taxpayers must capitalize direct and indirect costs allocable to such property (for example, purchasing, storage, and handling costs), even though production has not begun. If property is not held for production, indirect costs incurred prior to the beginning of the production period must be allocated to the property and capitalized if, at the time the costs are incurred, it is reasonably likely that production will occur at some future date. Thus, for example, a manufacturer must capitalize the costs of storing and handling raw materials before the raw materials are committed to production. In addition, § 1.263A–1T(e)(2)(i) provides that indirect material costs include the cost of materials that are not an integral part of specific property produced and the cost of materials that are consumed in the ordinary course of performing production or resale activities that cannot be identified or associated with particular units of property.

Therefore, if tangible property is acquired with the expectation of being used in the production of other property, and it is reasonably likely that production will occur at some future date, section 263A may apply to capitalize the cost of the property acquired. Thus, for example, if a taxpayer acquires a component part, the cost of which is otherwise eligible for the de minimis safe harbor, but the component part is installed, or expected to be installed in the future, in the taxpayer's manufacturing equipment used to produce property for sale, under section 263A, the cost of the component part must be capitalized as an indirect cost of property produced by the taxpayer. On the other hand, if property is acquired without the expectation of being used in the production of property and the taxpayer elects and properly applies the de minimis rule to the amount paid for property in the taxable year, if expectations change in a subsequent taxable year and the property is actually used in production, then section 263A will not require capitalization of the cost of the property at the time the expectation changes or when the property is used in production.

I. Change in Accounting Procedures Not Change in Method of Accounting

Several commenters questioned whether a change in a taxpayer's financial accounting procedures (for example, its financial accounting capitalization policy) is a change in method of accounting for de minimis expenses to which the provisions of sections 446 and 481 and the accompanying regulations apply. The final regulations provide that the use of the de minimis safe harbor is a taxable year election and may not be made by the filing of an application for a change in method of accounting. Thus, if a taxpayer meets the requirements for the safe harbor, which requires, in part, having written accounting procedures in place at the beginning of the taxable year and treating amounts paid for property as an expense in accordance with those procedures, then a change in the procedures, by itself, is not a change in accounting method. For example, if a taxpayer's written financial accounting capitalization policy at the beginning of 2014 states that amounts paid for property costing less than $200 will be treated as an expense, and the taxpayer changes its written policy as of the beginning of 2015 to treat amounts paid for property costing less that $500 as an expense, the taxpayer is not required to file an application for its 2015 taxable year to change its method of accounting for applying the de minimis safe harbor or determining amounts paid to acquire or produce tangible property under § 1.263(a)–1(f).

V. Amounts Paid To Acquire or Produce Tangible Property Under § 1.263(a)–2

Section 1.263(a)–2T of the 2011 temporary regulations provided rules for applying section 263(a) to amounts paid to acquire or produce a unit of real or personal property. In general, the final regulations retain the rules from the 2011 temporary regulations, including general requirements to capitalize amounts paid to acquire or produce a unit of real or personal property, requirements to capitalize amounts paid to defend or perfect title to real or personal property, and rules for determining the extent to which taxpayers must capitalize transaction costs related to the acquisition of property. In the final regulations, the de minimis safe harbor has been moved to § 1.263(a)–1(f) to reflect its broader application to amounts paid for tangible property, including amounts paid for improvements and materials and supplies, except as otherwise provided under section 263A.

The 2011 temporary regulations provided that a taxpayer must, in general, capitalize amounts paid to facilitate the acquisition or production of real or personal property. To alleviate controversy between taxpayers and the IRS, the 2011 temporary regulations included a list of inherently facilitative amounts. In addition, the 2011 temporary regulations provided 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 unless they are described in the regulations as inherently facilitative costs. The 2011 temporary regulations also provided that inherently facilitative amounts allocable to real or personal property are capital expenditures related to such property, even if such property is not eventually acquired or produced.

Commenters requested that the requirement to capitalize facilitative costs be removed as overbroad. Commenters also stated that it was inappropriate to provide a special rule that depends on the nature of the property acquired (real property or personal property) and inappropriate to require capitalization of inherently facilitative amounts allocable to property not acquired. Other commenters recommended that the list describing inherently facilitative amounts be revised to exclude activities that are dependent on the type of service provider (for example, a broker), rather than being based on a specific activity (for example, securing an appraisal). One commenter asked for clarification regarding the treatment of a broker's commission if the commission was contingent on the buyer's successful acquisition of real property but a portion of the broker's activities were performed in investigating the acquisition.

The final regulations generally retain the 2011 temporary regulation rules addressing facilitative amounts. As in the 2011 temporary regulations, the final regulations include the special rule for the acquisition of real property providing that, except for amounts specifically identified as inherently facilitative, an amount paid by a 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. The final regulations do not expand the deduction of such pre-decisional, investigatory costs to personal property because, unlike real property acquisitions, personal property acquisitions do not typically raise issues of whether the transaction costs should be characterized as deductible business expansion costs rather than costs to acquire a specific property. In addition, personal property acquisitions do not typically provide clear evidence establishing the timing of decisions. Thus, such a rule could generate significant controversy over unduly small amounts.

Moreover, the final regulations retain the list of inherently facilitative costs that generally must be capitalized as transaction costs. However, in response to comments, the final regulations clarify the meaning of finders' fees and brokers' commissions and provide a definition of contingency fees. The final regulations provide that for purposes of § 1.263(a)–2, a contingency fee is an amount paid that is contingent on the successful closing of the acquisition of real or personal property. The final regulations also clarify that contingency fees facilitate the acquisition of the property ultimately acquired and are not allocable to real or personal property not acquired. Therefore, if a real estate broker's commission is contingent on the successful closing of the acquisition of real property, the amount paid as the broker's commission inherently facilitates the acquisition of the property acquired and, therefore, must be capitalized as part of the basis of such property. However, no portion of the broker's contingency fee is allocable to real property that the taxpayer did not acquire. In addition, the final regulations retain the rule that inherently facilitative amounts allocable to real or personal property are capital expenditures related to such property, even if such property is not eventually acquired or produced. As discussed in the preamble to the 2008 proposed regulations, the IRS and the Treasury Department believe that this rule is consistent with established authorities. See, for example, *Sibley, Lindsay & Curr Co.* v. *Commissioner,* 15 T.C. 106 (1950), *acq.,* 1951–1 CB 3. The final regulations also clarify that, except for contingency fees as discussed above, inherently facilitative amounts allocable to property not acquired may be allocated to those properties and recovered in accordance with the applicable provisions of the Code, including sections 165, 167, and 168.

VI. Amounts Paid To Improve Property Under § 1.263(a)–3

A. Overview

Comments received with respect to the rules under the 2011 temporary regulations for determining whether an amount improves, betters, or restores property largely focused on the application of the rules to building property, the lack of a safe harbor for routine maintenance for building property, the standards to be applied in determining whether a betterment has occurred, the treatment of post-casualty expenditures under the restoration standards, and the standards to be applied in determining whether a replacement of a major component or substantial structural part has occurred.

The final regulations generally retain the rules of the 2011 temporary regulations for determining the unit of property and for determining whether there is an improvement to a unit of property. The final regulations also retain the simplifying conventions set out in the 2011 temporary regulations, including the routine maintenance safe harbor and the optional regulatory accounting method. In addition, in response to the comments, the final regulations modify the 2011 temporary regulations in several areas. The concerns raised by commenters and the relevant changes to the 2011 temporary regulations are discussed in this preamble.

B. Determining the Unit of Property

The 2011 temporary regulations generally defined the unit of property as consisting of all the components of property that are functionally interdependent, but provided special rules for determining the unit of property for buildings, plant property, and network assets. The 2011 temporary regulations also provided special rules for determining the units of property for condominiums, cooperatives, and leased property, and for the treatment of improvements (including leasehold improvements). The final regulations retain the unit of property rules contained in the 2011 temporary regulations.

The 2011 temporary regulations generally defined a building as a unit of property, but required the application of the improvement standards to the building structure and the enumerated building systems. A number of comments objected to the requirement that the taxpayer perform the improvement analysis at the building structure and system level. The comments stated that such treatment is inconsistent with the treatment of other complex property under the 2011 temporary regulations, is inconsistent with the treatment of building property under depreciation rules, and fails to take into account the relative importance of the various building systems. Several comments requested that the building, including its structural components, should be treated as the unit of property for applying the improvement rules to buildings. Other commenters pointed out that a functional interdependence standard, used in the 2011 temporary regulations for non-building property and applied by the courts and the IRS for determining when components of a single property are placed in service for cost recovery purposes, may be a more consistent general standard for identifying the relevant property upon which to apply the improvement analysis.

Like plant property, buildings are complex properties composed of numerous component parts that perform discrete and major functions or operations. Unlike plant property, however, where the discrete and major functions or operations are not consistent from plant to plant, the discrete and major functions or operations performed from building to building are frequently similar. The building system definitions set forth in the 2011 temporary regulations are based on well understood costing standards that have been routinely applied to buildings for many years for valuations, cost accounting, and financial reporting. To help ensure that the improvement standards are applied equitably and consistently across building property, the final regulations continue to apply the improvement rules to both the building structure and the defined building systems. To the extent the particular facts and circumstances of a subset of buildings used in one or more industries present unique challenges to application of the building structure or building system definitions, taxpayers are encouraged to request guidance under the Industry Issue Resolution (IIR) procedures.

C. Unit of Property for Leasehold Improvements

The 2011 temporary regulations provide rules for determining the unit of property for leased property and for determining the unit of property for leasehold improvements. The IRS and the Treasury Department received no written comments on these rules, and the final regulations retain the rules from the 2011 temporary regulations, with some clarifications. Under the rule in the 2011 temporary regulations, a question could arise regarding the property to be analyzed for determining whether an improvement to a lessee improvement constitutes an improvement to the lessee's property. In this context, the 2011 temporary regulations suggested that the taxpayer must determine whether there has been an improvement to the lessee improvement by itself, rather than by applying the improvement standards to the general unit of property rules for leased buildings or for leased property other than buildings. The final regulations clarify that for purposes of determining whether an amount paid by a lessee constitutes a leasehold improvement, the unit of property and the improvement rules are applied in accordance with the rules for leased buildings (or leased portions of building) under § 1.263(a)–3(e)(2)(v) or for leased property other than buildings under § 1.263(a)–3(e)(3)(iv). Thus, for example, if a lessee pays an amount for work on an addition that it previously made to a leased building, the taxpayer determines whether the work performed constitutes an improvement to the entire leased building structure, not merely to the addition. The final regulations also clarify that when a lessee or lessor improvement is comprised of a building erected on leased property, then the unit of property for the building and the application of the improvement rules are determined under the provisions for buildings, rather than under the provisions for leased buildings.

D. Special Rules for Determining Improvement Costs

1. Costs Incurred During an Improvement

The 2011 temporary regulations did not prescribe rules related to the ''plan of rehabilitation'' doctrine as traditionally described in the case law. The judicially-created plan of rehabilitation doctrine provides that a taxpayer must capitalize otherwise deductible repair or maintenance costs if they are incurred as part of a general plan of rehabilitation, modernization, and improvement to the property. See, for example, *Moss* v. *Commissioner,* 831 F.2d 833 (9th Cir. 1987); *United States* v. *Wehrli,* 400 F.2d 686 (10th Cir. 1968); *Norwest Corp.* v. *Commissioner,* 108 T.C. 265 (1997). The 2011 temporary regulations did not restate the plan of rehabilitation doctrine but, rather, used the language of the section 263A rule providing that a taxpayer must capitalize both the direct costs of an improvement as well as the indirect costs that directly benefit or are incurred by reason of the improvement. The 2011 temporary regulations also included an exception to this provision for an individual residence, which permitted an individual taxpayer to capitalize repair and maintenance costs incurred at the time of a substantial residential remodel.

The final regulations retain the rules from the 2011 temporary regulations and continue to provide that indirect costs, such as repair and maintenance costs, that do not directly benefit and that are not incurred by reason of an improvement are not required to be capitalized under section 263(a), regardless of whether they are incurred at the same time as an improvement. In addition, in response to comments requesting examples of the application of this standard, the final regulations add this analysis to several examples. By providing a standard based on the section 263A language, the final regulations set out a clear rule for determining when otherwise deductible indirect costs must be capitalized as part of an improvement to property and obsolete the plan of rehabilitation doctrine to the extent that the court-created doctrine provides different standards.

2. Removal Costs

The 2011 temporary regulations did not provide a separate rule for the treatment of removal costs. Rather, the 2011 temporary regulations addressed component removal costs as an example of a type of indirect cost that must be capitalized if the removal costs directly benefit or are incurred by reason of an improvement. The preamble to the 2011 temporary regulations stated that the costs of removing a component of a unit of property should be analyzed in the same manner as any other indirect cost (such as a repair cost) incurred during a repair or an improvement to property. Therefore, the preamble concluded, if the cost of removing a component of a unit of property directly benefitted or was incurred by reason of an improvement to the unit of property, the cost must be capitalized. The preamble to the 2011 temporary regulations also noted that the 2011 temporary regulations were not intended to affect the holding of Rev. Rul. 2000–7 (2000–1 CB 712) as it applied to the cost of removing an entire unit of property. Under Rev. Rul. 2000–7, a taxpayer is not required to capitalize the cost of removing a retired depreciable asset under section 263(a) or section 263A, even when the retirement and removal occur in connection with the installation of a replacement asset. Rev. Rul. 2000–7 reasoned that the costs of removing a depreciable asset generally have been allocable to the removed asset and, thus, generally have been deductible when the asset is retired. See §§ 1.165–3(b); 1.167(a)–1(c); 1.167(a)–11(d)(3)(x); Rev. Rul. 74–455 (1974–2 CB 63); Rev. Rul. 75–150 (1975–1 CB 73).

Commenters acknowledged the preamble language but observed that the 2011 temporary regulations did not explicitly state that the costs incurred to remove an entire unit of property are not required to be capitalized, even when incurred in connection with the installation of a replacement asset. Commenters requested that the final regulations include this explicit conclusion. Commenters also asked whether the principles of Rev. Rul. 2000–7 would apply to allow the deduction of removal costs when the taxpayer disposes of a component of a unit of property and the taxpayer takes into account the adjusted basis of the component in realizing loss. Commenters also questioned whether a taxpayer would be required to capitalize component removal costs if these costs were an indirect cost of a restoration (for example, the replacement of a component when the taxpayer has properly deducted a loss for that component) rather than a betterment to the underlying unit of property.

The final regulations provide a specific rule clarifying the treatment of removal costs in these contexts. The final regulations state that if a taxpayer disposes of a depreciable asset (including a partial disposition under Prop. Reg. § 1.168(i)–1(e)(2)(ix) September 19, 2013, or Prop. Reg. § 1.168(i)–8(d) (September 19, 2013)) for Federal tax purposes and has taken into account the adjusted basis of the asset or component of the asset in realizing gain or loss, the costs of removing the asset or component are not required to be capitalized under section 263(a). The final regulations also provide that if a taxpayer disposes of a component of a unit of property and the disposal is not a disposition for Federal tax purposes, then the taxpayer must deduct or capitalize the costs of removing the component based on whether the removal costs directly benefit or are incurred by reason of a repair to the unit of property or an improvement to the unit of property. In addition, the final regulations provide several examples illustrating these principles.

E. Safe Harbor for Small Taxpayers

The 2011 temporary regulations did not provide any special rules for small taxpayers to assist them in applying the general rules for improvements to buildings. One commenter stated that small taxpayers generally do not have the administrative means or sufficient documentation or information to apply the improvement rules to their building structures and systems as required under the 2011 temporary regulations. Therefore, the commenter requested that an annual dollar threshold, such as $10,000, be established for buildings with an initial cost of $1,000,000 or less and that taxpayers be permitted to deduct annual amounts spent on the building if they did not exceed the threshold amount. In response to this request, the final regulations include a safe harbor election for building property held by taxpayers with gross receipts of $10,000,000 or less (''a qualifying small taxpayer''). The final regulations permit a qualifying small taxpayer to elect to not apply the improvement rules to an eligible building property if the total amount paid during the taxable year for repairs, maintenance, improvements, and similar activities performed on the eligible building does not exceed the lesser of $10,000 or 2 percent of the unadjusted basis of the building. Eligible building property includes a building unit of property that is owned or leased by the qualifying taxpayer, provided the unadjusted basis of the building unit of property is $1,000,000 or less. The final regulations provide the IRS and the Treasury Department with the authority to adjust the amounts of the safe harbor and gross receipts limitations through published guidance. The final regulations provide simple rules for determining the unadjusted basis of both owned and leased building units of property. In this situation, the final regulations also eliminate the need to separately analyze the building structure and the building systems, as required elsewhere in the improvement rules in the final regulations.

Under the safe harbor for small taxpayers, a taxpayer includes amounts not capitalized under the de minimis safe harbor election of § 1.263(a)–1(f) and under the routine maintenance safe harbor for buildings (discussed later in this preamble) to determine the annual amount paid for repairs, maintenance, improvements, and similar activities performed on the building. If the amount paid for repairs, maintenance, improvements, and similar activities performed on a building unit of property exceeds the safe harbor threshold for a taxable year, then the safe harbor is not applicable to any amounts spent during the taxable year. In that case, the taxpayer must apply the general rules for determining improvements, including the routine maintenance safe harbor for buildings. The taxpayer may also elect to apply the de minimis safe harbor under § 1.263(a)–1(f) to amounts qualifying under the de minimis safe harbor, regardless of the application of the safe harbor for small taxpayers.

The safe harbor for building property held small taxpayers may be elected annually on a building-by-building basis by including a statement on the taxpayer's timely filed original Federal tax return, including extensions, for the year the costs are incurred for the building. Amounts paid by the taxpayer to which the taxpayer properly applies and elects the safe harbor are not treated as improvements to the building under § 1.263(a)–3 and may be deducted under § 1.162–1 or § 1.212–1, as applicable, in the taxable year that the amounts are paid or incurred, provided the amounts otherwise qualify for deduction under those sections. A taxpayer may not revoke an election to apply the safe harbor for small taxpayers.

F. Safe Harbor for Routine Maintenance

1. Buildings

The 2011 temporary regulations provided that the costs of performing certain routine maintenance activities for property other than a building or the structural components of a building are not required to be capitalized as an improvement. Under the routine maintenance safe harbor, an amount paid was deemed not to improve a unit of property if it was for the recurring activities that a taxpayer (or a lessor) expected to perform as a result of the taxpayer's (or the lessee's) use of the unit of property to keep the unit of property in its ordinarily efficient operating condition. The 2011 temporary regulations provided that the activities are routine only if, at the time the unit of property was placed in service, the taxpayer reasonably expected to perform the activities more than once during the period prescribed under sections 168(g)(2) and 168(g)(3) (the Alternative Depreciation System class life), regardless of whether the property was depreciated under the Alternative Depreciation System. The preamble to the 2011 temporary regulations explained that the routine maintenance safe harbor did not apply to building property, because the long class life for such property (40 years under section 168(g)(2)) arguably could allow major remodeling or restoration projects to be deducted under the safe harbor, regardless of the nature or extent of the work involved, and that deducting such costs would be inconsistent with case law. The 2011 temporary regulations provided several factors for taxpayers to consider in determining whether a taxpayer is performing routine maintenance, including 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.

Comments on the routine maintenance safe harbor generally requested that the safe harbor be extended to building property. One commenter stated that because the improvement standards under the 2011 temporary regulations must now be applied to the building structure and each building system separately, these components are more analogous to section 1245 property, which qualifies for the routine maintenance safe harbor. Commenters suggested that using a period shorter than a building's class life, such as 20 years, could alleviate the IRS and the Treasury Department's concern that the cost of true improvements would not be properly capitalized if the safe harbor were extended to buildings. Another commenter argued that the distinction between building property and non-building property for purposes of the safe harbor is arbitrary because, in many respects, retail buildings are similar to other complex property, such as aircraft, which are not excluded from the safe harbor.

In response to these comments, the final regulations contain a safe harbor for routine maintenance for buildings. The inclusion of a routine maintenance safe harbor for buildings is expected to alleviate some of the difficulties that could arise in applying the improvement standards for certain restorations to building structures and building systems. To balance commenters' suggestions of using a shorter period, such as 20 years, with the concerns expressed in the preamble to the 2011 temporary regulations, the final regulations use 10 years as the period of time in which a taxpayer must reasonably expect to perform the relevant activities more than once. While periods longer than 10 years were considered, the use of a period much longer than 10 years would, contrary to current authority, permit the costs of many major remodeling and restoration projects to be deducted under the safe harbor, regardless of the nature or extent of the work involved.

2. Other Changes

The final regulations make several additional changes and clarifications to the safe harbor for routine maintenance, which are applicable to both buildings and other property. First, the regulations confirm that routine maintenance can be performed any time during the life of the property provided that the activities qualify as routine under the regulation. Second, for purposes of determining whether a taxpayer is performing routine maintenance, the final regulations remove the taxpayer's treatment of the activity on its applicable financial statement from the factors to be considered. Taxpayers may have several different reasons for capitalizing maintenance activities on their applicable financial statements, and such treatment may not be indicative of whether the activities are routine. Third, the final regulations clarify the applicability of the routine maintenance safe harbor by adding three items to the list of exceptions from the routine maintenance safe harbor: (1) Amounts paid for a betterment to a unit of property, (2) amounts paid to adapt a unit of property to a new or different use, and (3) amounts paid for repairs, maintenance, or improvement of network assets. The first two exceptions were included in the general rule for the safe harbor in the 2011 temporary regulations, but were not clearly stated as exceptions. The exception for network assets was added because of the difficulty in defining the unit of property for network assets and the preference for resolving issues involving network assets through the IIR program. Finally, the exception relating to amounts paid for property for which a taxpayer has taken a basis adjustment resulting from a casualty loss is slightly modified to be consistent with the revised casualty loss restoration rule, which is discussed in this preamble.

3. Reasonable Expectation That Activities Will Be Performed More Than Once

A taxpayer's reasonable expectation of whether it will perform qualifying maintenance activities more than once during the relevant period will be determined at the time the unit of property (or building structure or system, as applicable) is placed in service. The final regulations modify the safe harbor for routine maintenance by adding that a taxpayer's expectation will not be deemed unreasonable merely because the taxpayer does not actually perform the maintenance a second time during the relevant period, provided that the taxpayer can otherwise substantiate that its expectation was reasonable at the time the property was placed in service. Thus, for a unit of property previously placed in service, whether the maintenance is actually performed more than once during the relevant period is not controlling for assessing the reasonableness of a taxpayer's original expectation. However, if a similar or identical unit of property is placed in service in a future tax year, the taxpayer's experience with the original property may be taken into account as a factor in assessing whether the taxpayer reasonably expects to perform the activities more than once during the relevant period for the similar or identical unit of property. The taxpayer's actual experience, therefore, may be used in assessing the reasonableness of the taxpayer's expectation of the frequency of restoration or replacement at the time a new unit of property is placed in service, but hindsight should not be used to invalidate a taxpayer's reasonable expectation as established at the time the unit of property was first placed in service when subsequent events do not conform to the taxpayer's reasonable expectation.

4. Amounts Not Qualifying for the Routine Maintenance Safe Harbor

The final regulations clarify that amounts incurred for activities falling outside the routine maintenance safe harbor are not necessarily expenditures required to be capitalized under § 1.263(a)–3. Amounts incurred for activities that do not meet the routine maintenance safe harbor are subject to analysis under the general rules for improvements.

G. Betterments

1. Overview

The 2011 temporary regulations provided that an amount paid results in a betterment, and accordingly, an improvement, if it (1) ameliorates a material condition or defect that existed prior to the acquisition of the property or arose during the production of the property; (2) results in a material addition to the unit of property (including a physical enlargement, expansion, or extension); or (3) results in a material increase in the capacity, productivity, efficiency, strength, or quality of the unit of property or its output. As applied to buildings, an amount results in a betterment to the building if it results in a betterment to the building structure or any of the building systems.

The final regulations retain the provisions of the 2011 temporary regulations related to betterments with several refinements. Specifically, the final regulations reorganize and clarify the types of activities that constitute betterments to property. Also, the final regulations no longer phrase the betterment test in terms of amounts that *result in* a betterment. Rather, the final regulations provide that a taxpayer must capitalize amounts that are reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of a unit of property or that are for a material addition to a unit of property. Elimination of the ''results in'' standard should reduce controversy for expenditures that span more than one tax year or when the outcome of the expenditure is uncertain when the expenditure is made.

2. Amelioration of Material Condition or Defect

Commenters requested that certain examples be clarified to distinguish more clearly between circumstances that require capitalization of amounts paid to ameliorate a material condition or defect and circumstances that do not require capitalization. One commenter requested that the final regulations include a rule that would provide for an allocation of expenditures between pre- and post-acquisition periods based on facts and circumstances if an expenditure both ameliorates a pre-existing condition and ameliorates normal wear and tear that results from the taxpayer's use of the property. With respect to whether amounts paid to ameliorate conditions are betterments, other comments reiterated suggestions provided in response to the 2008 proposed regulations, as described in the preamble to the 2011 temporary regulations.

The final regulations do not adopt the comments with respect to expenditures to ameliorate pre-existing conditions or defects. The facts and circumstances rule provided in the final regulations is consistent with established case law and represents an administrable standard for determining whether an improvement has occurred.

3. Material Addition or Increase in Productivity, Efficiency, Strength, Quality, or Output

Many commenters requested that the final regulations provide explanations and quantitative bright lines for determining the materiality of an addition to a unit of property or an increase in capacity, productivity, efficiency, strength, quality, or output of a unit of property. Additionally, commenters requested more explanation of terms such as productivity, quality, and output, and how such standards should be applied across a variety of different types of tangible property.

These suggestions were extensively considered, but the final regulations do not adopt the suggestions to establish quantitative bright lines. Quantitative bright lines, although objective, would produce inconsistent results given the broad array of factual settings where the betterment rules apply. Instead, the final regulations continue to rely on qualitative factors to provide fair and equitable treatment for all taxpayers in determining whether a particular cost constitutes a betterment.

The final regulations clarify, however, that not every single quantitative or qualitative factor listed in the betterment standard applies to every type of property. Whether any single factor applies to a particular unit of property depends on the nature of the property. For example, while amounts paid for work performed on an office building or a retail building may clearly comprise a physical enlargement or increase the capacity, efficiency, strength, or quality of such building under certain facts, it is unclear how to measure whether work performed on an office building or retail building increases the productivity or output of such buildings, as those terms are generally understood. Thus, the productivity and output factors would not generally apply to buildings. On the other hand, it is appropriate to evaluate many items of manufacturing equipment in terms of output or productivity as well as size, capacity, efficiency, strength, and quality. Accordingly, the final regulations clarify that the applicability of each quantitative and qualitative factor depends on the nature of the unit of property, and if an addition or increase in a particular factor cannot be measured in the context of a specific type of property, then the factor is not relevant in determining whether there has been a betterment to the property.

4. Application of Betterment Rule

Several commenters questioned the betterment rule in the 2011 temporary regulations that requires consideration of all facts and circumstances, including the treatment of the expenditures on a taxpayer's applicable financial statement. One commenter questioned whether the treatment of an expenditure on a taxpayer's applicable financial statement should be relevant in determining whether an amount paid results in a betterment and suggested removal of this factor from the facts and circumstances test provided in the 2011 temporary regulations. The IRS and the Treasury Department recognize that taxpayers may apply different standards for capitalizing amounts on their applicable financial statements and such standards may not be controlling for whether the activities are betterments for Federal tax purposes. Thus, the final regulations remove the taxpayer's treatment of the expenditure on its financial statement as a factor to be considered in performing a betterment analysis under the final regulations. In addition, the final regulations omit the reference to the taxpayer's facts and circumstances in determining whether amounts are paid for a betterment to the taxpayer's property. The IRS and the Treasury Department believe that an analysis of a taxpayer's particular facts and circumstances is implicit in the application of all the final regulations governing improvements and need not be specifically provided in the application of the betterment rules.

The 2011 temporary regulations provided that, when an expenditure is necessitated by a particular event, the determination of whether an expenditure is for the betterment of a 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 event necessitating the expenditure. The IRS and the Treasury Department received comments requesting that the final regulations clarify the application of the appropriate comparison rule for determining whether an expenditure is for a betterment of a unit of property. The final regulations retain this general rule but clarify that the rule applies when the event necessitating the expenditure is either normal wear and tear or damage to the unit of property during the taxpayer's use of the property. Thus, the final regulations clarify that the appropriate comparison rule focuses on events affecting the condition of the property and not on business decisions made by taxpayers. In addition, the final regulations confirm that the rule does not apply to wear, tear, or damage that occurs prior to the taxpayer's acquisition or use of the property. In these situations, the amelioration of a material condition or defect rule may apply.

5. Retail Store Refresh or Remodels

A substantial number of comments were received with respect to the betterment examples in the 2011 temporary regulations that address retail store refresh or remodel projects, requesting the addition of quantitative bright lines and the inclusion of additional detail in the examples.

As discussed previously in this preamble, the final regulations do not adopt the suggestions to provide quantitative bright lines in applying the betterment rules. However, the final regulations include additional detail in a number of the examples, including the examples related to building refresh or remodels, illustrating distinctions between betterments and maintenance activities when a taxpayer undertakes multiple simultaneous activities on a building. To the extent the rules in the final regulations present situations that might be addressed through the IIR program, taxpayers may pursue additional guidance through the IIR process.

H. Restorations

1. Overview

The 2011 temporary regulations provided that an amount is paid to restore, and therefore improve, a unit of property if it meets one of six tests: (1) it 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); (2) it 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; (3) it 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 (''casualty loss rule''); (4) it 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; (5) it results in the rebuilding of the unit of property to a like-new condition after the end of its class life; or (6) it is for the replacement of a major component or a substantial structural part of the unit of property (''major component rule'').

The IRS and the Treasury Department received a number of comments regarding the 2011 temporary regulations restoration rules. The final regulations generally retain the restoration standards set forth in the 2011 temporary regulations but revise both the major component rule and the casualty loss rule in response to comments.

2. Replacement of a Major Component or Substantial Structural Part

a. Definition of Major Component and Substantial Structural Part

The 2011 temporary regulations provided that an amount paid for the replacement of a major component or substantial structural part of a unit of property is an amount paid to restore (and, therefore, improve) the unit of property. The determination of whether a component or part was ''major'' or ''substantial'' depended on the facts and circumstances, including both qualitative and quantitative factors.

Commenters expressed concern that the lack of a bright-line test or additional definitions would result in uncertainty and disputes in applying the restoration rules contained in the 2011 temporary regulations. Several commenters stated that the standards provided in the 2011 temporary regulations were too subjective, and numerous commenters requested that the final regulations reintroduce a bright-line definition of what constitutes a major component or substantial structural part for purposes of applying the restoration standards, particularly with regard to buildings. Several commenters suggested that a fixed percentage of a building should be defined as the major component. In addition, commenters asked for clarifying guidance or more examples, arguing that the major component test of the 2011 temporary regulations uses broad, undefined, and subjective terms.

The final regulations retain the substantive rules of the 2011 temporary regulations, but clarify the definition of major component, and, more significantly, add a new definition for major components and substantial structural parts of buildings. Although the IRS and the Treasury Department considered several bright-line tests, none were found to fairly, equitably, and in a readily implementable manner distinguish between expenditures that constitute restorations and expenditures that constitute deductible repairs or maintenance consistent with the case law and administrative rulings in the area.

In many cases, particularly with regard to buildings, establishing a clear threshold, such as 30 percent of a defined amount, would be unworkable. Largely due to the complex nature of the property involved and the fact that units of property include assets placed in service in multiple taxable years, applying a fixed percentage to a building structure or a building system in a way that creates a consistent and equitable result proved exceedingly intricate and complex, thereby failing to achieve the simplifying objective of a bright line test. The final regulations, therefore, do not adopt any of the bright-line tests suggested.

b. General Rule for Major Component and Substantial Structural Part

To provide additional guidance for determining what constitutes a major component or substantial structural part, the final regulations clarify the distinction between a major component and a substantial structural part. Specifically, the final regulations separate ''major component,'' which focuses on the function of the component in the unit of property, from ''substantial structural part,'' which focuses on the size of the replacement component in relation to the unit of property. The final regulations define a major component as a part or combination of parts that performs a discrete and critical function in the operation of the unit of property. The final regulations define a substantial structural part as a part or combination of parts that comprises a large portion of the physical structure of the unit of property.

In response to comments, the final regulations retain, but also clarify, the exception to the major component rule. The 2011 temporary regulations provided that the replacement of a minor component, even though such component might affect the function of the unit of property, generally would not, by itself, constitute a major component. The exception was meant to apply to relatively minor components, such as a switch, which generally performs a discrete function (turning property on and off) and is critical to the operation of a unit of property (that is, property will not run without it). To provide additional clarification regarding this exception, the final regulations clarify that an incidental component of a unit of property, even though such component performs a discrete and critical function in the operation of the unit of property, generally will not, by itself, constitute a major component.

c. Major Component and Substantial Structural Part of Buildings

The final regulations address the request for additional clarity regarding the definition of major component for buildings by adding a new definition for major components and substantial structural parts of buildings. In the case of buildings, the final regulations provide that an amount is for the replacement of a major component or substantial structural part if the replacement includes a part or combination of parts that (1) comprises a major component or a significant portion of a major component of the building structure or any building system, or (2) comprises a large portion of the physical structure of the building structure or any building system.

While the definition of major component for buildings introduces an additional level of analysis (a significant portion of a major component) that must be applied in determining whether an amount spent on a building constitutes a restoration, the rule provides an analytical framework and reaches conclusions that are generally consistent with the case law. Therefore, in practice this framework should be readily applicable for amounts spent on buildings. In combination with the addition of a routine maintenance safe harbor for buildings, the modifications to the section 168 disposition regulations, the safe harbor for small taxpayers, and the addition and revision of many examples, the revised definition of major component for buildings should relieve much of the controversy in determining whether the replacement of a major component or a substantial structural part of a unit of property is an amount paid to restore a building.

3. Casualty Loss Rule

The 2011 temporary regulations provided that an amount is paid to restore a unit of property if it is for the repair of damage to the 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 (''casualty loss rule''). Capitalization of restoration costs is required under the casualty loss rule, even when the amounts paid for the repair exceed the adjusted basis remaining in the property and regardless of whether the amounts may otherwise qualify as repair costs. The 2011 temporary regulations recognized a taxpayer's ability to deduct a casualty loss under section 165 or, to the extent eligible, to deduct the repair expense associated with the casualty damage. But the 2011 temporary regulations did not permit a taxpayer to deduct both amounts arising from the same event in the same taxable year.

Commenters requested that the final regulations eliminate the casualty loss rule. Commenters argued that recognition of a casualty loss under section 165 is irrelevant in determining whether the costs to restore the damage resulting from a casualty should be capitalized, and the 2011 temporary regulations should not deny one tax benefit (the ability to deduct repair costs) based on a taxpayer's realization of another tax benefit (the ability to deduct a casualty loss). Similarly, commenters argued that the Code allows both a casualty loss and a repair deduction, and the IRS and the Treasury Department had not offered any justification for denying a deduction for the cost to repair damaged property only because the taxpayer has taken a casualty loss deduction. Commenters argued that the 2011 temporary regulations penalize taxpayers that have suffered a casualty as a result of property damage. Commenters suggested that the casualty loss rule in the 2011 temporary regulations results in similarly situated taxpayers being treated differently, based on whether an asset has adjusted basis at the time of a casualty event. As an alternative to eliminating the casualty loss rule, commenters requested that the final regulations allow a taxpayer to elect to forego recognizing the casualty loss and making a corresponding adjustment to basis to avoid application of the casualty loss rule.

The casualty loss rule in 2011 temporary regulations was based on the capitalization rule provided in section 263(a)(2), which states that no deduction shall be allowed for any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made. When property has been damaged in a casualty and a loss for such property has been claimed, amounts paid to replace the damaged property are incurred to restore property for which an allowance has been made. Thus, under section 263(a)(2), when the basis in replaced property has been recovered by the taxpayer, capitalization of the replacement property is appropriate.

Recognizing that such a rule can provide harsh results for a taxpayer with valuable property with low adjusted basis that is destroyed in a casualty event, considerable consideration was given to the suggestion that the regulations provide an election to forgo a casualty loss deduction. Ultimately, however, it was concluded that the IRS and the Treasury Department do not have the authority to permit taxpayers to electively avoid the basis adjustment requirement imposed by section 1016(a). Section 1016(a) states that ''a proper adjustment in respect of the property shall in all cases be made for . . . losses, or other items, properly chargeable to capital account. . .'' Therefore, even if a taxpayer could choose to forgo claiming a loss for property damage under section 165, section 1016 requires an adjustment to the basis of the property because a loss properly could be claimed.

In response to commenters' suggestions, the final regulations revise the casualty loss rule to permit a deduction, where otherwise permissible, for amounts spent in excess of the adjusted basis of the property damaged in a casualty event. Thus, a taxpayer is still required to capitalize amounts paid to restore damage to property for which the taxpayer has properly recorded a basis adjustment, but the costs required to be capitalized under the casualty loss rule are limited to the excess of (1) the taxpayer's basis adjustments resulting from the casualty event, over (2) the amount paid for restoration of damage to the unit of property that also constitutes a restoration under the other criteria of

§ 1.263(a)–3(k)(1) (excluding the casualty loss rule). Casualty-related expenditures in excess of this limitation are not treated as restoration costs under § 1.263(a)–3(k)(1)(iii) and may be properly deducted if they otherwise constitute ordinary and necessary business expenses (for example, repair and maintenance expenses) under section 162. The final regulations contain several examples illustrating the casualty loss rule, including one example that demonstrates the operation of the new limitation on amounts required to be capitalized.

4. Salvage Value Exception

Under the 2011 temporary regulations, a restoration includes amounts paid for the replacement of a component of a unit of property when the taxpayer has properly deducted a loss for that component (other than a casualty loss under § 1.165–7) and for the replacement of a component of a unit of property when 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. In response to comments, the final regulations retain these rules but provide an exception for property that cannot be depreciated to an adjusted basis of zero due to the application of salvage value (for example, property placed in service before 1981, and post-1980 assets that do not qualify for the Accelerated Cost Recovery System of former section 168 (ACRS) or MACRS). When a loss is properly deducted or the adjusted basis of the component is realized from a sale or exchange, and the amount of loss or basis adjustment is attributable only to the remaining salvage value (the amount a taxpayer is expected to receive in cash or trade-in allowance upon disposition of an asset at the end of its useful life) as computed for Federal income tax purposes, a taxpayer is not required to treat amounts paid for the replacement of the component as a restoration under § 1.263(a)–3(k)(1)(i) or (k)(1)(ii). Amounts subject to this exception must be evaluated under other provisions of the regulations to determine if the amounts are paid to improve tangible property.

5. Rebuild to Like-New Condition

The 2011 temporary regulations provided that 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. Commenters asked for clarification on whether comprehensive maintenance programs, conducted according to manufacturer's original specifications, constitute rebuilding a unit of property to like-new condition. The final regulations adopt the standard provided in the 2011 temporary regulations but clarify that generally a comprehensive maintenance program, even though substantial, does not return a unit of property to like-new condition.

I. Adaptation to a New or Different Use

The 2011 temporary regulations required a taxpayer to capitalize amounts paid to adapt a unit of property to a new or different use (that is, a use inconsistent with the taxpayer's intended ordinary use at the time the property was originally placed in service by the taxpayer). As applied to buildings, the new or different use standard is applied separately to the building structure and its building systems. Commenters requested clarification of the adaptation rules and additional examples. Commenters also asked that, for specific industries, the regulations provide that changes to facilities in response to a change in product mix, a reallocation of floor space, the need to rebrand, or the introduction of a new product line do not constitute a new or different use.

The final regulations retain the substantive rules of the 2011 temporary regulations but add additional examples to illustrate the rules. The final regulations provide that if an amount adapts the unit of property in a manner inconsistent with the taxpayer's intended ordinary use of the property when placed in service, the amount must be capitalized as an adaptation of the unit of property to a new or different use. In response to comments, two new examples address circumstances in which part of a retail building unit of property is converted to provide new services or products. However, providing tailored guidance for specific industries or specific types of property (for example, retail sales facilities) is not appropriate for broadly applicable guidance. Specific industry guidance is better addressed through the IIR program.

VII. Optional Regulatory Accounting Method

The 2011 temporary regulations provided an optional regulatory method, which permitted certain regulated taxpayers to follow the method of accounting they used for regulatory accounting purposes in determining whether an amount paid improves property. For purposes of the optional method, a taxpayer in a regulated industry is a taxpayer subject to the regulatory accounting rules of the Federal Energy Regulatory Commission (FERC), the Federal Communications Commission (FCC), or the Surface Transportation Board (STB). A taxpayer that uses the regulatory accounting method does not apply the rules under sections 162, 212, or 263(a) in determining whether amounts paid to repair, maintain, or improve property are capital expenditures or deductible expenses. Section 263A continues to apply to costs required to be capitalized to property produced by the taxpayer or to property acquired for resale.

The IRS and the Treasury Department received no comments on this methodology, and the final regulations retain the rule from the 2011 temporary regulations, with one modification. The final regulations modify the description of the regulatory accounting method to clarify that, for purposes of determining whether an amount is for a capital expenditure, an eligible taxpayer must apply the method of accounting that it is required to follow by FERC, FCC, or STB (whichever is applicable).

VIII. Election To Capitalize Repair and Maintenance Costs

The 2011 temporary regulations did not contain an election for taxpayers to capitalize expenditures made with respect to tangible property that would otherwise be deductible under these regulations. Commenters requested that, to reduce uncertainty in applying subjective standards and to reduce administrative burden, the final regulations include an election to capitalize repair and maintenance expenditures as improvements if the taxpayer treats such costs as capital expenditures for financial accounting purposes. In response to these comments as well as in recognition of the significant administrative burden reduction achieved by permitting a taxpayer to follow for Federal income tax purposes the capitalization policies used for its books and records, the final regulations permit a taxpayer to elect to treat amounts paid during the taxable year for repair and maintenance to tangible property as amounts paid to improve that property and as an asset subject to the allowance for depreciation, as long as the taxpayer incurs the amounts in carrying on a trade or business and the taxpayer treats the amounts as capital expenditures on its books and records used for regularly computing income. Under the final regulations, a taxpayer that elects this treatment must apply the election to all amounts paid for repair and maintenance to tangible property that it treats as capital expenditures on its books and records in that taxable year. A taxpayer making the election must begin to depreciate the cost of such improvements when the improvements are placed in service by the taxpayer under the applicable provisions of the Code and regulations. The election is made by attaching a statement to the taxpayer's timely filed original Federal tax return (including extensions) for the taxable year in which the improvement is placed in service. Once made, the election may not be revoked.

A taxpayer that capitalizes repair and maintenance costs under the election is still eligible to apply the de minimis safe harbor, the safe harbor for small taxpayers, and the routine maintenance safe harbor to repair and maintenance costs that are not treated as capital expenditures on its books and records.

IX. Applicability Dates

The final regulations generally apply to taxable years beginning on or after January 1, 2014. However, certain provisions of the final regulations only apply to amounts paid or incurred in taxable years beginning on or after January 1, 2014. For example, the de minimis safe harbor election under § 1.263(a)–1(f) only applies to amounts paid or incurred for tangible property after January 1, 2014, for taxable years beginning on or after January 1, 2014.

Alternatively, a taxpayer may generally choose to apply the final regulations to taxable years beginning on or after January 1, 2012. For taxpayers choosing this early application, certain provisions of the final regulations only apply to amounts paid or incurred in taxable years beginning on or after January 1, 2012. For example, for these taxpayers, the de minimis safe harbor election only applies to amounts paid or incurred for tangible property after January 1, 2012, for taxable years beginning on or after January 1, 2012.

For taxpayers choosing to apply the final regulations to taxable years beginning on or after January 1, 2012, or where applicable, to amounts paid or incurred in taxable years beginning on or after January 1, 2012, the final regulations provide transition relief for taxpayers that did not make the certain elections (for example, the election to apply the de minimis safe harbor or the election to apply the safe harbor for small taxpayers) on their timely filed original Federal tax return for their 2012 or 2013 taxable year (the applicable taxable year). Specifically, for taxable years beginning on or after January 1, 2012, and ending on or before September 19, 2013, a taxpayer is permitted to make these elections by filing an amended Federal tax return (including any applicable statements) for the applicable taxable year on or before 180 days from the due date including extensions of the taxpayer's Federal tax return for the applicable taxable year, notwithstanding that the taxpayer may not have extended the due date.

Finally, a taxpayer may also choose to apply the 2011 temporary regulations to taxable years beginning on or after January 1, 2012, and before January 1, 2014. For taxpayers choosing to apply the temporary regulations to these taxable years, certain provisions of the temporary regulations only apply to amounts paid or incurred in taxable years beginning on or after January 1, 2012, and before January 1, 2014.

X. Change in Method of Accounting

The IRS and the Treasury Department received several comments regarding the procedures that a taxpayer should utilize to change its method of accounting to comply with the regulations. Several commenters favored the use of a cut-off method, primarily for reasons of administrative convenience. However, other commenters asserted that any change in method of accounting must include a section 481(a) adjustment.

The final regulations provide that, except as otherwise stated, a change to comply with the final regulations is a change in method of accounting to which the provisions of sections 446 and 481 and the accompanying regulations apply. A taxpayer seeking to change to a method of accounting permitted in the final regulations must secure the consent of the Commissioner in accordance with § 1.446–1(e) and follow the administrative procedures issued under § 1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to change its accounting method. In general, a taxpayer seeking a change in method of accounting to comply with these regulations must take into account a full adjustment under section 481(a).

The imposition of a section 481(a) adjustment for a change in method of accounting to conform to the final regulations provides for a uniform and consistent rule for all taxpayers and ultimately reduces the administrative burdens on taxpayers and the IRS in enforcing the requirements of section 263(a). Although the IRS and the Treasury Department recognize that requiring a section 481(a) adjustment may place a burden on taxpayers to calculate reasonable adjustments, taxpayers have shown a willingness and ability to make these calculations in requesting method changes after the publication of the 2008 proposed regulations and after the publication of the 2011 temporary regulations. In addition, taxpayers and the IRS routinely reach agreements on calculation methodologies and amounts.

Separate procedures will be provided under which taxpayers may obtain automatic consent for a taxable year beginning on or after January 1, 2012, to change to a method of accounting provided in the final regulations. Although a taxpayer seeking a change in method of accounting to comply with these regulations generally must take into account a full adjustment under section 481(a), it is anticipated that for the specific situation where a taxpayer seeks to change to a method of accounting that is applicable only to amounts paid or incurred in taxable years beginning on or after January 1, 2014, a limited section 481(a) adjustment will apply, taking into account only amounts paid or incurred in taxable years beginning on or after January 1, 2014, or at a taxpayer's option, amounts paid or incurred in taxable years beginning on or after January 1, 2012.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. 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.

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that these final regulations will not have a significant economic impact on a substantial number of small entities. This regulation affects all small business taxpayers. While a collection of information is required by this regulation in §§ 1.263(a)–1(f)(5), 1.263(a)–2(h)(6), and 1.263(a)–3(n), this collection will not have a significant economic impact on small entities. This information is required for a taxpayer to elect to use the de minimis safe harbor, to elect a safe harbor for determining the treatment of amounts related to buildings owned or leased by small taxpayers, and to elect to capitalize certain repair and maintenance costs. These elections were provided in the regulations in response to comment letters submitted on behalf of small business taxpayers requesting that these types of provisions be added to the regulations to assist small businesses. All of these elections are voluntary, beneficial, and were designed to simplify the application of sections 162 and 263(a) to small taxpayers. The provisions require a taxpayer to file a statement with the taxpayer's timely filed original tax return to inform the IRS that the taxpayer is electing to use these provisions. The estimated time to prepare a statement should not exceed 15 minutes, and the filing of the statement allows the taxpayer to receive the beneficial treatment for the amounts that qualify for the statement. Based on these facts, a regulatory flexibility analysis under Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Statement of Availability for IRS Documents

For copies of recently issued revenue procedures, revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin or Cumulative Bulletin, please visit the IRS Web site at *http://www.irs.gov*.

Drafting Information

The principal authors of these regulations are Merrill D. Feldstein and Kathleen Reed, Office of the Associate Chief Counsel (Income Tax and Accounting). Other personnel from the IRS and the Treasury Department have participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Record and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are 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-incidental materials and supplies.* Except as provided in paragraphs (d), (e), and (f) of this section, amounts paid to acquire or produce materials and supplies (as defined in paragraph (c) of this section) are deductible in the taxable year in which the materials and supplies are first used in the taxpayer's operations or are consumed in the taxpayer's operations.

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

(3) *Use or consumption of rotable and temporary spare parts.* Except as provided in paragraphs (d), (e), and (f) of this section, for purposes of paragraph (a)(1) of this section, rotable and temporary spare parts (defined under paragraph (c)(2) of this section) are first used in the taxpayer's operations or are consumed in the taxpayer's operations in the taxable year in which the taxpayer disposes of the parts.

(b) *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 § 1.263(a)–3, which requires taxpayers to capitalize amounts paid to improve tangible 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, of property produced by the taxpayer and property acquired for resale. See also § 1.471–1, which requires taxpayers to include in inventory certain materials and supplies.

(c) *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 that is not inventory and that—

(i) Is a component acquired to maintain, repair, or improve a unit of tangible property (as determined under § 1.263(a)–3(e)) owned, leased, or serviced by the taxpayer and that is not acquired as part of any single unit of tangible property;

(ii) Consists of fuel, lubricants, water, and similar items, reasonably expected to be consumed in 12 months or less, beginning when used in the taxpayer's operations;

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

(iv) Is a unit of property as determined under § 1.263(a)–3(e) that has an acquisition cost or production cost (as determined under section 263A) of $200 or less (or other amount as identified in published guidance in the **Federal Register** or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter); or

(v) 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) *Rotable and temporary spare parts.* For purposes of this section, rotable spare parts are materials and supplies under paragraph (c)(1)(i) of this section that are acquired for installation on a unit of property, removable from that unit of property, generally repaired or improved, and either reinstalled on the same or other property or stored for later installation. Temporary spare parts are materials and supplies under paragraph (c)(1)(i) of this section that are used temporarily until a new or repaired part can be installed and then are removed and stored for later installation.

(3) *Standby emergency spare parts.* Standby emergency spare parts are materials and supplies under paragraph (c)(1)(i) of this section that are—

(i) Acquired when particular machinery or equipment is acquired (or later acquired and set aside for use in particular machinery or equipment);

(ii) Set aside for use as replacements to avoid substantial operational time loss caused by emergencies due to particular machinery or equipment failure;

(iii) Located at or near the site of the installed related machinery or equipment so as to be readily available when needed;

(iv) Directly related to the particular machinery or piece of equipment they serve;

(v) Normally expensive;

(vi) Only available on special order and not readily available from a vendor or manufacturer;

(vii) Not subject to normal periodic replacement;

(viii) Not interchangeable in other machines or equipment;

(x) Not acquired in quantity (generally only one is on hand for each piece of machinery or equipment); and

(xi) Not repaired and reused.

(4) *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 (c)(4)(iii) of this section), the economic useful life of a unit of property, solely for the purposes of applying the provisions of paragraph (c)(4)(iii) 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 a unit of property was originally acquired or produced, the economic useful life of the unit of property must be determined under paragraph (c)(4)(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 (c)(4)(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 a unit of property costing less than a certain dollar amount, notwithstanding that the unit of property has a useful life of more than one year, the economic useful life of the unit of property must be determined under paragraph (c)(4)(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 (c)(4)(iii)(A) through (C) of this section that has the highest priority (including within paragraph (c)(4)(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 certified public accountant (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 agency (other than the SEC or the Internal Revenue Service).

(5) *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.

(6) *Produce.* For purposes of this section, *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 (c)(6) and are separately defined and addressed in § 1.263(a)–3. Amounts paid to produce materials and supplies are subject to section 263A.

(d) *Election to capitalize and depreciate certain materials and supplies*—(1) *In general.* A taxpayer may elect to treat as a capital expenditure and to treat as an asset subject to the allowance for depreciation the cost of any rotable spare part, temporary spare part, or standby emergency spare part as defined in paragraph (c)(3) or (c)(4) of this section. Except as specified in paragraph (d)(2) of this section, an election made under this paragraph (d) applies to amounts paid during the taxable year to acquire or produce any rotable, temporary, or standby emergency spare part to which paragraph (a) of this section would apply (but for the election under this paragraph (d)). Any property for which this election is made shall not be treated as a material or a supply.

(2) *Exceptions.* A taxpayer may not elect to capitalize and depreciate under paragraph (d) of this section any amount paid to acquire or produce a rotable, temporary, or standby emergency spare part defined in paragraph (c)(3) or (c)(4) of this section if—

(i) The rotable, temporary, or standby emergency spare part is intended to be used as a component of a unit of property under paragraph (c)(1)(iii), (iv), or (v) of this section;

(ii) The rotable, temporary, or standby emergency spare part is intended to be used as a component of a property described in paragraph (c)(1)(i) and the taxpayer cannot or has not elected to capitalize and depreciate that property under this paragraph (d); or

(iii) The amount is paid to acquire or produce a rotable or temporary spare part and the taxpayer uses the optional method of accounting for rotable and temporary spare parts under paragraph (e) to of this section.

(3) *Manner of electing.* A taxpayer makes the election under paragraph (d) of this section by capitalizing the amounts paid to acquire or produce a rotable, temporary, or standby emergency spare part in the taxable year the amounts are paid and by beginning to recover the costs when the asset is placed in service by the taxpayer for the purposes of determining depreciation under the applicable provisions of the Internal Revenue Code and the Treasury Regulations. See § 1.263(a)–2 for the treatment of amounts paid to acquire or produce real or personal tangible property. A taxpayer must make this election in its timely filed original Federal tax return (including extensions) for the taxable year the asset is placed in service by the taxpayer for purposes of determining depreciation. See §§ 301.9100–1 through 301.9100–3 of this chapter for the provisions governing extensions of time to make regulatory elections. In the case of an S corporation or a partnership, the election is made by the S corporation or partnership, and not by the shareholders or partners. A taxpayer may make an election for each rotable, temporary, or standby emergency spare part that qualifies for the election under this paragraph (d). A taxpayer may revoke an election made under this paragraph (d) with respect to a rotable, temporary, or standby emergency spare part only by filing a request for a private letter ruling and obtaining the Commissioner's consent to revoke the election. The Commissioner may grant a request to revoke this election if the taxpayer acted reasonably and in good faith and the revocation will not prejudice the interests of the Government. See generally § 301.9100–3 of this chapter. The manner of electing and revoking the election to capitalize under this paragraph (d) may be modified through

guidance of general applicability (see §§ 601.601(d)(2) and 601.602 of this chapter). An election may not be made or revoked through the filing of an application for change in accounting method or, before obtaining the Commissioner's consent to make the late election or to revoke the election, by filing an amended Federal tax return.

(e) *Optional method of accounting for rotable and temporary spare parts*—(1) *In general.* This paragraph (e) provides an optional method of accounting for rotable and temporary spare parts (the optional method for rotable parts). A taxpayer may use the optional method for rotable parts, instead of the general rule under paragraph (a)(3) of this section, to account for its rotable and temporary spare parts as defined in paragraph (c)(2) of this section. A taxpayer that uses the optional method for rotable parts must use this method for all of its pools of rotable and temporary spare parts used in the same trade or business and for which it uses this method for its books and records. If a taxpayer uses the optional method for rotable and temporary spare parts for pools of rotable or temporary spare parts for which the taxpayer does not use the optional method for its book and records, then the taxpayer must use the optional method for all its pools of rotable spare parts in the same trade or business. The optional method for rotable parts is a method of accounting under section 446(a). Under the optional method for rotable parts, the taxpayer must apply the rules in this paragraph (e) to each rotable or temporary spare part (part) upon the taxpayer's initial installation, removal, repair, maintenance or improvement, reinstallation, and disposal of each part.

(2) *Description of optional method for rotable parts*—(i) *Initial installation.* The taxpayer must deduct the amount paid to acquire or produce the part in the taxable year that the part is first installed on a unit of property for use in the taxpayer's operations.

(ii) *Removal from unit of property.* In each taxable year in which the part is removed from a unit of property to which it was initially or subsequently installed, the taxpayer must—

(A) Include in gross income the fair market value of the part; and

(B) Include in the basis of the part the fair market value of the part included in income under paragraph (e)(2)(ii)(A) of this section and the amount paid to remove the part from the unit of property.

(iii) *Repair, maintenance, or improvement of part.* The taxpayer may not currently deduct and must include in the basis of the part any amounts paid to maintain, repair, or improve the part in the taxable year these amounts are paid.

(iv) *Reinstallation of part.* The taxpayer must deduct the amounts paid to reinstall the part and those amounts included in the basis of the part under paragraphs (e)(2)(ii)(B) and (e)(2)(iii) of this section, to the extent that those amounts have not been previously deducted under this paragraph (e)(2)(iv), in the taxable year that the part is reinstalled on a unit of property.

(v) *Disposal of the part.* The taxpayer must deduct the amounts included in the basis of the part under paragraphs (e)(2)(ii)(B) and (e)(2)(iii) of this section, to the extent that those amounts have not been previously deducted under paragraph (e)(2)(iv) of this section, in the taxable year in which the part is disposed of by the taxpayer.

(f) *Application of de minimis safe harbor.* If a taxpayer elects to apply the de minimis safe harbor under § 1.263(a)–1(f) to amounts paid for the production or acquisition of tangible property, then the taxpayer must apply the de minimis safe harbor to amounts paid for all materials and supplies that meet the requirements of § 1.263(a)–1(f), except for those materials and supplies that the taxpayer elects to capitalize and depreciate under paragraph (d) of this section or for which the taxpayer properly uses the optional method of accounting for rotable and temporary spare parts under paragraph (e) of this section. If the taxpayer properly applies the de minimis safe harbor under § 1.263(a)–1(f) to amounts paid for materials and supplies, then these amounts are not treated as amounts paid for materials and supplies under this section. See § 1.263(a)–1(f)(5) for the time and manner of electing the de minimis safe harbor and § 1.263(a)–1(f)(3)(iv) for the treatment of safe harbor amounts.

(g) *Sale or disposition of materials and supplies.* Upon sale or other disposition, materials and supplies as defined in this section are not treated as a capital asset under section 1221 or as property used in the trade or business under section 1231. Any asset for which the taxpayer makes the election to capitalize and depreciate under paragraph (d) of this section shall not be treated as a material or supply, and the recognition and character of the gain or loss for such depreciable asset are determined under other applicable provisions of the Code.

(h) *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 computes its income on a calendar year basis, that the taxpayer does not make the election to apply paragraph (d) of this section, or use the method of accounting described in paragraph (e) of this section, and that the taxpayer has not elected to apply the de minimis safe harbor under § 1.263(a)–1(f). The following examples illustrate only the application of this section and, unless otherwise stated, do not address the treatment under other provisions of the Code (for example, section 263A).

Example 1. Non-rotable components. A owns a fleet of aircraft that it operates in its business. In Year 1, A purchases a stock of spare parts, which it uses to maintain and repair its aircraft. A keeps a record of consumption of these spare parts. In Year 2, A uses the spare parts for the repair and maintenance of one of its aircraft. Assume each aircraft is a unit of property under § 1.263(a)–3(e) and that spare parts are not rotable or temporary spare parts under paragraph (c)(2) of this section. Assume these repair and maintenance activities do not improve the aircraft under § 1.263(a)–3. These parts are materials and supplies under paragraph (c)(1)(i) of this section because they are components acquired and used to maintain and repair A's aircraft. Under paragraph (a)(1) of this section, the amounts that A paid for the spare parts in Year 1 are deductible in Year 2, the taxable year in which the spare parts are first used to repair and maintain the aircraft.

Example 2. Rotable spare parts; disposal method. B operates a fleet of specialized vehicles that it uses in its service business. Assume that each vehicle is a unit of property under § 1.263(a)–3(e). At the time that it acquires a new type of vehicle, B also acquires a substantial number of rotable spare parts that it will keep on hand to quickly replace similar parts in B's vehicles as those parts break down or wear out. These rotable parts are removable from the vehicles and are repaired so that they can be reinstalled on the same or similar vehicles. In Year 1, B acquires several vehicles and a number of rotable spare parts to be used as replacement parts in these vehicles. In Year 2, B repairs several vehicles by using these rotable spare parts to replace worn or damaged parts. In Year 3, B removes these rotable spare parts from its vehicles, repairs the parts, and reinstalls them on other similar vehicles. In Year 5, B can no longer use the rotable parts it acquired in Year 1 and disposes of them as scrap. Assume that B does not improve any of the rotable spare parts under § 1.263(a)–3. Under paragraph (c)(1)(i) of this section, the rotable spare parts acquired in Year 1 are materials and supplies. Under paragraph (a)(3) of this section, rotable spare parts are generally used or consumed in the taxable year in which the taxpayer disposes of the parts. Therefore, under paragraph (a)(1) of this section, the amounts that B paid for the rotable spare parts in Year 1 are deductible in Year 5, the taxable year in which B disposes of the parts.

Example 3. Rotable spare parts; application of optional method of *accounting.* C operates a fleet of specialized vehicles that it uses in its service business. Assume that each vehicle is a unit of property under § 1.263(a)–3(e). At the time that it acquires a new type of vehicle, C also acquires a substantial number of rotable spare parts that it will keep on hand to replace similar parts in C's vehicles as those parts break down or wear out. These rotable parts are removable from the vehicles and are repaired so that they can be reinstalled on the same or similar vehicles. C uses the optional method of accounting for all its rotable and temporary spare parts under paragraph (e) of this section. In Year 1, C acquires several vehicles and a number of rotable spare parts (the ''Year 1 rotable parts'') to be used as replacement parts in these vehicles. In Year 2, C repairs several vehicles and uses the Year 1 rotable parts to replace worn or damaged parts. In Year 3, C pays amounts to remove these Year 1 rotable parts from its vehicles. In Year 4, C pays amounts to maintain, repair, or improve the Year 1 rotable parts. In Year 5, C pays amounts to reinstall the Year 1 rotable parts on other similar vehicles. In Year 8, C removes the Year 1 rotable parts from these vehicles and stores these parts for possible later use. In Year 9, C disposes of the Year 1 rotable parts. Under paragraph (e) of this section, C must deduct the amounts paid to acquire and install the Year 1 rotable parts in Year 2, the taxable year in which the rotable parts are first installed by C in C's vehicles. In Year 3, when C removes the Year 1 rotable parts from its vehicles, C must include in its gross income the fair market value of each part. Also, in Year 3, C must include in the basis of each Year 1 rotable part the fair market value of the rotable part and the amount paid to remove the rotable part from the vehicle. In Year 4, C must include in the basis of each Year 1 rotable part the amounts paid to maintain, repair, or improve each rotable part. In Year 5, the year that C reinstalls the Year 1 rotable parts (as repaired or improved) in other vehicles, C must deduct the reinstallation costs and the amounts previously included in the basis of each part. In Year 8, the year that C removes the Year 1 rotable parts from the vehicles, C must include in income the fair market value of each rotable part removed. In addition, in Year 8, C must include in the basis of each part the fair market value of that part and the amount paid to remove each rotable part from the vehicle. In Year 9, the year that C disposes of the Year 1 rotable parts, C may deduct the amounts remaining in the basis of each rotable part.

Example 4. Rotable part acquired as part of a single unit of property; not material or supply. D operates a fleet of aircraft. In Year 1, D acquires a new aircraft, which includes two new aircraft engines. The aircraft costs $500,000 and has an economic useful life of more than 12 months, beginning when it is placed in service. In Year 5, after the aircraft is operated for several years in D's business, D removes the engines from the aircraft, repairs or improves the engines, and either reinstalls the engines on a similar aircraft or stores the engines for later reinstallation. Assume the aircraft purchased in Year 1, including its two engines, is a unit of property under § 1.263(a)–3(e). Because the engines were acquired as part of the aircraft, a single unit of property, the engines are not materials or supplies under paragraph (c)(1)(i) of this section nor rotable or temporary spare parts under paragraph (c)(2) of this section. Accordingly, D may not apply the rules of this section to the aircraft engines upon the original acquisition of the aircraft nor after the removal of the engines from the aircraft for use in the same or similar aircraft. Rather, D must apply the rules under §§ 1.263(a)–2 and 1.263(a)–3 to the aircraft, including its engines, to determine the treatment of amounts paid to acquire, produce, or improve the unit of property.

Example 5. Consumable property. E operates a fleet of aircraft that carries freight for its customers. E has several storage tanks on its premises, which hold jet fuel for its aircraft. Assume that once the jet fuel is placed in E's aircraft, the jet fuel is reasonably expected to be consumed within 12 months or less. On December 31, Year 1, E purchases a two-year supply of jet fuel. In Year 2, E uses a portion of the jet fuel purchased on December 31, Year 1, to fuel the aircraft used in its business. The jet fuel that E purchased in Year 1 is a material or supply under paragraph (c)(1)(ii) of this section because it is reasonably expected to be consumed within 12 months or less from the time it is placed in E's aircraft. Under paragraph (a)(1) of this section, E may deduct in Year 2 the amounts paid for the portion of jet fuel used in the operation of E's aircraft in Year 2.

Example 6. Unit of property that costs $200 or less. F operates a business that rents out a variety of small individual items to customers (rental items). F maintains a supply of rental items on hand. In Year 1, F purchases a large quantity of rental items to use in its rental business. Assume that each rental item is a unit of property under § 1.263(a)–3(e) and costs $200 or less. In Year 2, F begins using all the rental items purchased in Year 1 by providing them to customers of its rental business. F does not sell or exchange these items on established retail markets at any time after the items are used in the rental business. The rental items are materials and supplies under paragraph (c)(1)(iv) of this section. Under paragraph (a)(1) of this section, the amounts that F paid for the rental items in Year 1 are deductible in Year 2, the taxable year in which the rental items are first used in F's business.

Example 7. Unit of property that costs $200 or less. G provides billing services to its customers. In Year 1, G pays amounts to purchase 50 scanners to be used by its employees. Assume each scanner is a unit of property under § 1.263(a)–3(e) and costs less than $200. In Year 1, G's employees begin using 35 of the scanners, and F stores the remaining 15 scanners for use in a later taxable year. The scanners are materials and supplies under paragraph (c)(1)(iv) of this section. Under paragraph (a)(1) of this section, the amounts G paid for 35 of the scanners are deductible in Year 1, the taxable year in which G first uses each of those scanners. The amounts that G paid for each of the remaining 15 scanners are deductible in the taxable year in which each machine is first used in G's business.

Example 8. Materials and supplies that cost less than $200; de minimis safe harbor. Assume the same facts as in *Example 7* except that G's scanners qualify for the de minimis safe harbor under § 1.263(a)–1(f), and G properly elects to apply the de minimis safe harbor under § 1.263(a)–1(f) to amounts paid in Year 1. G must apply the de minimis safe harbor under § 1.263(a)–1(f) to amounts paid for the scanners, rather than treat these amounts as costs of materials and supplies under this section. In accordance with § 1.263(a)–1(f)(3)(iv), G may deduct the amounts paid for all 50 scanners under § 1.162–1 in the taxable year the amounts are paid.

Example 9. Unit of property that costs $200 or less; bulk purchase. H provides consulting services to its customers. In Year 1, H pays $500 to purchase one box of 10 toner cartridges to use as needed for H's printers. Assume each toner cartridge is a unit of property under § 1.263(a)–3(e). In Year 1, H's employees place 8 of the toner cartridges in printers in H's office, and store the remaining 2 cartridges for use in a later taxable year. The toner cartridges are materials and supplies under paragraph (c)(1)(iv) of this section because even though purchased in one box costing more than $200, the allocable cost of each unit of property equals $50. Therefore, under paragraph (a)(1) of this section, the $400 paid by H for 8 of the cartridges is deductible in Year 1, the taxable year in which H first uses each of those cartridges. The amounts paid by H for each of the remaining 2 cartridges ($50 each) are deductible in the taxable year in which each cartridge is first used in H's business.

Example 10. Materials and supplies used in improvements; coordination with § 1.263(a)–3. J owns various machines that are used in its business. Assume that each machine is a unit of property under § 1.263(a)–3(e). In Year 1, J purchases a supply of spare parts for its machines. J acquired the parts to use in the repair or maintenance of the machines under § 1.162–4 or in the improvement of the machines under § 1.263(a)–3. The spare parts are not rotable or temporary spare parts under paragraph (c)(2) of this section. In Year 2, J uses all of these spare parts in an activity that improves a machine under § 1.263(a)–3. Under paragraph (c)(1)(i) of this section, the spare parts purchased by J in Year 1 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 Year 2, the taxable year in which J uses those parts. However, because these materials and supplies are used to improve J's machine, J is required to capitalize the amounts paid for those spare parts under § 1.263(a)–3.

Example 11. Cost of producing materials and supplies; coordination with section 263A. K is a manufacturer that produces liquid waste as part of its operations. K determines that its current liquid waste disposal process is inadequate. To remedy the problem, in Year 1, K constructs a leaching pit to provide a draining area for the liquid waste. Assume the leaching pit is a unit of property under § 1.263(a)–3(e) and has an economic useful life of 12 months or less, starting on the date that K begins to use the leaching pit as a draining area. At the end of this period, K's factory will be connected to the local sewer system. In Year 2, K 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 (c)(1)(iii) of this section. However, the amounts paid to construct the leaching pit may be subject to capitalization under section 263A if these amounts comprise the direct or allocable indirect costs of property produced by K.

Example 12. Costs of acquiring materials and supplies for production of property; coordination with section 263A. In Year 1, L purchases jigs, dies, molds, and patterns for use in the manufacture of L's products. Assume each jig, die, mold, and pattern is a unit of property under § 1.263(a)–3(e). 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. The jigs, dies, molds, and patterns are not components acquired to maintain, repair, or improve any of L's equipment under paragraph (c)(1)(i) of this section. L begins using the jigs, dies, molds and patterns in Year 2 to manufacture its products. These items are materials and supplies under paragraph (c)(1)(iii) of this section. Under paragraph (a)(1) of this section, the amounts paid for the items are otherwise deductible in Year 2, the taxable year in which L first uses those items. However, the amounts paid for these materials and supplies may be subject to capitalization under section 263A if these amounts comprise the direct or allocable indirect costs of property produced by L.

Example 13. Election to capitalize and depreciate. M is in the mining business. M acquires certain temporary spare parts, which it keeps on hand to avoid operational time loss in the event it must make temporary repairs to a unit of property that is subject to depreciation. These parts are not used to improve property under § 1.263(a)–3(d). These temporary spare parts are used until a new or repaired part can be installed and then are removed and stored for later temporary installation. M does not use the optional method of accounting for rotable and temporary spare parts in paragraph (e) of this section for any of its rotable or temporary spare parts. The temporary spare parts are materials and supplies under paragraph (c)(1)(i) of this section. Under paragraphs (a)(1) and (a)(3) of this section, the amounts paid for the temporary spare parts are deductible in the taxable year in which they are disposed of by M. However, because it is unlikely that the temporary spare parts will be disposed of in the near future, M would prefer to treat the amounts paid for the spare parts as capital expenditures subject to depreciation. M may elect under paragraph (d) of this section to treat the cost of each temporary spare part as a capital expenditure and as an asset subject to an allowance for depreciation. M makes this election by capitalizing the amounts paid for each spare part in the taxable year that M acquires the spare parts and by beginning to recover the costs of each part on its timely filed Federal tax return for the taxable year in which the part is placed in service for purposes of determining depreciation under the applicable provisions of the Internal Revenue Code and the Treasury Regulations. See § 1.263(a)–2(g) for the treatment of capital expenditures.

Example 14. Election to apply de minimis safe harbor. (i) N provides consulting services to its customers. In Year 1, N pays amounts to purchase 50 laptop computers. Each laptop computer is a unit of property under § 1.263(a)–3(e), costs $400, and has an economic useful life of more than 12 months. Also in Year 1, N purchases 50 office chairs to be used by its employees. Each office chair is a unit of property that costs $100. N has an applicable financial statement (as defined in § 1.263(a)–1(f)(4)) and N has a written accounting policy at the beginning Year 1 to expense amounts paid for units of property costing $500 or less. N treats amounts paid for property costing $500 or less as an expense on its applicable financial statement in Year 1.

(ii) The laptop computers are not materials or supplies under paragraph (c) of this section. Therefore, the amounts N pays for the computers must generally be capitalized under § 1.263(a)–2(d) as amounts paid for the acquisition of tangible property. The office chairs are materials and supplies under paragraph (c)(1)(iv) of this section. Thus, under paragraph (a)(1) of this section, the amounts paid for the office chairs are deductible in the taxable year in which they are first used in N's business. However, under paragraph (f) of this section, if N properly elects to apply the de minimis safe harbor under § 1.263(a)–1(f) to amounts paid in Year 1, then N must apply the de minimis safe harbor under § 1.263(a)–1(f) to amounts paid for the computers and the office chairs, rather than treat the office chairs as the costs of materials and supplies under § 1.162–3. Under the de minimis safe harbor, N may not capitalize the amounts paid for the computers under § 1.263(a)–2 nor treat the office chairs as materials and supplies under § 1.162–3. Instead, in accordance with § 1.263(a)–1(f)(3)(iv), under § 1.162–1, N may deduct the amounts paid for the computers and the office chairs in the taxable year paid.

(i) *Accounting method changes.* Except as otherwise provided in this section, a change to comply with this section is a change in method of accounting to which the provisions of sections 446 and 481 and the accompanying regulations apply. A taxpayer seeking to change to a method of accounting permitted in this section must secure the consent of the Commissioner in accordance with § 1.446–1(e) and follow the administrative procedures issued under § 1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to change its accounting method.

(j) *Effective/applicability date*—(1) *In general.* This section generally applies to amounts paid or incurred in taxable years beginning on or after January 1, 2014. However, a taxpayer may apply paragraph (e) of this section (the optional method of accounting for rotable and temporary spare parts) to taxable years beginning on or after January 1, 2014. Except as provided in paragraphs (j)(2) and (j)(3) of this section, § 1.162–3 as contained in 26 CFR part 1 edition revised as of April 1, 2011, applies to taxable years beginning before January 1, 2014.

(2) *Early application of this section*—(i) *In general.* Except for paragraph (e) of this section, a taxpayer may choose to apply this section to amounts paid or incurred in taxable years beginning on or after January 1, 2012. A taxpayer may choose to apply paragraph (e) of this section (the optional method of accounting for rotable and temporary spare parts) to taxable years beginning on or after January 1, 2012.

(ii) *Transition rule for election to capitalize materials and supplies on 2012 and 2013 returns.* If under paragraph (j)(2)(i) of this section, a taxpayer chooses to make the election to capitalize and depreciate certain materials and supplies under paragraph (d) of this section for its taxable year beginning on or after January 1, 2012, and ending on or before September 19, 2013 (applicable taxable year), and the taxpayer did not make the election specified in paragraph (d)(3) of this section on its timely filed original Federal tax return for the applicable taxable year, the taxpayer must make the election specified in paragraph (d)(3) of this section for the applicable taxable year by filing an amended Federal tax return for the applicable taxable year on or before 180 days from the due date including extensions of the taxpayer's Federal tax return for the applicable taxable year, notwithstanding that the taxpayer may not have extended the due date.

(3) *Optional application of TD 9564.* Except for section 1.162–3T(e), a taxpayer may choose to apply § 1.162–3T as contained in TD 9564 (76 FR 81060) December 27, 2011, to amounts paid or incurred (to acquire or produce property) in taxable years beginning on or after January 1, 2012, and before January 1, 2014. A taxpayer may choose to apply section 1.162–3T(e) (the optional method of accounting for rotable and temporary spare parts) as contained in TD 9564 (76 FR 81060) December 27, 2011, to taxable years beginning on or after January 1, 2012, and before January 1, 2014.

§ 1.162–3T [Removed]

■ **Par. 3.** Section 1.162–3T is removed.

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

§ 1.162–4 Repairs.

(a) *In general.* A taxpayer may deduct amounts paid for repairs and maintenance to tangible property if the amounts paid are not otherwise required to be capitalized. For the election to capitalize amounts paid for repair and maintenance consistent with the taxpayer's books and records, see § 1.263(a)–3(n).

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

(c) *Effective/applicability date*—(1) *In general.* This section applies to taxable years beginning on or after January 1, 2014. Except as provided in paragraphs (c)(2) and (c)(3) of this section, § 1.162–4 as contained in 26 CFR part 1 edition revised as of April 1, 2011, applies to taxable years beginning before January 1, 2014.

(2) *Early application of this section.* A taxpayer may choose to apply this section to taxable years beginning on or after January 1, 2012.

(3) *Optional application of TD 9564.* A taxpayer may choose to apply § 1.162–4T as contained in TD 9564 (76 FR 81060), December 27, 2011, to taxable years beginning on or after January 1, 2012, and before January 1, 2014.

§ 1.162–4T [Removed]

■ **Par. 5.** Section 1.162–4T is removed.

■ **Par. 6.** Section 1.162–11 is amended by:

■ 1. Revising paragraph (b).

■ 2. Removing paragraphs (c) and (d).

The revision reads as follows:

§ 1.162–11 Rentals.

* * * * *

(b) *Improvements by lessee on lessor's property*—(1) In general. The cost to a taxpayer of erecting buildings or making permanent improvements on property of which the taxpayer is a lessee is a capital expenditure. For the rules regarding improvements to leased property when the improvements are tangible property, see § 1.263(a)–3(f). For the rules regarding depreciation or amortization deductions for leasehold improvements, see § 1.167(a)–4.

(2) *Effective/applicability date*—(i) *In general.* This paragraph (b) applies to taxable years beginning on or after January 1, 2014. Except as provided in paragraphs (b)(2)(ii) and (b)(2)(iii) of this section, § 1.162–11(b) as contained in 26 CFR part 1 edition revised as of April 1, 2011, applies to taxable years beginning before January 1, 2014.

(ii) *Early application of this paragraph.* A taxpayer may choose to apply this paragraph (b) to taxable years beginning on or after January 1, 2012.

(iii) *Optional application of TD 9564.* A taxpayer may choose to apply § 1.162–11T(b) as contained in TD 9564 (76 FR 81060) December 27, 2011, to taxable years beginning on or after January 1, 2012, and before January 1, 2014.

§ 1.162–11T [Removed]

■ **Par. 7.** Section 1.162–11T is removed.

■ **Par. 8.** Section 1.165–2 is amended by:

■ 1. Revising paragraphs (c) and (d).

■ 2. Removing paragraph (e).

The revisions read as follows:

§ 1.165–2 Obsolescence of nondepreciable property.

* * * * *

(c) *Cross references.* For the allowance under section 165(a) of losses arising from the permanent withdrawal of depreciable property from use in the trade or business or in the production of income, see § 1.167(a)–8, § 1.168(i)–1, § 1.168(i)–1T, § 1.168(i)–8T, Prop. Reg. § 1.168(i)–1 (September 19, 2013), or Prop. Reg. § 1.168(i)–8 (September 19, 2013), as applicable. For provisions respecting the obsolescence of depreciable property for which depreciation is determined under section 167 (but not under section 168, section 1400I, section 1400L(c), section 168 prior to its amendment by the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2121 (1986)), or under an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k) through (n), 1400L(b), or 1400N(d))), see § 1.167(a)–9. For the allowance of casualty losses, see § 1.165–7.

(d) *Effective/applicability date*—(1) *In general.* This section applies to taxable years beginning on or after January 1, 2014. Except as provided in paragraphs (d)(2) and (d)(3) of this section, § 1.165–2 as contained in 26 CFR part 1 edition revised as of April 1, 2011, applies to taxable years beginning before January 1, 2014.

(2) *Early application of § 1.165–2(c).* A taxpayer may choose to apply paragraph (c) of this section to taxable years beginning on or after January 1, 2012.

(3) *Optional application of TD 9564.* A taxpayer may choose to apply § 1.165–2T as contained in TD 9564 (76 FR 81060) December 27, 2011, to taxable years beginning on or after January 1, 2012, and before January 1, 2014.

§ 1.165–2T [Removed]

■ **Par. 9.** Section 1.165–2T is removed.

■ **Par. 10.** Section 1.167(a)–4 is revised to read as follows:

§ 1.167(a)–4 Leased property.

(a) *In general.* Capital expenditures made by either a lessee or lessor for the erection of a building or for other permanent improvements on leased property are recovered by the lessee or lessor under the provisions of the Internal Revenue Code (Code) applicable to the cost recovery of the building or improvements, if subject to depreciation or amortization, without regard to the period of the lease. For example, if the building or improvement is property to which section 168 applies, the lessee or lessor determines the depreciation deduction for the building or improvement under section 168. See section 168(i)(8)(A). If the improvement is property to which section 167 or section 197 applies, the lessee or lessor determines the depreciation or amortization deduction for the improvement under section 167 or section 197, as applicable.

(b) *Effective/applicability date*—(1) *In general.* Except as provided in paragraph (b)(2) or (b)(3) of this section, this section applies to taxable years beginning on or after January 1, 2014.

(2) *Application of this section to leasehold improvements placed in service after December 31, 1986, in taxable years beginning before January 1, 2014.* For leasehold improvements placed in service after December 31, 1986, in taxable years beginning before January 1, 2014, a taxpayer may—

(i) Apply the provisions of this section; or

(ii) Depreciate any leasehold improvement to which section 168 applies under the provisions of section 168 and depreciate or amortize any leasehold improvement to which section 168 does not apply under the provisions of the Code that are applicable to the cost recovery of that leasehold improvement, without regard to the period of the lease.

(3) *Application of this section to leasehold improvements placed in service before January 1, 1987.* Section 1.167(a)–4 as contained in 26 CFR part 1 edition revised as of April 1, 2011, applies to leasehold improvements placed in service before January 1, 1987.

(4) *Change in method of accounting.* Except as provided in § 1.446–1(e)(2)(ii)(*d*)(*3*)(*i*), a change to comply with this section for depreciable assets placed in service in a taxable year ending on or after December 30, 2003, is a change in method of accounting to which the provisions of section 446(e) and the regulations under section 446(e) apply. Except as provided in § 1.446–1(e)(2)(ii)(*d*)(*3*)(*i*), a taxpayer also may treat a change to comply with this section for depreciable assets placed in service in a taxable year ending before December 30, 2003, as a change in method of accounting to which the provisions of section 446(e) and the regulations under section 446(e) apply.

§ 1.167(a)–4T [Removed]

■ **Par. 11.** Section 1.167(a)–4T is removed.

■ **Par. 12.** Section 1.167(a)–7 is amended by:

■ 1. Revising paragraphs (e) and (f).

■ 2. Removing paragraph (g).

The revisions read as follows:

§ 1.167(a)–7 Accounting for depreciable property.

* * * * *

(e) *Applicability.* Paragraphs (a), (b), and (d) of this section apply to property for which depreciation is determined under section 167 (but not under section 168, section 1400I, section 1400L(c), section 168 prior to its amendment by the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2121 (1986)), or under an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k) through (n), 1400L(b), or 1400N(d))). Paragraph (c) of this section does not apply to general asset accounts as provided by section 168(i)(4), § 1.168(i)–1, § 1.168(i)–1T and Prop. Reg. § 1.168(i)–1 (September 19, 2013).

(f) *Effective/applicability date*—(1) *In general.* This section applies to taxable years beginning on or after January 1, 2014. Except as provided in paragraphs (f)(2) and (f)(3) of this section, § 1.167(a)–7 as contained in 26 CFR part 1 edition revised as of April 1, 2011, applies to taxable years beginning before January 1, 2014.

(2) *Early application of § 1.167(a)–7(e).* A taxpayer may choose to apply paragraph (e) of this section to taxable years beginning on or after January 1, 2012.

(3) *Optional application of TD 9564.* A taxpayer may choose to apply § 1.167(a)–7T as contained in TD 9564 (76 FR 81060) December 27, 2011, to taxable years beginning on or after January 1, 2012, and before January 1, 2014.

§ 1.167(a)–7T [Removed]

■ **Par. 13.** Section 1.167(a)–7T is removed.

■ **Par. 14.** Section 1.167(a)–8 is amended by:

■ 1. Revising paragraphs (g) and (h).

■ 2. Removing paragraph (i).

The revisions read as follows:

§ 1.167(a)–8 Retirements.

* * * * *

(g) *Applicability.* This section applies to property for which depreciation is determined under section 167 (but not under section 168, section 1400I, section 1400L(c), section 168 prior to its amendment by the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2121(1986)), or under an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k) through (n), 1400L(b), or 1400N(d))).

(h) *Effective/applicability date*—(1) *In general.* This section applies to taxable years beginning on or after January 1, 2014. Except as provided in paragraphs (h)(2) and (h)(3) of this section, § 1.167(a)–8 as contained in 26 CFR part 1 edition revised as of April 1, 2011, applies to taxable years beginning before January 1, 2014.

(2) *Early application of § 1.167(a)–8(g).* A taxpayer may choose to apply paragraph (g) of this section to taxable years beginning on or after January 1, 2012.

(3) *Optional application of TD 9564.* A taxpayer may choose to apply § 1.167(a)–8T as contained in TD 9564 (76 FR 81060) December 27, 2011, to taxable years beginning on or after January 1, 2012, and before January 1, 2014.

§ 1.167(a)–8T [Removed]

■ **Par. 15.** Section 1.167(a)–8T is removed.

■ **Par. 16.** Section 1.168(i)–7 is added to read as follows:

§ 1.168(i)–7 Accounting for MACRS property.

(a) *In general.* A taxpayer may account for MACRS property (as defined in § 1.168(b)–1(a)(2)) by treating each individual asset as an account (a ''single asset account'' or an ''item account'') or by combining two or more assets in a single account (a ''multiple asset account'' or a ''pool''). A taxpayer may establish as many accounts for MACRS property as the taxpayer wants. This section does not apply to assets included in general asset accounts. For rules applicable to general asset accounts, see § 1.168(i)–1, § 1.168(i)–1T, or Prop. Reg. § 1.168(i)–1 (September 19, 2013), as applicable.

(b) *Required use of single asset accounts.* A taxpayer must account for an asset in a single asset account if the taxpayer uses the asset both in a trade or business (or for the production of income) and in a personal activity, or if the taxpayer places in service and disposes of the asset during the same taxable year. Also, if general asset account treatment for an asset terminates under § 1.168(i)–1T(c)(1)(ii)(A), (e)(3)(iii), (e)(3)(vii), (g), or (h)(2) or Prop. Reg. § 1.168(i)–1(c)(1)(ii)(A), (e)(3)(iii), (e)(3)(vii), (g), or (h)(2) (September 19, 2013), as applicable, the taxpayer must account for the asset in a single asset account beginning in the taxable year in which the general asset account treatment for the asset terminates. If a taxpayer accounts for an asset in a multiple asset account or a pool and the taxpayer disposes of the asset, the taxpayer must account for the asset in a single asset account beginning in the taxable year in which the disposition occurs. See § 1.168(i)–8T(g)(2)(i) or Prop. Reg. § 1.168(i)–8(h)(2)(i) (September 19, 2013), as applicable. If a taxpayer disposes of a component of a larger asset and the unadjusted depreciable basis of the disposed of component is included in the unadjusted depreciable basis of the larger asset, the taxpayer must account for the component in a single asset account beginning in the taxable year in which the disposition occurs. See Prop. Reg. § 1.168(i)–8(g)(3)(i) (September 19, 2013).

(c) *Establishment of multiple asset accounts or pools*—(1) *Assets eligible for multiple asset accounts or pools.* Except as provided in paragraph (b) of this section, assets that are subject to either the general depreciation system of section 168(a) or the alternative depreciation system of section 168(g) may be accounted for in one or more multiple asset accounts or pools.

(2) *Grouping assets in multiple asset accounts or pools*—(i) *General rules.* Assets that are eligible to be grouped into a single multiple asset account or pool may be divided into more than one multiple asset account or pool. Each multiple asset account or pool must include only assets that—

(A) Have the same applicable depreciation method;

(B) Have the same applicable recovery period;

(C) Have the same applicable convention; and

(D) Are placed in service by the taxpayer in the same taxable year.

(ii) *Special rules.* In addition to the general rules in paragraph (c)(2)(i) of this section, the following rules apply when establishing multiple asset accounts or pools—

(A) Assets subject to the mid-quarter convention may only be grouped into a multiple asset account or pool with assets that are placed in service in the same quarter of the taxable year;

(B) Assets subject to the mid-month convention may only be grouped into a multiple asset account or pool with assets that are placed in service in the same month of the taxable year;

(C) Passenger automobiles for which the depreciation allowance is limited under section 280F(a) must be grouped into a separate multiple asset account or pool;

(D) Assets not eligible for any additional first year depreciation deduction (including assets for which the taxpayer elected not to deduct the additional first year depreciation) provided by, for example, section 168(k) through (n), 1400L(b), or 1400N(d), must be grouped into a separate multiple asset account or pool;

(E) Assets eligible for the additional first year depreciation deduction may only be grouped into a multiple asset account or pool with assets for which the taxpayer claimed the same percentage of the additional first year depreciation (for example, 30 percent, 50 percent, or 100 percent);

(F) Except for passenger automobiles described in paragraph (c)(2)(ii)(C) of this section, listed property (as defined in section 280F(d)(4)) must be grouped into a separate multiple asset account or pool;

(G) Assets for which the depreciation allowance for the placed-in-service year is not determined by using an optional depreciation table (for further guidance, see section 8 of Rev. Proc. 87–57, 1987–2 CB 687, 693 (see § 601.601(d)(2) of this chapter)) must be grouped into a separate multiple asset account or pool; and

(H) Mass assets (as defined in § 1.168(i)–8T(b)(2) or Prop. Reg. § 1.168(i)–8(b)(3) (September 19, 2013), as applicable) that are or will be subject to § 1.168(i)–8T(f)(2)(iii) or Prop. Reg. § 1.168(i)–8(g)(2)(iii) (September 19, 2013), as applicable,(disposed of or converted mass asset is identified by a mortality dispersion table) must be grouped into a separate multiple asset account or pool.

(d) *Cross references.* See § 1.167(a)–7(c) for the records to be maintained by a taxpayer for each account. In addition, see § 1.168(i)–1(l)(3) for the records to be maintained by a taxpayer for each general asset account.

(e) *Effective/applicability date*—(1) *In general.* This section applies to taxable years beginning on or after January 1, 2014.

(2) *Early application of this section.* A taxpayer may choose to apply the provisions of this section to taxable years beginning on or after January 1, 2012.

(3) *Optional application of TD 9564.* A taxpayer may choose to apply § 1.168(i)–7T as contained in TD 9564 (76 FR 81060) December 27, 2011, to taxable years beginning on or after January 1, 2012, and before January 1, 2014.

(4) *Change in method of accounting.* A change to comply with this section for depreciable assets placed in service in a taxable year ending on or after December 30, 2003, is a change in method of accounting to which the provisions of section 446(e) and the regulations under section 446(e) apply. A taxpayer also may treat a change to comply with this section for depreciable assets placed in service in a taxable year ending before December 30, 2003, as a change in method of accounting to which the provisions of section 446(e) and the regulations under section 446(e) apply.

§ 1.168(i)–7T [Removed]

■ **Par. 17.** Section 1.168(i)–7T is removed.

■ **Par. 18.** Section 1.263(a)–0 is amended by:

■ 1. The table of contents introductory text is revised.

■ 2. Revising the section heading and entries to the table of contents for §§ 1.263(a)–1, 1.263(a)–2 and 1.263(a)–3.

■ 3. Adding § 1.263(a)–6 to the table of contents. The revisions and additions read as follows:

§ 1.263(a)–0 Outline of regulations under section 263(a).

This section lists the paragraphs in §§ 1.263(a)–1 through 1.263(a)–3 and § 1.263(a)–6.

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

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

(B) Election to capitalize.
(3) Treatment of transaction costs.
(i) In general.
(ii) Treatment of inherently facilitative amounts.
(iii) Contingency fees.
(4) Examples.
(g) Treatment of capital expenditures.
(h) Recovery of capitalized amounts.
(1) In general.
(2) Examples.
(i) Accounting method changes.
(j) Effective/applicability date.
(1) In general.
(2) Early application of this section.
(i) In general.
(ii) Transition rule for election to capitalize employee compensation and overhead costs on 2012 or 2013 returns.
(3) Optional application of TD 9564.

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

(a) Overview.
(b) Definitions.
(1) Amount paid.
(2) Personal property.
(3) Real property.
(4) Owner.
(c) Coordination with other provisions of the Internal Revenue Code.
(1) In general.
(2) Materials and supplies.
(3) Example.
(d) Requirement to capitalize amounts paid for improvements.
(e) Determining the unit of property.
(1) In general.
(2) Building.
(i) In general.
(ii) Application of improvement rules to a building.
(A) Building structure.
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(A) In general.
(B) Application of improvement rules to a condominium.
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(A) In general.
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(A) In general.
(B) Application of improvement rules to a leased building.
(*1*) Entire building.
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(3) Property other than a building.
(i) In general.
(ii) Plant property.
(A) Definition.
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(A) Definition.
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(5) Additional rules.
(i) Year placed in service.
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(f) Improvements to leased property.
(1) In general.
(2) Lessee improvements.
(i) Requirement to capitalize.
(ii) Unit of property for lessee improvements.
(3) Lessor improvements.
(i) Requirement to capitalize.
(ii) Unit of property for lessor improvements.
(4) Examples.
(g) Special rules for determining improvement costs.
(1) Certain costs incurred during an improvement.
(i) In general.
(ii) Exception for individuals' residences.
(2) Removal costs.
(i) In general.
(ii) Examples.
(3) Related amounts.
(4) Compliance with regulatory requirements.
(h) Safe harbor for small taxpayers.
(1) In general.
(2) Application with other safe harbor provisions.
(3) Qualifying taxpayer.
(i) In general.
(ii) Application to new taxpayers.
(iii) Treatment of short taxable year.
(iv) Definition of gross receipts.
(4) Eligible building property.
(5) Unadjusted basis.
(i) Eligible building property owned by the taxpayer.
(ii) Eligible building property leased to the taxpayer.
(6) Time and manner of election.
(7) Treatment of safe harbor amounts.
(8) Safe harbor exceeded.
(9) Modification of safe harbor amounts.
(10) Examples.
(i) Safe harbor for routine maintenance.
(1) In general.
(i) Routine maintenance for buildings.
(ii) Routine maintenance for property other than buildings.
(2) Rotable and temporary spare parts.
(3) Exceptions.
(4) Class life.
(5) Coordination with section 263A.
(6) Examples.
(j) Capitalization of betterments.
(1) In general.
(2) Application of betterment rules.
(i) In general.
(ii) Application of betterment rules to buildings.
(iii) Unavailability of replacement parts.
(iv) Appropriate comparison.
(A) In general.
(B) Normal wear and tear.
(C) Damage to property.
(4) Examples.
(k) Capitalization of restorations.
(1) In general.
(2) Application of restorations to buildings.
(3) Exception for losses based on salvage value.
(4) Restoration of damage from casualty.
(i) Limitation.
(ii) Amounts in excess of limitation.
(5) Rebuild to like-new condition.
(6) Replacement of a major component or substantial structural part.
(i) In general.
(A) Major component.
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(ii) Major components and substantial structural parts of buildings.
(7) Examples.
(l) Capitalization of amounts to adapt property to a new or different use.
(1) In general.
(2) Application of adaptation rule to buildings.
(3) Examples.
(m) Optional regulatory accounting method.
(1) In general.
(2) Eligibility for regulatory accounting method.
(3) Description of regulatory accounting method.
(4) Examples.
(n) Election to capitalize repair and maintenance costs.
(1) In general.
(2) Time and manner of election.
(3) Exception.
(4) Examples.
(o) Treatment of capital expenditures.
(p) Recovery of capitalized amounts.
(q) Accounting method changes.
(r) Effective/applicability date.
(1) In general.
(2) Early application of this section.
(i) In general.
(ii) Transition rule for elections on 2012 and 2013 returns.
(3) Optional application of TD 9564.

* * * * *

§ 1.263(a)–6 Election to deduct or capitalize certain expenditures.

(a) In general.
(b) Election provisions.
(c) Effective/applicability date.
(1) In general.
(2) Early application of this section.
(3) Optional application of TD 9564.

§ 1.263(a)–0T [Removed]

■ **Par. 19.** Section 1.263(a)–0T is removed.

Par. 20. Section 1.263(a)–1 is revised to read as follows:

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

(a) *General rule for capital expenditures.* Except as provided in chapter 1 of the Internal Revenue Code, no deduction is allowed for—

(1) Any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate; or

(2) Any amount paid in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

(b) *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 or the Treasury Regulations other than section 162(a) or section 212 and the regulations under those sections. For example, see section 263A, which requires taxpayers to capitalize the direct and allocable indirect costs to property produced by the taxpayer and property acquired for resale. See also section 195 requiring taxpayers to capitalize certain costs as start-up expenditures.

(c) *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) *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 (c)(2) and are separately defined and addressed in § 1.263(a)–3.

(d) *Examples of capital expenditures.* The following amounts paid are examples of capital expenditures:

(1) An amount paid to acquire or produce a unit of real or personal tangible property. See § 1.263(a)–2.

(2) An amount paid to improve a unit of real or personal tangible property. See § 1.263(a)–3.

(3) An amount paid to acquire or create intangibles. See § 1.263(a)–4.

(4) An amount paid or incurred to facilitate an acquisition of a trade or business, a change in capital structure of a business entity, and certain other transactions. See § 1.263(a)–5.

(5) An amount paid to acquire or create interests in land, such as easements, life estates, mineral interests, timber rights, zoning variances, or other interests in land.

(6) An amount assessed and paid under an agreement between bondholders or shareholders of a corporation to be used in a reorganization of the corporation or voluntary contributions by shareholders to the capital of the corporation for any corporate purpose. See section 118 and § 1.118–1.

(7) An amount paid by a holding company to carry out a guaranty of dividends at a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stockholdings in the subsidiary. This amount must be added to the cost of the stock in the subsidiary.

(e) *Amounts paid to sell property*—(1) *In general.* Commissions and other transaction costs paid to facilitate the sale of property are not currently deductible under section 162 or 212. Instead, the amounts are capitalized costs that reduce the amount realized in the taxable year in which the sale occurs or are taken into account in the taxable year in which the sale is abandoned if a deduction is permissible. These amounts are not added to the basis of the property sold or treated as an intangible asset under § 1.263(a)–4. See § 1.263(a)–5(g) for the treatment of amounts paid to facilitate the disposition of assets that constitute a trade or business.

(2) *Dealer in property.* In the case of a dealer in property, amounts paid to facilitate the sale of such property are treated as ordinary and necessary business expenses.

(3) *Examples.* The following examples, which assume the sale is not an installment sale under section 453, illustrate the rules of this paragraph (e):

Example 1. Sales costs of real property. A owns a parcel of real estate. A sells the real estate and pays legal fees, recording fees, and sales commissions to facilitate the sale. A must capitalize the fees and commissions and, in the taxable year of the sale, must reduce the amount realized from the sale of the real estate by the fees and commissions.

Example 2. Sales costs of dealers. Assume the same facts as in *Example 1,* except that A is a dealer in real estate. The commissions and fees paid to facilitate the sale of the real estate may be deducted as ordinary and necessary business expenses under section 162.

Example 3. Sales costs of personal property used in a trade or business. B owns a truck for use in B's trade or business. B decides to sell the truck on November 15, Year 1. B pays for an appraisal to determine a reasonable asking price. On February 15, Year 2, B sells the truck to C. In Year 1, B must capitalize the amount paid to appraise the truck, and in Year 2, must reduce the amount realized from the sale of the truck by the amount paid for the appraisal.

Example 4. Costs of abandoned sale of personal property used in a trade or business. Assume the same facts as in *Example 3,* except that, instead of selling the truck on February 15, Year 2, B decides on that date not to sell the truck and takes the truck off the market. In Year 1, B must capitalize the amount paid to appraise the truck. However, B may recognize the amount paid to appraise the truck as a loss under section 165 in Year 2, the taxable year when the sale is abandoned.

Example 5. Sales costs of personal property not used in a trade or business. Assume the same facts as in *Example 3,* except that B does not use the truck in B's trade or business but instead uses it for personal purposes. In Year 1, B must capitalize the amount paid to appraise the truck, and in Year 2, must reduce the amount realized from the sale of the truck by the amount paid for the appraisal.

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, Year 2, B decides on that date not to sell the truck and takes the truck off the market. In Year 1, B must capitalize the amount paid to appraise the truck. Although B abandons the sale in Year 2, B may not treat the amount paid to appraise the truck as a loss under section 165 because the truck was not used in B's trade or business or in a transaction entered into for profit.

(f) *De minimis safe harbor election*—(1) *In general.* Except as otherwise provided in paragraph (f)(2) of this section, a taxpayer electing to apply the de minimis safe harbor under this paragraph (f) may not capitalize under § 1.263(a)–2(d)(1) or § 1.263(a)–3(d) any amount paid in the taxable year for the acquisition or production of a unit of tangible property nor treat as a material or supply under § 1.162–3(a) any amount paid in the taxable year for tangible property if the amount specified under this paragraph (f)(1) meets the requirements of paragraph (f)(1)(i) or (f)(1)(ii) of this section. But see section 263A and the regulations under section 263A, which require taxpayers to capitalize the direct and allocable indirect costs of property produced by the taxpayer (for example, property improved by the taxpayer) and property acquired for resale.

(i) *Taxpayer with applicable financial statement.* A taxpayer electing to apply the de minimis safe harbor may not capitalize under § 1.263(a)–2(d)(1) or § 1.263(a)–3(d) nor treat as a material or supply under § 1.162–3(a) any amount paid in the taxable year for property described in paragraph (f)(1) of this section if—

(A) The taxpayer has an applicable financial statement (as defined in paragraph (f)(4) of this section);

(B) The taxpayer has at the beginning of the taxable year written accounting procedures treating as an expense for non-tax purposes—

(*1*) Amounts paid for property costing less than a specified dollar amount; or

(*2*) Amounts paid for property with an economic useful life (as defined in § 1.162–3(c)(3)) of 12 months or less;

(C) The taxpayer treats the amount paid for the property as an expense on its applicable financial statement in accordance with its written accounting procedures; and

(D) The amount paid for the property does not exceed $5,000 per invoice (or per item as substantiated by the invoice) or other amount as identified in published guidance in the **Federal Register** or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter).

(ii) *Taxpayer without applicable financial statement.* A taxpayer electing to apply the de minimis safe harbor may not capitalize under § 1.263(a)–2(d)(1) or § 1.263(a)–3(d) nor treat as a material or supply under § 1.162–3(a) any amount paid in the taxable year for property described in paragraph (f)(1) of this section if—

(A) The taxpayer does not have an applicable financial statement (as defined in paragraph (f)(4) of this section);

(B) The taxpayer has at the beginning of the taxable year accounting procedures treating as an expense for non-tax purposes—

(*1*) Amounts paid for property costing less than a specified dollar amount; or

(*2*) Amounts paid for property with an economic useful life (as defined in § 1.162–3(c)(3)) of 12 months or less;

(C) The taxpayer treats the amount paid for the property as an expense on its books and records in accordance with these accounting procedures; and

(D) The amount paid for the property does not exceed $500 per invoice (or per item as substantiated by the invoice) or other amount as identified in published guidance in the **Federal Register** or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter).

(iii) *Taxpayer with both an applicable financial statement and a non-qualifying financial statement.* For purposes of this paragraph (f)(1), if a taxpayer has an applicable financial statement defined in paragraph (f)(4) of this section in addition to a financial statement that does not meet requirements of paragraph (f)(4) of this section, the taxpayer must meet the requirements of paragraph (f)(1)(i) of this section to qualify to elect the de minimis safe harbor under this paragraph (f).

(2) *Exceptions to de minimis safe harbor.* The de minimis safe harbor in paragraph (f)(1) of this section does not apply to the following:

(i) Amounts paid for property that is or is intended to be included in inventory property;

(ii) Amounts paid for land;

(iii) Amounts paid for rotable, temporary, and standby emergency spare parts that the taxpayer elects to capitalize and depreciate under § 1.162–3(d); and

(iv) Amounts paid for rotable and temporary spare parts that the taxpayer accounts for under the optional method of accounting for rotable parts pursuant to § 1.162–3(e).

(3) *Additional rules*—(i) *Transaction and other additional costs.* A taxpayer electing to apply the de minimis safe harbor under paragraph (f)(1) of this section is not required to include in the cost of the tangible property the additional costs of acquiring or producing such property if these costs are not included in the same invoice as the tangible property. However, the taxpayer electing to apply the de minimis safe harbor under paragraph (f)(1) of this section must include in the cost of such property all additional costs (for example, delivery fees, installation services, or similar costs) if these additional costs are included on the same invoice with the tangible property. For purposes of this paragraph, if the invoice includes amounts paid for multiple tangible properties and such invoice includes additional invoice costs related to these multiple properties, then the taxpayer must allocate the additional invoice costs to each property using a reasonable method, and each property, including allocable labor and overhead, must meet the requirements of paragraph (f)(1)(i) or paragraph (f)(1)(ii) of this section, whichever is applicable. Reasonable allocation methods include, but are not limited to specific identification, a pro rata allocation, or a weighted average method based on the property's relative cost. For purposes of this paragraph (f)(3)(i), additional costs consist of the costs of facilitating the acquisition or production of such tangible property under § 1.263(a)–2(f) and the costs for work performed prior to the date that the tangible property is placed in service under § 1.263(a)–2(d).

(ii) *Materials and supplies.* If a taxpayer elects to apply the de minimis safe harbor provided under this paragraph (f), then the taxpayer must also apply the de minimis safe harbor to amounts paid for all materials and supplies (as defined under § 1.162–3) that meet the requirements of § 1.263(a)–1(f). See paragraph (f)(3)(iv) of this section for treatment of materials and supplies under the de minimis safe harbor.

(iii) *Sale or disposition.* Property to which a taxpayer applies the de minimis safe harbor contained in this paragraph (f) is not treated upon sale or other disposition as a capital asset under section 1221 or as property used in the trade or business under section 1231.

(iv) *Treatment of de minimis amounts.* An amount paid for property to which a taxpayer properly applies the de minimis safe harbor contained in this paragraph (f) is not treated as a capital expenditure under § 1.263(a)–2(d)(1) or § 1.263(a)–3(d) or as a material and supply under § 1.162–3, and may be deducted under § 1.162–1 in the taxable year the amount is paid provided the amount otherwise constitutes an ordinary and necessary expenses incurred in carrying on a trade or business.

(v) *Coordination with section 263A.* Amounts paid for tangible property described in paragraph (f)(1) of this section may be subject to capitalization under section 263A if the amounts paid for tangible property comprise the direct or allocable indirect costs of other property produced by the taxpayer or property acquired for resale. See, for example, § 1.263A–1(e)(3)(ii)(R) requiring taxpayers to capitalize the cost of tools and equipment allocable to property produced or property acquired for resale.

(vi) *Written accounting procedures for groups of entities.* If the taxpayer's financial results are reported on the applicable financial statement (as defined in paragraph (f)(4) of this section) for a group of entities then, for purposes of paragraph (f)(1)(i)(A) of this section, the group's applicable financial statement may be treated as the applicable financial statement of the taxpayer, and for purposes of paragraphs (f)(1)(i)(B) and (f)(1)(i)(C) of this section, the written accounting procedures provided for the group and utilized for the group's applicable financial statement may be treated as the written accounting procedures of the taxpayer.

(vii) *Combined expensing accounting procedures.* For purposes of paragraphs (f)(1)(i) and (f)(1)(ii) of this section, if the taxpayer has, at the beginning of the taxable year accounting procedures treating as an expense for non-tax purposes (1) amounts paid for property costing less than a specified dollar amount; and (2) amounts paid for property with an economic useful life (as defined in § 1.162–3(c)(3)) of 12 months or less, then a taxpayer electing to apply the de minimis safe harbor under this paragraph (f) must apply the provisions of this paragraph (f) to amounts qualifying under either accounting procedure.

(4) *Definition of applicable financial statement.* For purposes of this paragraph (f), the taxpayer's applicable financial statement (AFS) is the taxpayer's financial statement listed in paragraphs (f)(4)(i) through (iii) of this section that has the highest priority (including within paragraph (f)(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 certified public accountant (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 agency (other than the SEC or the Internal Revenue Service).

(5) *Time and manner of election.* A taxpayer that makes the election under this paragraph (f) must make the election for all amounts paid during the taxable year for property described in paragraph (f)(1) of this section and meeting the requirements of paragraph (f)(1)(i) or paragraph (f)(1)(ii) of this section, as applicable. A taxpayer makes the election by attaching a statement to the taxpayer's timely filed original Federal tax return (including extensions) for the taxable year in which these amounts are paid. See §§ 301.9100–1 through 301.9100–3 of this chapter for the provisions governing extensions of time to make regulatory elections. The statement must be titled ''Section 1.263(a)–1(f) de minimis safe harbor election'' and include the taxpayer's name, address, taxpayer identification number, and a statement that the taxpayer is making the de minimis safe harbor election under § 1.263(a)–1(f). In the case of a consolidated group filing a consolidated income tax return, the election is made for each member of the consolidated group by the common parent, and the statement must also include the names and taxpayer identification numbers of each member for which the election is made. In the case of an S corporation or a partnership, the election is made by the S corporation or the partnership and not by the shareholders or partners. An election may not be made through the filing of an application for change in accounting method or, before obtaining the Commissioner's consent to make a late election, by filing an amended Federal tax return. A taxpayer may not revoke an election made under this paragraph (f). The manner of electing the de minimis safe harbor under this paragraph (f) may be modified through guidance of general applicability (see §§ 601.601(d)(2) and 601.602 of this chapter).

(6) *Anti-abuse rule.* If a taxpayer acts to manipulate transactions with the intent to achieve a tax benefit or to avoid the application of the limitations provided under paragraphs (f)(1)(i)(B)(*1*), (f)(1)(i)(D), (f)(1)(ii)(B)(*1*), and (f)(1)(ii)(D) of this section, appropriate adjustments will be made to carry out the purposes of this section. For example, a taxpayer is deemed to act to manipulate transactions with an intent to avoid the purposes and requirements of this section if—

(i) The taxpayer applies the de minimis safe harbor to amounts substantiated with invoices created to componentize property that is generally acquired or produced by the taxpayer (or other taxpayers in the same or similar trade or business) as a single unit of tangible property; and

(ii) This property, if treated as a single unit, would exceed any of the limitations provided under paragraphs (f)(1)(i)(B)(*1*), (f)(1)(i)(D), (f)(1)(ii)(B)(*1*), and (f)(1)(ii)(D) of this section, as applicable.

(7) *Examples.* The following examples illustrate the application of this paragraph (f). Unless otherwise provided, assume that section 263A does not apply to the amounts described.

Example 1. De minimis safe harbor; taxpayer without AFS. In Year 1, A purchases 10 printers at $250 each for a total cost of $2,500 as indicated by the invoice. Assume that each printer is a unit of property under § 1.263(a)–3(e). A does not have an AFS. A has accounting procedures in place at the beginning of Year 1 to expense amounts paid for property costing less than $500, and A treats the amounts paid for the printers as an expense on its books and records. The amounts paid for the printers meet the requirements for the de minimis safe harbor under paragraph (f)(1)(ii) of this section. If A elects to apply the de minimis safe harbor under this paragraph (f) in Year 1, A may not capitalize the amounts paid for the 10 printers or any other amounts meeting the criteria for the de minimis safe harbor under paragraph (f)(1). Instead, in accordance with paragraph (f)(3)(iv) of this section, A may deduct these amounts under § 1.162–1 in the taxable year the amounts are paid provided the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on a trade or business.

Example 2. De minimis safe harbor; taxpayer without AFS. In Year 1, B purchases 10 computers at $600 each for a total cost of $6,000 as indicated by the invoice. Assume that each computer is a unit of property under § 1.263(a)–3(e). B does not have an AFS. B has accounting procedures in place at the beginning of Year 1 to expense amounts paid for property costing less than $1,000 and B treats the amounts paid for the computers as an expense on its books and records. The amounts paid for the printers do not meet the requirements for the de minimis safe harbor under paragraph (f)(1)(ii) of this section because the amount paid for the property exceeds $500 per invoice (or per item as substantiated by the invoice). B may not apply the de minimis safe harbor election to the amounts paid for the 10 computers under paragraph (f)(1) of this section.

Example 3. De minimis safe harbor; taxpayer with AFS. C is a member of a consolidated group for Federal income tax purposes. C's financial results are reported on the consolidated applicable financial statements for the affiliated group. C's affiliated group has a written accounting policy at the beginning of Year 1, which is followed by C, to expense amounts paid for property costing $5,000 or less. In Year 1, C pays $6,250,000 to purchase 1,250 computers at $5,000 each. C receives an invoice from its supplier indicating the total amount due ($6,250,000) and the price per item ($5,000). Assume that each computer is a unit of property under § 1.263(a)–3(e). The amounts paid for the computers meet the requirements for the de minimis safe harbor under paragraph (f)(1)(i) of this section. If C elects to apply the de minimis safe harbor under this paragraph (f) for Year 1, C may not capitalize the amounts paid for the 1,250 computers or any other amounts meeting the criteria for the de minimis safe harbor under paragraph (f)(1) of this section. Instead, in accordance with paragraph (f)(3)(iv) of this section, C may deduct these amounts under § 1.162–1 in the taxable year the amounts are paid provided the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on a trade or business.

Example 4. De minimis safe harbor; taxpayer with AFS. D is a member of a consolidated group for Federal income tax purposes. D's financial results are reported on the consolidated applicable financial statements for the affiliated group. D's affiliated group has a written accounting policy at the beginning of Year 1, which is followed by D, to expense amounts paid for property costing less than $15,000. In Year 1, D pays $4,800,000 to purchase 800 elliptical machines at $6,000 each. D receives an invoice from its supplier indicating the total amount due ($4,800,000) and the price per item ($6,000). Assume that each elliptical machine is a unit of property under § 1.263(a)–3(e). D may not apply the de minimis safe harbor election to the amounts paid for the 800 elliptical machines under paragraph (f)(1) of this section because the amount paid for the property exceeds $5,000 per invoice (or per item as substantiated by the invoice).

Example 5. De minimis safe harbor; additional invoice costs. E is a member of a consolidated group for Federal income tax purposes. E's financial results are reported on the consolidated applicable financial statements for the affiliated group. E's affiliated group has a written accounting policy at the beginning of Year 1, which is followed by E, to expense amounts paid for property costing less than $5,000. In Year 1, E pays $45,000 for the purchase and installation of wireless routers in each of its 10 office locations. Assume that each wireless router is a unit of property under § 1.263(a)–3(e). E receives an invoice from its supplier indicating the total amount due ($45,000), including the material price per item ($2,500), and total delivery and installation ($20,000). E allocates the additional invoice costs to the materials on a pro rata basis, bringing the cost of each router to $4,500 ($2,500 materials + $2,000 labor and overhead). The amounts paid for each router, including the allocable additional invoice costs, meet the requirements for the de minimis safe harbor under paragraph (f)(1)(i) of this section. If E elects to apply the de minimis safe harbor under this paragraph (f) for Year 1, E may not capitalize the amounts paid for the 10 routers (including the additional invoice costs) or any other amounts meeting the criteria for the de minimis safe harbor under paragraph (f)(1) of this section. Instead, in accordance with paragraph (f)(3)(iv) of this section, E may deduct these amounts under § 1.162–1 in the taxable year the amounts are paid provided the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on a trade or business.

Example 6. De minims safe harbor; non-invoice additional costs. F is a corporation that provides consulting services to its customer. F does not have an AFS, but F has accounting procedures in place at the beginning of Year 1 to expense amounts paid for property costing less than $500. In Year 1, F pays $600 to an interior designer to shop for, evaluate, and make recommendations regarding purchasing new furniture for F's conference room. As a result of the interior designer's recommendations, F acquires a conference table for $500 and 10 chairs for $300 each. In Year 1, F receives an invoice from the interior designer for $600 for his services, and F receives a separate invoice from the furniture supplier indicating a total amount due of $500 for the table and $300 for each chair. For Year 1, F treats the amount paid for the table and each chair as an expense on its books and records, and F elects to use the de minimis safe harbor for amounts paid for tangible property that qualify under the safe harbor. The amount paid to the interior designer is a cost of facilitating the acquisition of the table and chairs under § 1.263(a)–2(f). Under paragraph (f)(3)(i) of this section, F is not required to include in the cost of tangible property the additional costs of acquiring such property if these costs are not included in the same invoice as the tangible property. Thus, F is not required to include a pro rata allocation of the amount paid to the interior designer to determine the application of the de minimis safe harbor to the table and the chairs. Accordingly, the amounts paid by F for the table and each chair meet the requirements for the de minimis safe harbor under paragraph (f)(1)(ii) of this section, and F may not capitalize the amounts paid for the table or each chair under paragraph (f)(1) of this section. In addition, F is not required to capitalize the amounts paid to the interior designer as a cost that facilitates the acquisition of tangible property under § 1.263(a)–2(f)(3)(i). Instead, F may deduct the amounts paid for the table, chairs, and interior designer under § 1.162–1 in the taxable year the amounts are paid provided the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on a trade or business.

Example 7. De minimis safe harbor; 12-month economic useful life. G operates a restaurant. In Year 1, G purchases 10 hand-held point-of-service devices at $300 each for a total cost of $3,000 as indicated by invoice. G also purchases 3 tablet computers at $500 each for a total cost of $1,500 as indicated by invoice. Assume each point-of-service device and each tablet computer has an economic useful life of 12 months or less, beginning when they are used in G's business. Assume that each device and each tablet is a unit of property under § 1.263(a)–3(e). G does not have an AFS, but G has accounting procedures in place at the beginning of Year 1 to expense amounts paid for property costing $300 or less and to expense amounts paid for property with an economic useful life of 12 months or less. Thus, G expenses the amounts paid for the hand-held devices on its books and records because each device costs $300. G also expenses the amounts paid for the tablet computers on its books and records because the computers have an economic useful life of 12 months of less, beginning when they are used. The amounts paid for the hand-held devices and the tablet computers meet the requirements for the de minimis safe harbor under paragraph (f)(1)(ii) of this section. If G elects to apply the de minimis safe harbor under this paragraph (f) in Year 1, G may not capitalize the amounts paid for the hand-held devices, the tablet computers, or any other amounts meeting the criteria for the de minimis safe harbor under paragraph (f)(1) of this section. Instead, in accordance with paragraph (f)(3)(iv) of this section, G may deduct the amounts paid for the hand-held devices and tablet computers under § 1.162–1 in the taxable year the amounts are paid provided the amounts otherwise constitute deductible ordinary and necessary business expenses incurred in carrying on a trade or business.

Example 8. De minimis safe harbor; limitation. Assume the facts as in *Example 7,* except G purchases the 3 tablet computers at $600 each for a total cost of $1,800. The amounts paid for the tablet computers do not meet the de minimis rule safe harbor under paragraphs (f)(1)(ii) and (f)(3)(vii) of this section because the cost of each computer exceeds $500. Therefore, the amounts paid for the tablet computers may not be deducted under the safe harbor.

Example 9. De minimis safe harbor; materials and supplies. H is a corporation that provides consulting services to its customers. H has an AFS and a written accounting policy at the beginning of the taxable year to expense amounts paid for property costing $5,000 or less. In Year 1, H purchases 1,000 computers at $500 each for a total cost of $500,000. Assume that each computer is a unit of property under § 1.263(a)–3(e) and is not a material or supply under § 1.162–3. In addition, H purchases 200 office chairs at $100 each for a total cost of $20,000 and 250 customized briefcases at $80 each for a total cost of $20,000. Assume that each office chair and each briefcase is a material or supply under § 1.162–3(c)(1). H treats the amounts paid for the computers, office chairs, and briefcases as expenses on its AFS. The amounts paid for computers, office chairs, and briefcases meet the requirements for the de minimis safe harbor under paragraph (f)(1)(i) of this section. If H elects to apply the de minimis safe harbor under this paragraph (f) in Year 1, H may not capitalize the amounts paid for the 1,000 computers, the 200 office chairs, and the 250 briefcases under paragraph (f)(1) of this section. H may deduct the amounts paid for the computers, the office chairs, and the briefcases under § 1.162–1 in the taxable year the amounts are paid provided the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on a trade or business.

Example 10. De minimis safe harbor; coordination with section 263A. J is a member of a consolidated group for Federal income tax purposes. J's financial results are reported on the consolidated AFS for the affiliated group. J's affiliated group has a written accounting policy at the beginning of Year 1, which is followed by J, to expense amounts paid for property costing less than $1,000 or that has an economic useful life of 12 months or less. In Year 1, J acquires jigs, dies, molds, and patterns for use in the manufacture of J's products. Assume each jig, die, mold, and pattern is a unit of property under § 1.263(a)–3(e) and costs less than $1,000. In Year 1, J begins using the jigs, dies, molds and patterns to manufacture its products. Assume these items are materials and supplies under § 1.162–3(c)(1)(iii), and J elects to apply the de minimis safe harbor under paragraph (f)(1)(i) of this section to amounts qualifying under the safe harbor in Year 1. Under paragraph (f)(3)(v) of this section, the amounts paid for the jigs, dies, molds, and patterns may be subject to capitalization under section 263A if the amounts paid for these tangible properties comprise the direct or allocable indirect costs of other property produced by the taxpayer or property acquired for resale.

Example 11. De minimis safe harbor; anti-abuse rule. K is a corporation that provides hauling services to its customers. In Year 1, K decides to purchase a truck to use in its business. K does not have an AFS. K has accounting procedures in place at the beginning of Year 1 to expense amounts paid for property costing less than $500. K arranges to purchase a used truck for a total of $1,500. Prior to the acquisition, K requests the seller to provide multiple invoices for different parts of the truck. Accordingly, the seller provides K with four invoices during Year 1—one invoice of $500 for the cab, one invoice of $500 for the engine, one invoice of $300 for the trailer, and a fourth invoice of $200 for the tires. K treats the amounts paid under each invoice as an expense on its books and records. K elects to apply the de minimis safe harbor under paragraph (f) of this section in Year 1 and does not capitalize the amounts paid for each invoice pursuant to the safe harbor. Under paragraph (f)(6) of this section, K has applied the de minimis rule to amounts substantiated with invoices created to componentize property that is generally acquired as a single unit of tangible property in the taxpayer's type of business, and this property, if treated as single unit, would exceed the limitations provided under the de minimis rule. Accordingly, K is deemed to manipulate the transaction to acquire the truck with the intent to avoid the purposes of this paragraph (f). As a result, K may not apply the de minimis rule to these amounts and is subject to appropriate adjustments.

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

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

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

(ii) *Transition rule for de minimis safe harbor election on 2012 or 2013 returns.* If under paragraph (h)(2)(i) of this section, a taxpayer chooses to make the election to apply the de minimis safe harbor under paragraph (f) of this section for amounts paid in its taxable year beginning on or after January 1, 2012, and ending on or before September 19, 2013 (applicable taxable year), and the taxpayer did not make the election specified in paragraph (f)(5) of this section on its timely filed original Federal tax return for the applicable taxable year, the taxpayer must make the election specified in paragraph (f)(5) of this section for the applicable taxable year by filing an amended Federal tax return for the applicable taxable year on or before 180 days from the due date including extensions of the taxpayer's Federal tax return for the applicable taxable year, notwithstanding that the taxpayer may not have extended the due date.

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

§ 1.263(a)–1T [Removed]

■ **Par. 21.** Section 1.263(a)–1T is removed.

■ **Par. 22.** 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 general requirement to capitalize amounts paid to acquire or produce a unit of real or personal property. Paragraph (e) of this section provides the requirement to capitalize amounts paid to defend or perfect title to real or personal property. Paragraph (f) of this section provides the rules for determining the extent to which taxpayers must capitalize transaction costs related to the acquisition of tangible property. Paragraphs (g) and (h) of this section address the treatment and recovery of capital expenditures. Paragraph (i) of this section provides for changes in methods of accounting to comply with this section, and paragraph (j) of this section provides the effective and applicability dates for the rules under this section.

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

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

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

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

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

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

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

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

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

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

Example 2. Acquisition of personal property that is a material or supply; coordination with § 1.162–3. B operates a fleet of aircraft. In Year 1, B acquires a stock of component parts, which it intends to use to maintain and repair its aircraft. Assume that each component part is a material or supply under § 1.162–3(c)(1) and B does not make elections under § 1.162–3(d) to treat the materials and supplies as capital expenditures. In Year 2, B uses the component parts in the repair and maintenance of its aircraft. Because the parts are materials and supplies under § 1.162–3, B is not required to capitalize the amounts paid for the parts under paragraph (d)(1) of this section. Rather, to determine the treatment of these amounts, B must apply the rules under § 1.162–3, governing the treatment of materials and supplies.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(2) *Scope of facilitate*—(i) *In general.* Except as otherwise provided in this section, an amount is paid to facilitate the acquisition of real or personal property if the amount is paid in the process of investigating or otherwise pursuing the acquisition. Whether an amount is paid in the process of investigating or otherwise pursuing the acquisition is determined based on all of the facts and circumstances. In determining whether an amount is paid to facilitate an acquisition, the fact that the amount would (or would not) have been paid but for the acquisition is relevant but is not determinative. Amounts paid to facilitate an acquisition include, but are not limited to, inherently facilitative amounts specified in paragraph (f)(2)(ii) of this section.

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

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

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

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

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

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

(F) Examining and evaluating the title of property;

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

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

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

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

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

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

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

(iv) *Employee compensation and overhead costs*—(A) *In general.* For purposes of paragraph (f) of this section, amounts paid for employee compensation (within the meaning of § 1.263(a)–4(e)(4)(ii)) and overhead are treated as amounts that do not facilitate the acquisition of real or personal property. See section 263A, however, 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.

(B) *Election to capitalize.* A taxpayer may elect to treat amounts paid for employee compensation or overhead as amounts that facilitate the acquisition of property. The election is made separately for each acquisition and applies to employee compensation or overhead, or both. For example, a taxpayer may elect to treat overhead, but not employee compensation, as amounts that facilitate the acquisition of property. A taxpayer makes the election by treating the amounts to which the election applies as amounts that facilitate the acquisition in the taxpayer's timely filed original Federal tax return (including extensions) for the taxable year during which the amounts are paid. See §§ 301.9100–1 through 301.9100–3 of this chapter for the provisions governing extensions of time to make regulatory elections. In the case of an S corporation or a partnership, the election is made by the S corporation or by the partnership, and not by the shareholders or partners. A taxpayer may revoke an election made under this paragraph (f)(2)(iv)(B) with respect to each acquisition only by filing a request for a private letter ruling and obtaining the Commissioner's consent to revoke the election. The Commissioner may grant a request to revoke this election if the taxpayer acted reasonably and in good faith and the revocation will not prejudice the interests of Government. See generally § 301.9100–3 of this chapter. The manner of electing and revoking the election to capitalize under this paragraph (f)(2)(iv)(B) may be modified through guidance of general applicability (see §§ 606.601(d)(2) and 601.602 of this section). An election may not be made or revoked through the filing of an application for change in accounting method or, before obtaining the Commissioner's consent to make the late election or to revoke the election, by filing an amended Federal tax return.

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

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

(iii) *Contingency Fees.* For purposes of this section, a contingency fee is an amount paid that is contingent on the successful closing of the acquisition of real or personal property. Contingency fees must be included in the basis of the property acquired and may not be allocated to the property not acquired.

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

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

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

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

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

Example 5. Scope of facilitate. F is in the business of providing legal services to clients. F is interested in acquiring a new conference table for its office. F hires and incurs fees for an interior designer to shop for, evaluate, and make recommendations to F regarding which new table to acquire. Under paragraphs (f)(1) and (2) of this section, F must capitalize the amounts paid to the interior designer to provide these services because they are paid in the process of investigating or otherwise pursuing the acquisition of personal property.

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

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

Example 8. Special rule for acquisitions of real property. J owns several retail stores. J decides to examine the feasibility of opening a new store in City X. In October, Year 1, J hires and incurs costs for a development consulting firm to study City X and perform market surveys, evaluate zoning and environmental requirements, and make preliminary reports and recommendations as to areas that J should consider for purposes of locating a new store. In December, Year 1, J continues to consider whether to purchase real property in City X and which property to acquire. J hires, and incurs fees for, an appraiser to perform appraisals on two different sites to determine a fair offering price for each site. In March, Year 2, J decides to acquire one of these two sites for the location of its new store. At the same time, J determines not to acquire the other site. Under paragraph (f)(2)(iii) of this section, J is not required to capitalize amounts paid to the development consultant in Year 1 because the amounts relate to activities performed in the process of determining whether to acquire real property and which real property to acquire, and the amounts are not inherently facilitative costs under paragraph (f)(2)(ii) of this section. However, J must capitalize amounts paid to the appraiser in Year 1 because the appraisal costs are inherently facilitative costs under paragraph (f)(2)(ii)(B) of this section. In Year 2, J must include the appraisal costs allocable to property acquired in the basis of the property acquired. In addition, J may recover the appraisal costs allocable to the property not acquired in accordance with paragraphs (f)(3)(ii) and (h) of this section. See, for example, § 1.165–2 for losses on the permanent withdrawal of non-depreciable property.

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

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

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

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

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

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

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

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

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

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

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

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

§ 1.263(a)–2T [Removed]

■ **Par. 23.** Section 1.263(a)–2T is removed.

■ **Par. 24.** 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 the requirement to capitalize amounts paid to improve tangible property and provides the general rules for determining whether a unit of property is improved. Paragraph (e) of this section provides the rules for determining the appropriate unit of property. Paragraph (f) of this section provides rules for leasehold improvements. Paragraph (g) of this section provides special rules for determining improvement costs in particular contexts, including indirect costs incurred during an improvement, removal costs, aggregation of related costs, and regulatory compliance costs. Paragraph (h) of this section provides a safe harbor for small taxpayers. Paragraph (i) provides a safe harbor for routine maintenance costs. Paragraph (j) of this section provides rules for determining whether amounts are paid for betterments to the unit of property. Paragraph (k) of this section provides rules for determining whether amounts are paid to restore the unit of property. Paragraph (l) of this section provides rules for amounts paid to adapt the unit of property to a new or different use. Paragraph (m) of this section provides an optional regulatory accounting method. Paragraph (n) of this section provides an election to capitalize repair and maintenance costs consistent with books and records. Paragraphs (o) and (p) of this section provide for the treatment and recovery of amounts capitalized under this section. Paragraphs (q) and (r) of this section provide for accounting method changes and state the effective/applicability date for the rules in this section.

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

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

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

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

(4) *Owner* means the taxpayer that has the benefits and burdens of ownership of the unit of property for Federal income tax purposes.

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

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

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

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

(d) *Requirement to capitalize amounts paid for improvements.* Except as provided in paragraph (h) or paragraph (n) of this section or under § 1.263(a)–1(f), a taxpayer generally must capitalize the related amounts (as defined in paragraph (g)(3) of this section) paid to improve a unit of property owned by the taxpayer. However, see paragraph (f) of this section for the treatment of amounts paid to improve leased property. See section 263A for the requirement to capitalize the direct and allocable indirect costs of property produced by the taxpayer and 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—

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

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

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

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

(2) *Building*—(i) *In general.* Except as otherwise provided in paragraphs (e)(4), and (e)(5)(ii) of this section, in the case of a building (as defined in § 1.48–1(e)(1)), each building and its structural components (as defined in § 1.48–1(e)(2)) is a single unit of property (''building''). See paragraph (e)(2)(iii) of this section for condominiums, paragraph (e)(2)(iv) of this section for cooperatives, and paragraph (e)(2)(v) of this section for leased buildings.

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

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

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

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

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

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

(*4*) All escalators;

(*5*) All elevators;

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(iii) *Network assets*—(A) *Definition.* For purposes of this paragraph (e), the term *network assets* means railroad track, oil and gas pipelines, water and sewage pipelines, power transmission and distribution lines, and telephone and cable lines that are owned or leased by taxpayers in each of those respective industries. The term includes, for example, trunk and feeder lines, pole lines, and buried conduit. It does not include property that would be included as building structure or building systems under paragraphs (e)(2)(ii)(A) and (e)(2)(ii)(B) of this section, nor does it include separate property that is adjacent to, but not part of a network asset, such as bridges, culverts, or tunnels.

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

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

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

(5) *Additional rules*—(i) *Year placed in service.* Notwithstanding the unit of property determination under paragraph (e)(3) of this section, a component (or a group of components) of a unit property must be treated as a separate unit of property if, at the time the unit of property is initially placed in service by the taxpayer, the taxpayer has properly treated the component as being within a different class of property under section 168(e) (MACRS classes) than the class of the unit of property of which the component is a part, or the taxpayer has properly depreciated the component using a different depreciation method than the depreciation method of the unit of property of which the component is a part.

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

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

Example 1. Building systems. A owns an office building that contains a HVAC system. The HVAC system incorporates ten roof-mounted units that service different parts of the building. The roof-mounted units are not connected and have separate controls and duct work that distribute the heated or cooled air to different spaces in the building's interior. A pays an amount for labor and materials for work performed on the roof-mounted units. Under paragraph (e)(2)(i) of this section, A must treat the building and its structural components as a single unit of property. As provided under paragraph (e)(2)(ii) of this section, an amount is paid to improve a building if it is for an improvement to the building structure or any designated building system. Under paragraph (e)(2)(ii)(B)(*1*) of this section, the entire HVAC system, including all of the roof-mounted units and their components, comprise a building system. Therefore, under paragraph (e)(2)(ii) of this section, if an amount paid by A for work on the roof-mounted units is an improvement (for example, a betterment) to the HVAC system, A must treat this amount as an improvement to the building.

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

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

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

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

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

Example 7. Plant property; industrial process. G operates a restaurant that prepares and serves food to retail customers. Within its restaurant, G has a large piece of equipment that uses an assembly line-like process to prepare and cook tortillas that G serves only to its restaurant customers. Because the tortilla-making equipment is property other than a building, the unit of property for the equipment is initially determined under the general rule in paragraph (e)(3)(i) of this section and is comprised of all the components that are functionally interdependent. Under this rule, the initial unit of property is the entire tortilla-making equipment because the various components of the equipment are functionally interdependent. The equipment is not plant property under paragraph (e)(3)(ii) of this section because the equipment is not used in an industrial process, as it performs a small-scale function in G's restaurant operations. Thus, G is not required to further divide the equipment into separate units of property based on the components that perform discrete and major functions.

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

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

Example 10. Building structure and systems; leased building. K is a retailer of consumer products. K conducts its retail sales in a building that it leases from L. The leased building consists of the building structure (including the floor, walls, and roof) and various building systems, including a plumbing system, an electrical system, an HVAC system, a security system, and a fire protection and prevention system. K pays an amount for labor and materials to perform work on the HVAC system of the leased building. Under paragraph (e)(2)(v)(A) of this section, because K leases the entire building, K must treat the leased building and its structural components as a single unit of property. As provided under paragraph (e)(2)(v)(B) of this section, an amount is paid to improve a leased building property if it is for an improvement (for example, a betterment) to the leased building structure or to any building system within the leased building. Therefore, under paragraphs (e)(2)(v)(B)(*1*) and (e)(2)(ii)(B)(*1*) of this section, if an amount paid by K for work on the HVAC system is for an improvement to the HVAC system in the leased building, K must treat this amount as an improvement to the entire leased building property.

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

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

Example 13. Buildings and structural components; leased office space. M provides consulting services to its clients. M conducts its consulting services business in two office spaces in the same building, each of which it leases from N under separate lease agreements. Each office space contains a separate HVAC system, which is part of the leased property. Both lease agreements provide that M is responsible for maintaining, repairing, and replacing the HVAC system that is part of the leased property. M pays amounts to perform work on the HVAC system in each office space. Because M leases two separate office spaces subject to two leases, M must treat the portion of the building structure and the structural components subject to each lease as a separate unit of property under paragraph (e)(2)(v)(A) of this section. As provided under paragraph (e)(2)(v)(B) of this section, an amount is paid to improve a leased building property, if it is for an improvement to the leased portion of the building structure or the portion of any designated building system subject to each lease. Under paragraphs (e)(2)(v)(B)(*1*) and (e)(2)(ii)(B)(*1*) of this section, M must treat the HVAC system associated with each leased office space as a building system of that leased building property. Thus, M must treat the HVAC system associated with the first leased office space as a building system of the first leased office space and the HVAC system associated with the second leased office space as a building system of the second leased office space. Under paragraph (e)(2)(v)(B) of this section, if the amount paid by M for work on the HVAC system in one leased office space is for an improvement (for example, a betterment) to the HVAC system that is part of that leased space, then M must treat the amount as an improvement to that individual leased property.

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

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

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

Example 16. Additional rules; year placed in service. R is engaged in the business of transporting freight throughout the United States. To conduct its business, R owns a fleet of truck tractors and trailers. Each tractor and trailer is comprised of various components, including tires. R purchased a truck tractor with all of its components, including tires. The tractor tires have an average useful life to R of more than one year. At the time R placed the tractor in service, it treated the tractor tires as a separate asset for depreciation purposes under section 168. R properly treated the tractor (excluding the cost of the tires) as 3-year property and the tractor tires as 5-year property under section 168(e). Because R's tractor is property other than a building, the initial units of property for the tractor are determined under the general rule in paragraph (e)(3)(i) of this section and are comprised of all the components that are functionally interdependent. Under this rule, R must treat the tractor, including its tires, as a single unit of property because the tractor and the tires are functionally interdependent (that is, the placing in service of the tires is dependent upon the placing in service of the tractor). However, under paragraph (e)(5)(i) of this section, R must treat the tractor and tires as separate units of property because R properly treated the tires as being within a different class of property under section 168(e).

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

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

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

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

(2) *Lessee improvements*—(i) *Requirement to capitalize.* A taxpayer lessee must capitalize the related amounts (see paragraph (g)(3) of this section) that it pays to improve (as defined under paragraph (d) of this section) a leased property except to the extent that section 110 applies to a construction allowance received by the lessee for the purpose of such improvement or when the improvement constitutes a substitute for rent. See § 1.61–8(c) for the treatment of lessee expenditures that constitute a substitute for rent. A taxpayer lessee must also capitalize the related amounts that a lessor pays to improve (as defined under paragraph (d) of this section) a leased property if the lessee is the owner of the improvement, except to the extent that section 110 applies to a construction allowance received by the lessee for the purpose of such improvement. An amount paid for a lessee improvement under this paragraph (f)(2)(i) is treated as an amount paid to acquire or produce a unit of real or personal property under § 1.263(a)–2(d)(1) of the regulations.

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

(3) *Lessor improvements*—(i) *Requirement to capitalize.* A taxpayer lessor must capitalize the related amounts (see paragraph (g)(3) of this section) that it pays directly, or indirectly through a construction allowance to the lessee, to improve (as defined in paragraph (d) of this section) a leased property when the lessor is the owner of the improvement or to the extent that section 110 applies to the construction allowance. A lessor must also capitalize the related amounts that the lessee pays to improve a leased property (as defined in paragraph (e) of this section) when the lessee's improvement constitutes a substitute for rent. See § 1.61–8(c) for treatment of expenditures by lessees that constitute a substitute for rent. Amounts capitalized by the lessor under this paragraph (f)(3)(i) may not be capitalized by the lessee. If a lessor improvement is comprised of an entire building erected on leased property, then the amount paid for the building is treated as an amount paid by the lessor to acquire or produce a unit of property under § 1.263(a)–2(d)(1). See paragraphs (e)(2) of this section for the unit of property for a building and paragraph (e)(3) of this section for the unit of property for real or personal property other than a building.

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

(4) *Examples.* The following examples illustrate the application of this paragraph (f) and do not address whether capitalization is required under

another provision of the Code (for example, section 263A). For purposes of the following examples, assume that section 110 does not apply to the lessee and the amounts paid by the lessee are not a substitute for rent.

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

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

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

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

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

Example 3. Lessor Improvements; additions to building. (i) T is a retailer of consumer products. In Year 1, T leases a building from L, which T intends to use as a retail sales facility. Pursuant to the lease, L provides a construction allowance to T, which T intends to use to construct an extension to the retail sales facility for additional warehouse space. Assume that the amount paid for any improvement to the building does not exceed the construction allowance and that L is treated as the owner of any improvement to the building. Under paragraph (e)(2)(i) of this section, L must treat the building and its structural components as a single unit of property. As provided under paragraph (e)(2)(ii) of this section, an amount is paid to improve a building if it is paid for an improvement to the building structure or to any building system.

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

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

Example 5. Lessor property; buildings on leased property. L is the owner of a parcel of unimproved real property that L leases to T. Pursuant to the lease, L provides a construction allowance to T of $500,000, which T agrees to use to construct a building costing not more than $500,000 on the leased real property and to lease the building from L after it is constructed. Assume that for Federal income tax purposes, L is treated as the owner of the building that T will construct. T uses the $500,000 to construct the building as required under the lease. The building consists of the building structure and the following building systems: (1) a plumbing system; (2) an electrical system; and (3) an HVAC system. Because L provides a construction allowance to T to construct a building and L is treated as the owner of the building, L must capitalize the amounts that it pays indirectly to T to construct the building as a lessor improvement under paragraph (f)(3)(i) of this section. In addition, the amounts paid by L for the construction allowance are treated as amounts paid by L to acquire and produce the building under § 1.263(a)–2(d)(1). Further, under paragraph (e)(2)(i) of this section, L must treat the building and its structural components as a single unit of property. Under paragraph (f)(3)(i) of this section, T, the lessee, may not capitalize the amounts paid (with the construction allowance received from L) for construction of the building.

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

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

(ii) *Exception for individuals' residences.* A taxpayer who is an individual may capitalize amounts paid for repairs and maintenance that are made at the same time as capital improvements to units of property not used in the taxpayer's trade or business or for the production of income if the amounts are paid as part of an improvement (for example, a remodeling) of the taxpayer's residence.

(2) *Removal Costs*—(i) *In general.* If a taxpayer disposes of a depreciable asset, including a partial disposition under Prop. Reg. § 1.168(i)–1(e)(2)(ix) (September 19, 2013), or Prop. Reg. § 1.168(i)–8(d) (September 19, 2013), for Federal income tax purposes and has taken into account the adjusted basis of the asset or component of the asset in realizing gain or loss, then the costs of removing the asset or component are not required to be capitalized under this section. If a depreciable asset is included in a general asset account under section 168(i)(4), and neither the regulations under section 168(i)(4) and § 1.168(i)–1T(e)(3) nor Prop. Reg. § 1.168(i)–1(e)(3) (September 19, 2013), apply to a disposition of such asset, or a portion of such asset under Prop. Reg. § 1.168(i)–1(e)(2)(ix) (September 19, 2013), a loss is treated as being realized in the amount of zero upon the disposition of the asset solely for purposes of this paragraph (g)(2)(i). If a taxpayer disposes of a component of a unit of property, but the disposal of the component is not a disposition for Federal tax purposes, then the taxpayer must deduct or capitalize the costs of removing the component based on whether the removal costs directly benefit or are incurred by reason of a repair to the unit of property or an improvement to the unit of property. But see § 1.280B–1 for the rules applicable to demolition of structures.

(ii) *Examples.* The following examples illustrate the application of paragraph (g)(2)(i) of this section and, unless otherwise stated, do not address whether capitalization is required under another provision of this section or another provision of the Code (for example, section 263A). For purposes of the following examples, assume that Prop. Reg. § 1.168(i)–1(e) (September 19, 2013), or Prop. Reg. § 1.168(i)–8 (September 19, 2013), applies and that § 1.280B–1 does not apply.

Example 1. Component removed during improvement; no disposition. X owns a factory building with a storage area on the second floor. X pays an amount to remove the original columns and girders supporting the second floor and replace them with new columns and girders to permit storage of supplies with a gross weight 50 percent greater than the previous load-carrying capacity of the storage area. Assume that the replacement of the columns and girders constitutes a betterment to the building structure and is therefore an improvement to the building unit of property under paragraphs (d)(1) and (j) of this section. Assume that X disposes of the original columns and girders and the disposal of these structural components is not a disposition under Prop. Reg. § 1.168(i)–1(e) (September 19, 2013), or Prop. Reg. § 1.168(i)-8 (September 19, 2013). Under paragraphs (g)(2)(i) and (j) of this section, the amount paid to remove the columns and girders must be capitalized as a cost of the improvement, because it directly benefits and is incurred by reason of the improvement to the building.

Example 2. Component removed during improvement; disposition. Assume the same facts as *Example 1,* except X disposes of the original columns and girders and elects to treat the disposal of these structural components as a partial disposition of the factory building under Prop. Reg. § 1.168(i)-8(d) (September 19, 2013), taking into account the adjusted basis of the components in realizing loss on the disposition. Under paragraph (g)(2)(i) of this section, the amount paid to remove the columns and girders is not required to be capitalized as part of the cost of the improvement regardless of their relation to the improvement. However, all the remaining costs of replacing the columns and girders must be capitalized as improvements to the building unit of property under paragraphs (d)(1), (j), and (g)(1) of this section.

Example 3. Component removed during repair or maintenance; no disposition. Y owns a building in which it conducts its retail business. The roof over Y's building is covered with shingles. Over time, the shingles begin to wear and Y begins to experience leaks into its retail premises. However, the building still functions in Y's business. To eliminate the problems, a contractor recommends that Y remove the original shingles and replace them with new shingles. Accordingly, Y pays the contractor to replace the old shingles with new but comparable shingles. The new shingles are comparable to original shingles but correct the leakage problems. Assume that Y disposes of the original shingles, and the disposal of these shingles is not a disposition under Prop. Reg. § 1.168(i)–1(e) (September 19, 2013), or Prop. Reg. § 1.168(i)–8 (September 19, 2013). Assume that replacement of old shingles with new shingles to correct the leakage is not a betterment or a restoration of the building structure or systems under paragraph (j) or (k) of this section and does not adapt the building structure or systems to a new or different use under paragraph (l) of this section. Thus, the amounts paid by Y to replace the shingles are not improvements to the building unit of property under paragraph (d) of this section. Under paragraph (g)(2)(i) of this section, the amounts paid to remove the shingles are not required to be capitalized because they directly benefit and are incurred by reason of repair or maintenance to the building structure.

Example 4. Component removed with disposition and restoration. Assume the same facts as *Example 3* except Y disposes of the original shingles, and Y elects to treat the disposal of these components as a partial disposition of the building under Prop. Reg.

§ 1.168(i)–8(d) (September 19, 2013), and deducts the adjusted basis of the components as a loss on the disposition. Under paragraph (k)(1)(i) of this section, amounts paid for replacement of the shingles constitute a restoration of the building structure because the amounts are paid for the replacement of a component of the structure and the taxpayer has properly deducted a loss for that component. Thus, under paragraphs (d)(2) and (k) of this section, Y is required to capitalize the amounts paid for the replacement of the shingles as an improvement to the building unit of property. However, under paragraph (g)(2)(i) of this section, the amounts paid by Y to remove the original shingles are not required to be capitalized as part of the costs of the improvement, regardless of their relation to the improvement.

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

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

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

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

(ii) $10,000.

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

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

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

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

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

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

(iv) *Definition of gross receipts.* For purposes of applying paragraph (h)(3)(i) of this section, the term *gross receipts* means the taxpayer's receipts for the taxable year that are properly recognized under the taxpayer's methods of accounting used for Federal income tax purposes for the taxable year. For this purpose, gross receipts include total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments and from incidental or outside sources. For example, gross receipts include interest (including original issue discount and tax-exempt interest within the meaning of section 103), dividends, rents, royalties, and annuities, regardless of whether such amounts are derived in the ordinary course of the taxpayer's trade of business. Gross receipts are not reduced by cost of goods sold or by the cost of property sold if such property is described in section 1221(a)(1), (3), (4), or (5). With respect to sales of capital assets as defined in section 1221, or sales of property described in section 1221(a)(2) (relating to property used in a trade or business), gross receipts shall be reduced by the taxpayer's adjusted basis in such property. Gross receipts do not include the repayment of a loan or similar instrument (for example, a repayment of the principal amount of a loan held by a commercial lender) and, except to the extent of gain recognized, do not include gross receipts derived from a non-recognition transaction, such as a section 1031 exchange. Finally, gross receipts do not include amounts received by the taxpayer with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority. If, in contrast, the tax is imposed on the taxpayer under the applicable law, then gross receipts include the amounts received that are allocable to the payment of such tax.

(4) *Eligible building property.* For purposes of this section, the term, *eligible building property* refers to each unit of property defined in paragraph (e)(2)(i) (building), paragraph (e)(2)(iii)(A) (condominium), paragraph (e)(2)(iv)(A) (cooperative), or paragraph (e)(2)(v)(A) (leased building or portion of building) of this section, as applicable, that has an unadjusted basis of $1,000,0000 or less.

(5) *Unadjusted basis*—(i) *Eligible building property owned by taxpayer.* For purposes of this section, the unadjusted basis of eligible building property owned by the taxpayer means the basis as determined under section 1012, or other applicable sections of Chapter 1, including subchapters O (relating to gain or loss on dispositions of property), C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). Unadjusted basis is determined without regard to any adjustments described in section 1016(a)(2) or (3) or to amounts for which the taxpayer has elected to treat as an expense (for example, under sections 179, 179B, or 179C).

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

(6) *Time and manner of election.* A taxpayer makes the election described in paragraph (h)(1) of this section by attaching a statement to the taxpayer's timely filed original Federal tax return (including extensions) for the taxable year in which amounts are paid for repairs, maintenance, improvements, and similar activities performed on the eligible building property providing that such amounts qualify under the safe harbor provided in paragraph (h)(1) of

this section. See §§ 301.9100–1 through 301.9100–3 of this chapter for the provisions governing extensions of time to make regulatory elections. The statement must be titled, ''Section 1.263(a)–3(h) Safe Harbor Election for Small Taxpayers'' and include the taxpayer's name, address, taxpayer identification number, and a description of each eligible building property to which the taxpayer is applying the election. In the case of an S corporation or a partnership, the election is made by the S corporation or by the partnership, and not by the shareholders or partners. An election may not be made through the filing of an application for change in accounting method or, before obtaining the Commissioner's consent to make a late election, by filing an amended Federal tax return. A taxpayer may not revoke an election made under this paragraph (h). The time and manner of making the election under this paragraph (h) may be modified through guidance of general applicability (see §§ 601.601(d)(2) and 601.602 of this chapter).

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

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

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

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

Example 1. Safe harbor for small taxpayers applicable. A is a qualifying taxpayer under paragraph (h)(3) of this section. A owns an office building in which A provides consulting services. In Year 1, A's building has an unadjusted basis of $750,000 as determined under paragraph (h)(5)(i) of this section. In Year 1, A pays $5,500 for repairs, maintenance, improvements and similar activities to the office building. Because A's building unit of property has an unadjusted basis of $1,000,000 or less, A's building constitutes eligible building property under paragraph (h)(4) of this section. The aggregate amount paid by A during Year 1 for repairs, maintenance, improvements and similar activities on this eligible building property does not exceed the lesser of $15,000 (2 percent of the building's unadjusted basis of $750,000) or $10,000. Therefore, under paragraph (h)(1) of this section, A may elect to not apply the capitalization rule of paragraph (d) of this section to the amounts paid for repair, maintenance, improvements, or similar activities on the office building in Year 1. If A properly makes the election under paragraph (h)(6) of this section for the office building and the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on a trade or business, A may deduct these amounts under § 1.162–1 in Year 1.

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

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

(ii) The total amount paid by B during Year 1 for repairs, maintenance, improvements and similar activities on Building M ($5,000) does not exceed the lesser of $6,000 (2 percent of the building's unadjusted basis of $300,000) or $10,000. Therefore, under paragraph (h)(1) of this section, for Year 1, B may elect to not apply the capitalization rule under paragraph (d) of this section to the amounts it paid for repairs, maintenance, improvements, and similar activities on Building M. If B properly makes the election under paragraph (h)(6) of this section for Building M and the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on B's trade or business, B may deduct these amounts under § 1.162–1.

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

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

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

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

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

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

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

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

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

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

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

(v) Amounts paid to return a unit of property to its ordinarily efficient operating condition, if the property has deteriorated to a state of disrepair and is no longer functional for its intended use (see paragraph (k)(1)(iv) of this section);

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

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

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

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

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

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

Example 1. Routine maintenance on component. (i) A is a commercial airline engaged in the business of transporting passengers and freight throughout the United States and abroad. To conduct its business, A owns or leases various types of aircraft. As a condition of maintaining its airworthiness certification for these aircraft, A is required by the Federal Aviation Administration (FAA) to establish and adhere to a continuous maintenance program for each aircraft within its fleet. These programs, which are designed by A and the aircraft's manufacturer and approved by the FAA, are incorporated into each aircraft's maintenance manual. The maintenance manuals require a variety of periodic maintenance visits at various intervals. One type of maintenance visit is an engine shop visit (ESV), which A expects to perform on its aircraft engines approximately every 4 years to keep its aircraft in its ordinarily efficient operating condition. In Year 1, A purchased a new aircraft, which included four new engines attached to the airframe. The four aircraft engines acquired with the aircraft are not materials or supplies under § 1.162–3(c)(1)(i) because they are acquired as part of a single unit of property, the aircraft. In Year 5, A performs its first ESV on the aircraft engines. The ESV includes disassembly, cleaning, inspection, repair, replacement, reassembly, and testing of the engine and its component parts. During the ESV, the engine is removed from the aircraft and shipped to an outside vendor who performs the ESV. If inspection or testing discloses a discrepancy in a part's conformity to the specifications in A's maintenance program, the part is repaired, or if necessary, replaced with a comparable and commercially available replacement part. After the ESVs, the engines are returned to A to be reinstalled on another aircraft or stored for later installation. Assume that the class life for A's aircraft, including the engines, is 12 years. Assume that none of the exceptions set out in paragraph (i)(3) of this section apply to the costs of performing the ESVs.

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

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

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

(ii) The additional aircraft engines are rotable spare parts because they were acquired separately from the aircraft, they are removable from the aircraft, and are repaired and reinstalled on other aircraft or stored for later installation. See § 1.162–3(c)(2) (definition of rotable and temporary spare parts). Assume the class life of an engine is the same as the airframe, 12 years. Because the ESVs involve the recurring activities that A expects to perform as a result of its use of the engines to keep the engines in ordinarily efficient operating condition, and consist of maintenance activities that A expects to perform more than once during the 12 year class life of the engine, the ESVs fall within the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section. Accordingly, the amounts paid for the ESVs for the four additional engines are deemed not to improve these engines and are not required to be capitalized under paragraph (d) of this section. For the treatment of amounts paid to acquire the engines, see § 1.162–3(a).

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

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

Example 5. Routine maintenance resulting from new owner's use. Assume the same facts as in *Example 4,* except that after B pays amounts for the maintenance in Year 1, B continues to operate the machine in its manufacturing business. In Year 4, B pays amounts to perform the next scheduled manufacturer recommended maintenance on the machine. Assume that the scheduled maintenance activities performed are the same as those performed in *Example 4* and that none of the exceptions set out in paragraph (i)(3) of this section apply to the amounts paid for the scheduled maintenance. Because the scheduled maintenance performed in Year 4 involves the recurring activities that B performs as a result of its use of the machine, keeps the machine in an ordinarily efficient operating condition, and consists of maintenance activities that B expects to perform more than once during the 10-year class life of the machine, B's scheduled maintenance costs are within the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section. Accordingly, the amounts paid for the scheduled maintenance in Year 4 are deemed not to improve the machine and are not required to be capitalized under paragraph (d) of this section.

Example 6. Routine maintenance; replacement of substantial structural part; coordination with section 263A. C is in the business of producing commercial products for sale. As part of the production process, C places raw materials into lined containers in which a chemical reaction is used to convert raw materials into the finished product. The lining, which comprises 60 percent of the total physical structure of the container, is a substantial structural part of the container. Assume that each container, including its lining, is the unit of property and that a container has a class life of 12 years. At the time that C placed the container into service, C was aware that approximately every three years, the container lining would need to be replaced with comparable and commercially available replacement materials. At the end of three years, the container will continue to function, but will become less efficient and the replacement of the lining will be necessary to keep the container in an ordinarily efficient operating condition. In Year 1, C acquired 10 new containers and placed them into service. In Year 4, Year 7, Year 9, and Year 12, C pays amounts to replace the containers' linings with comparable and commercially available replacement parts. Assume that none of the exceptions set out in paragraph (i)(3) of this section apply to the amounts paid for the replacement linings. Because the replacement of the linings involves recurring activities that C expects to perform as a result of its use of the containers to keep the containers in their ordinarily efficient operating condition and consists of maintenance activities that C expects to perform more than once during the 12-year class life of the containers, C's lining replacement costs are within the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section. Accordingly, the amounts that C paid for the replacement of the container linings are deemed not to improve the containers and are not required to be capitalized under paragraph (d) of this section. However, the amounts paid to replace the lining may be subject to capitalization under section 263A if the amounts paid for this maintenance comprise the direct or allocable indirect costs of the property produced by C. See § 1.263A–1(e)(3)(ii)(O).

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

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

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

Example 10. Routine maintenance with related betterments. Assume the same facts as *Example 9,* except that in Year 9 E's towboat engines are due for another scheduled maintenance visit. At this time, E decides to upgrade the engines to increase their horsepower and propulsion, which would permit the towboats to tow heavier loads. Accordingly, in Year 9, E pays amounts to perform many of the same activities that it would perform during the typical scheduled maintenance activities such as cleaning, inspecting, reconditioning, and replacing minor parts, but at the same time, E incurs costs to upgrade certain engine parts to increase the towing capacity of the boats in excess of the capacity of the boats when E placed them in service. In combination with the replacement of parts with new and upgraded parts, the scheduled maintenance must be completed to perform the horsepower and propulsion upgrade. Thus, the work done on the engines encompasses more than the recurring activities that E expected to perform as a result of its use of the towboats and did more than keep the towboat in its ordinarily efficient operating condition. Rather under paragraph (j) of this section, the amounts paid to increase the horsepower and propulsion of the engines are for a betterment to the towboat, and such amounts are excepted from the routine maintenance safe harbor under paragraph (i)(3)(i) of this section. In addition, under paragraph (g)(1)(i) of this section, the scheduled maintenance procedures directly benefit the upgrades. Therefore, the amounts that E paid in Year 9 for the maintenance and upgrade of the engines do not qualify for the routine maintenance safe harbor described under paragraph (i)(1)(ii) of this section. Rather, E must capitalize the amounts paid for maintenance and upgrades of the engines as an improvement to the towboats under paragraph (d) of this section.

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

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

Example 13. Routine maintenance on a building; escalator system. In Year 1, G acquires a large retail mall in which it leases space to retailers. The mall contains an escalator system with 40 escalators, which includes landing platforms, trusses, tracks, steps, handrails, and safety brushes. In Year 1, when G placed its building into service, G reasonably expected that it would need to replace the handrails on the escalators approximately every four years to keep the escalator system in its ordinarily efficient operating condition. After a routine inspection and test of the escalator system in Year 4, G determines that the handrails need to be replaced and pays an amount to replace the handrails with comparable and commercially available handrails. The escalator system, including the handrails, is a building system under paragraph (e)(2)(ii)(B)(*4*) of this section. Assume that none of the exceptions in paragraph (i)(3) of this section apply to the scheduled maintenance costs. Because the replacement of the handrails involves recurring activities that G expects to perform as a result of its use of the escalator system to keep the escalator system in an ordinarily efficient operating condition, and G reasonably expects to perform these activities more than once during the 10-year period beginning at the time building system was placed in service, the amounts paid by G for the handrail replacements are within the routine maintenance safe harbor under paragraph (i)(1)(i) of this section. Accordingly, the amounts paid for the replacement of the handrails in Year 4 are deemed not to improve the building unit of property and are not required to be capitalized under paragraph (d) of this section.

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

Example 15. Routine maintenance on building; reasonable expectation. In Year 1, H acquires a new office building, which it uses to provide services. The building contains an HVAC system, which is a building system under paragraph (e)(2)(ii)(B)(*1*) of this section. In Year 1, when H placed its building into service, H reasonably expected that every four years H would need to pay an outside contractor to perform detailed testing, monitoring, and preventative maintenance on its HVAC system to keep the HVAC system in its ordinarily efficient operating condition. This scheduled maintenance includes disassembly, cleaning, inspection, repair, replacement, reassembly, and testing of the HVAC system and many of its component parts. If inspection or testing discloses a problem with any component, the part is repaired, or if necessary, replaced with a comparable and commercially available replacement part. The scheduled maintenance at these intervals is recommended by the manufacturer of the HVAC system and is routinely performed on similar systems in similar buildings. Assume that none of the exceptions in paragraph (i)(3) of this section apply to the amounts paid for the maintenance on the HVAC system. In Year 4, H pays amounts to a contractor to perform the scheduled maintenance. However, H does not perform this scheduled maintenance on its building again until Year 11. Under paragraph (i)(1)(i) of this section, H's reasonable expectation that it would perform the maintenance every 4 years will not be deemed unreasonable merely because H did not actually perform the maintenance a second time during the 10-year period, provided that H can substantiate that its expectation was reasonable at the time the property was placed in service. If H can demonstrate that its expectation was reasonable in Year 1 using the other factors considered in paragraph (i)(1)(i), then the amounts H paid for the maintenance of the HVAC system in Year 4 and in Year 11 are within the routine maintenance safe harbor under paragraph (i)(1)(i) of this section.

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

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

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

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

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

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

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

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

(B) *Normal wear and tear.* If the expenditure is made to correct the effects of normal wear and tear to the unit of property that occurred during the taxpayer's use of the unit of property, the condition of the property immediately prior to the circumstances necessitating the expenditure is the condition of the property after the last time the taxpayer corrected the effects of normal wear and tear (whether the amounts paid were for maintenance or improvements) or, if the taxpayer has not previously corrected the effects of normal wear and tear, the condition of the property when placed in service by the taxpayer.

(C) *Damage to property.* If the expenditure is made to correct damage to a unit of property that occurred during the taxpayer's use of the unit of property, the condition of the property immediately prior to the circumstances necessitating the expenditure is the condition of the property immediately prior to damage.

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

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

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

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

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

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

Example 5. Amelioration of material condition or defect. (i) E acquires a building for use in its business of providing assisted living services. Before and after the purchase, the building functions as an assisted living facility. However, at the time of the purchase, E is aware that the building is in a condition that is below the standards that E requires for facilities used in its business. Immediately after the acquisition and during the following two years, while E continues to use the building as an assisted living facility, E pays amounts for extensive repairs and maintenance, and the acquisition of new property to bring the facility into the high-quality condition for which E's facilities are known. The work on E's building includes repairing damaged drywall, repainting, re-wallpapering, replacing windows, repairing and replacing doors, replacing and regrouting tile, repairing millwork, and repairing and replacing roofing materials. The work also involves the replacement of section 1245 property, including window treatments, furniture, and cabinets. The work that E performs affects only the building structure under paragraph (e)(2)(ii)(A) of this section and does not affect any of the building systems described in paragraph (e)(2)(ii)(B) of this section. Assume that each section 1245 property is a separate unit of property.

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

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

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

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

(ii) Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. Under paragraph (j)(1)(ii) of this section, the amounts paid by F to add the storage space, loading dock, overhead door, and expand the electrical system are for betterments to F's building structure and to the electrical system because they are for material additions to, and a material increase in capacity of, the structure and the electrical system of F's store building. Accordingly, F must treat the amounts paid for these betterments as improvements to the building unit of property and capitalize these amounts under paragraphs (d)(1) and (j) of this section. However, for the reasons discussed in *Example 6,* F is not required to treat the amounts paid for the refresh of its store building structure and systems as a betterments under paragraph (j)(1) of this section. In addition, F is not required under paragraph (g)(1) of this section to capitalize the refresh costs described in *Example 6* because these costs do not directly benefit and are not incurred by reason of the additions to the building structure and electrical system. As in *Example 6,* F is required to capitalize the amounts paid to acquire and install each section 1245 property in accordance with § 1.263(a)–2(d)(1).

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

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

Example 9. Not betterment; relocation and reinstallation of personal property. In Year 1, H purchases new cash registers for use in its retail store located in leased space in a shopping mall. Assume that each cash register is a unit of property as determined under paragraph (e)(3) of this section. In Year 1, H capitalizes the costs of acquiring and installing the new cash registers under § 1.263(a)–2(d)(1). In Year 3, H's lease expires, and H decides to relocate its retail store to a different building. In addition to various other costs, H pays $5,000 to move the cash registers and $1,000 to reinstall them in the new store. The cash registers are used for the same purpose and in the same manner that they were used in the former location. The amounts that H pays to move and reinstall the cash registers into its new store do not result in a betterment to the cash registers under paragraph (j) of this section.

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

Example 11. Betterment; regulatory requirement. K owns a building that it uses in its business. In Year 1, City C passes an ordinance setting higher safety standards for buildings because of the hazardous conditions caused by earthquakes. To comply with the ordinance, K pays an amount to add expansion bolts to its building structure. These bolts anchor the wooden framing of K's building to its cement foundation, providing additional structural support and resistance to seismic forces, making the building more resistant to damage from lateral movement. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. The framing and foundation are part of the building structure as defined in paragraph (e)(2)(ii)(A) of this section. Prior to the ordinance, the old building was in good condition but did not meet City C's new requirements for earthquake resistance. The amount paid by K for the addition of the expansion bolts met City C's new requirement, but also materially increased the strength of the building structure under paragraph (j)(1)(iii) of this section. Therefore, K must treat the amount paid to add the expansion bolts as a betterment to the building structure and must capitalize this amount as an improvement to building under paragraphs (d)(1) and (j) of this section. City C's new requirement that K's building meet certain safety standards to continue to operate is not relevant in determining whether the amount paid improved the building. See paragraph (g)(4) of this section.

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

Example 13. Not a betterment; new roof membrane. M owns a building that it uses for its retail business. Over time, the waterproof membrane (top layer) on the roof of M's building begins to wear, and M began to experience water seepage and leaks throughout its retail premises. To eliminate the problems, a contractor recommends that M put a new rubber membrane on the worn membrane. Accordingly, M pays the contractor to add the new membrane. The new membrane is comparable to the worn membrane when it was originally placed in service by the taxpayer. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. The roof is part of the building structure under paragraph (e)(2)(ii)(A) of this section. The condition necessitating the expenditure was the normal wear of M's roof. Under paragraph (j)(2)(iv) of this section, to determine whether the amounts are for a betterment, the condition of the building structure after the expenditure must be compared to the condition of the structure when M placed the building into service because M has not previously corrected the effects of normal wear and tear. Under these facts, the amount paid to add the new membrane to the roof is not for a material addition or a material increase in the capacity of the building structure under paragraph (j)(1)(ii) of this section as compared to the condition of the structure when it was placed in service. Moreover, the new membrane is not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the building structure under paragraph (j)(1)(iii) of this section as compared to the condition of the building structure when it was placed in service. Therefore, M is not required to treat the amount paid to add the new membrane as a betterment to the building under paragraph (d)(1) or (j) of this section.

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

Example 15. Material increase in capacity; channel. O owns harbor facilities consisting of a slip for the loading and unloading of barges and a channel leading from the slip to the river. At the time of purchase, the channel was 150 feet wide, 1,000 feet long, and 10 feet deep. Several years after purchasing the harbor facilities, to allow for ingress and egress and for the unloading of larger barges, O decides to deepen the channel to a depth of 20 feet. O pays a contractor to dredge the channel to 20 feet. Assume the channel is the unit of property. O must capitalize the amounts paid for the dredging as an improvement to the channel because they are for a material increase in the capacity of the unit of property under paragraph (j)(1)(ii) of this section.

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

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

Example 18. Not a material increase in capacity; building. P owns a building used in its trade or business. The first floor has a drop-ceiling. To fully expose windows on the first floor, P pays an amount to remove the drop-ceiling and repaint the original ceiling. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. The ceiling is part of the building structure as defined under paragraph (e)(2)(ii)(A) of this section. P is not required to treat the amount paid to remove the drop-ceiling as a betterment to the building because it was not for a material addition or material increase in the capacity of the building structure under paragraph (j)(1)(ii) of this section and it was not reasonably expected to materially increase to the efficiency, strength, or quality of the building structure under paragraph (j)(1)(iii) of this section. In addition, under paragraph (j)(2)(i) of this section, because the effect on productivity and output of the building structure cannot be measured in this context, these factors are not relevant in determining whether there is a betterment to the building structure.

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

Example 20. Not material increase in efficiency; HVAC system. R owns an office building that it uses to provide services to customers. The building contains an HVAC system that incorporates 10 roof-mounted units that provide heating and air conditioning for different parts of the building. The HVAC system also consists of controls for the entire system and duct work that distributes the heated or cooled air to the various spaces in the building's interior. After many years of use of the HVAC system, R begins to experience climate control problems in various offices throughout the office building and consults with a contractor to determine the cause. The contractor recommends that R replace two of the roof-mounted units. R pays an amount to replace the two specified units. The two new units are expected to eliminate the climate control problems and to be 10 percent more energy efficient than the replaced units in their original condition. No work is performed on the other roof-mounted heating/cooling units, the duct work, or the controls. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. The HVAC system, including the two-roof mounted units, is a building system under paragraph (e)(2)(ii)(B)(*1*) of this section. The replacement of the two roof-mounted units is not a material addition to or a material increase in the capacity of the HVAC system under paragraphs (j)(1)(ii) and (j)(3)(ii) of this section as compared to the condition of the system prior to the climate control problems. In addition, given the 10 percent efficiency increase in two units of the entire HVAC system, the replacement is not expected to materially increase the productivity, efficiency, strength, quality, or output of the HVAC system under paragraphs (j)(1)(iii) and (j)(2)(iv) of this section as compared to the condition of the system prior to the climate control problems. Therefore, R is not required to capitalize the amounts paid for these replacements as betterments to the building unit of property under paragraphs (d)(1) and (j) of this section.

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

Example 22. Material addition; building. T owns and operates a restaurant, which provides a variety of prepared foods to its customers. To better accommodate its customers and increase customer traffic, T decides to add a drive-through service area. As a result, T pays amounts to partition an area within its restaurant for a drive-through service counter, to construct a service window with necessary security features, to build an overhang for vehicles, and to construct a drive-up menu board. Assume that the drive-up menu board is section 1245 property that is a separate unit of property under paragraph (e)(3) of this section. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. The amounts paid for the partition, service window and overhang are betterments to the building structure because they comprise a material addition (that is, a physical expansion, extension, and addition of a major component) to the building structure under paragraph (j)(1)(ii) of this section. Accordingly, T must capitalize as an improvement the amounts paid to add the partition, drive-through window, and overhang under paragraphs (d)(1) and (j) of this section. T is also required to capitalize the amounts paid to acquire and install each section 1245 property in accordance with § 1.263(a)–2(d)(1).

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

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

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

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

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

(iv) Returns the unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use;

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

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

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

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

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

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

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

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

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

(6) *Replacement of a major component or a substantial structural part*—(i) *In general.* To determine whether an amount is for the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of the unit of property under paragraph (k)(1)(vi) of this section, it is appropriate to consider all the facts and circumstances. These facts and circumstances include the quantitative and qualitative significance of the part or combination of parts in relation to the unit of property.

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

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

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

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

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

(7) *Examples.* The following examples illustrate the application of this paragraph (k) only and do not address whether capitalization is required under another provision of this section or another provision of the Code (for example, section 263A). Unless otherwise stated, assume that the taxpayer has not properly deducted a loss for, nor taken into account the adjusted basis on a sale or exchange of, any unit of property, asset, or component of a unit of property that is replaced.

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

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

Example 3. Restoration after casualty loss. B owns an office building that it uses in its trade or business. A storm damages the office building at a time when the building has an adjusted basis of $500,000. B deducts under section 165 a casualty loss in the amount of $50,000, and properly reduces its basis in the office building to $450,000. B hires a contractor to repair the damage to the building, including the repair of the building roof and the removal of debris from the building premises. B pays the contractor $50,000 for the work. Under paragraph (k)(1)(iii) of this section, B must treat the $50,000 amount paid to the contractor as a restoration of the building structure because B properly adjusted its basis in that amount as a result of a casualty loss under section 165, and the amount does not exceed the limit in paragraph (k)(4) of this section. Therefore, B must treat the amount paid as an improvement to the building unit of property and, under paragraph (d)(2) of this section, must capitalize the amount paid.

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

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

(ii) Under paragraph (k)(1)(vi) of this section, C must capitalize as an improvement the $350,000 amount paid to the contractor to replace the roof structure because the roof structure constitutes a major component and a substantial structural part of the building unit of property. In addition, under paragraphs (k)(1)(iii) and (k)(4)(i), C must treat as a restoration the remaining costs, limited to the excess of the adjusted basis of the building over the amounts paid for the improvement under paragraph (k)(1)(vi). Accordingly, C must treat as a restoration $150,000 ($500,000—$350,000) of the $400,000 paid for the portion of the costs related to repairing and cleaning the building structure under paragraph (k)(1)(iii) of this section. Thus, in addition to the $350,000 to replace the roof structure, C must also capitalize the $150,000 as an improvement to the building unit of property under paragraph (d)(2) of this section. C is not required to capitalize the remaining $250,000 repair and cleaning costs under paragraph (k)(1)(iii) of this section.

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

Example 7. Rebuild of property to like-new condition before end of class life. E is a Class I railroad that owns a fleet of freight cars. Assume the freight cars have a recovery period of 7 years under section 168(c) and a class life of 14 years. Every 8 to 10 years, E rebuilds its freight cars. Ten years after E places the freight car in service, E performs a rebuild to the manufacturer's original specification, which includes a complete disassembly, inspection, and reconditioning or replacement of components of the suspension and draft systems, trailer hitches, and other special equipment. E also modifies the car to upgrade various components to the latest engineering standards. The freight car is stripped to the frame, with all of its substantial components either reconditioned or replaced. The frame itself is the longest-lasting part of the car and is reconditioned. The walls of the freight car are replaced or are sandblasted and repainted. New wheels are installed on the car. All the remaining components of the car are restored before they are reassembled. At the end of the rebuild, the freight car has been restored to like-new condition under the manufacturer's specifications. Assume the freight car is the unit of property. E is not required to treat as an improvement and capitalize the amounts paid to rebuild the freight car under paragraph (k)(1)(v) of this section because, although the amounts paid restore the freight car to like-new condition, the amounts were not paid after the end of the class life of the freight car. However, see paragraphs (k)(1)(vi) and (k)(6) of this section to determine whether any amounts must be capitalized because they are paid for the replacement of a major component or a substantial structural part of the unit of property.

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

Example 9. Not a rebuild to a like-new condition. F is a commercial airline engaged in the business of transporting freight and passengers. To conduct its business, F owns several aircraft. As a condition of maintaining its airworthiness certificates, F is required by the FAA to establish and adhere to a continuous maintenance program for each aircraft in its fleet. F performs heavy maintenance on its airframes every 8 to 10 years. In Year 1, F purchased an aircraft for $15 million. In Year 16, F paid $2 million for the labor and materials necessary to perform the second heavy maintenance visit on the airframe of an aircraft. To perform the heavy maintenance visit, F extensively disassembles the airframe, removing items such as engines, landing gear, cabin and passenger compartment seats, side and ceiling panels, baggage stowage bins, galleys, lavatories, floor boards, cargo loading systems, and flight control surfaces. As specified by F's maintenance manual for the aircraft, F then performs certain tasks on the disassembled airframe for the purpose of preventing deterioration of the inherent safety and reliability levels of the airframe. These tasks include lubrication and service, operational and visual checks, inspection and functional checks, reconditioning of minor parts and components, and removal, discard, and replacement of certain life-limited single cell parts, such as cartridges, canisters, cylinders, and disks. Reconditioning of parts includes burnishing corrosion, repairing cracks, dents, gouges, punctures, tightening or replacing loose or missing fasteners, replacing damaged seals, gaskets, or valves, and similar activities. In addition to the tasks described above, to comply with certain FAA airworthiness directives, F inspects specific skin locations, applies doublers over small areas where cracks were found, adds structural reinforcements, and replaces skin panels on a small section of the fuselage. However, the heavy maintenance does not include the replacement of any major components or substantial structural parts of the aircraft with new components. In addition, the heavy maintenance visit does not bring the aircraft to the status of new, rebuilt, remanufactured, or a similar status under FAA guidelines or the manufacturer's original specifications. After the heavy maintenance, the aircraft was reassembled. Assume the aircraft, including the engines, is a unit of property and has a class life of 12 years under section 168(c). Although the heavy maintenance is performed after the end of the class life of the aircraft, F is not required to treat the heavy maintenance as a restoration and improvement of the unit of property under paragraph (k)(1)(v) of this section because, although extensive, the amounts paid do not restore the aircraft to like-new condition. See also paragraph (i)(1)(iii) of this section for the application of the safe harbor for routine maintenance.

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

Example 11. Repair performed during restoration. Assume the same facts as in *Example 10,* except that, at the same time the engine and cab of the tractor are replaced, G pays amounts to paint the cab of the tractor with its company logo and to fix a broken taillight on the tractor. The repair of the broken taillight and the painting of the cab generally are deductible expenses under § 1.162–4. However, under paragraph (g)(1)(i) of this section, a taxpayer must capitalize all the direct costs of an improvement and all the indirect costs that directly benefit or are incurred by reason of an improvement. Repairs and maintenance that do not directly benefit or are not incurred by reason of an improvement are not required to be capitalized under section 263(a), regardless of whether they are made at the same time as an improvement. For the amounts paid to paint the logo on the cab, G's need to paint the logo arose from the replacement of the cab with a new cab. Therefore, under paragraph (g)(1)(i) of this section, G must capitalize the amounts paid to paint the cab as part of the improvement to the tractor because these amounts directly benefit and are incurred by reason of the restoration of the tractor. The amounts paid to repair the broken taillight are not for the replacement of a major component, do not directly benefit, and are not incurred by reason of the replacement of the cab or the engine under paragraph (g)(1)(i) of this section, even though the repair was performed at the same time as these replacements. Thus, G is not required to capitalize the amounts paid to repair the broken taillight.

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

(ii) H pays the permit fee to the county on October 15, Year 1. On December 15, Year 1, the contractor completes the removal of the old USTs and bills H for the costs of removal. On January 15, Year 2, the contractor completes the installation of the new USTs and bills H for the remainder of the work. Assume that H computes its taxes on a calendar year basis and H's gasoline pumping system is the unit of property. Under paragraph (k)(1)(vi) of this section, H must capitalize the amounts paid to replace the USTs as a restoration to the gasoline pumping system because the USTs are parts or combinations of parts that comprise a major component and substantial structural part of the gasoline pumping system. Moreover, under paragraph (g)(2) of this section, H must capitalize the costs of removing the old USTs because H has not taken a loss on the disposition of the USTs, and the amounts to remove the USTs directly benefit and are incurred by reason of the restoration of, and improvement to, the gasoline pumping system. In addition, under paragraph (g)(1) of this section, H must capitalize the permit fees because they directly benefit and are incurred by reason of the improvement to the gasoline pumping system. Finally, under paragraph (g)(3) of this section, H must capitalize the related amounts paid to improve the gasoline pumping system, including the permit fees, the amount paid to remove the old USTs, and the amount paid to install the new USTs, even though the amounts were separately invoiced, paid to different parties, and incurred in different tax years.

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

Example 14. Replacement of major component or substantial structural part; roof. K owns a manufacturing building. K discovers several leaks in the roof of the building and hires a contractor to inspect and fix the roof. The contractor discovers that a major portion of the decking has rotted and recommends the replacement of the entire roof. K pays the contractor to replace the entire roof, including the decking, insulation, asphalt, and various coatings. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount is paid to restore the building structure or any building system. The roof is part of the building structure as defined under paragraph (e)(2)(ii)(A) of this section. Because the entire roof performs a discrete and critical function in the building structure, the roof comprises a major component of the building structure under paragraph (k)(6)(ii)(A) of this section. In addition, because the roof comprises a large portion of the physical structure of the building structure, the roof comprises a substantial structural part of the building structure under paragraph (k)(6)(ii)(B) of this section. Therefore, under either analysis, K must treat the amount paid to replace the roof as a restoration of the building under paragraphs (k)(1)(vi) and (k)(2) of this section and must capitalize the amount paid as an improvement under paragraph (d)(2) of this section.

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

Example 16. Not a replacement of major component or substantial structural part; HVAC system. M owns a building in which it operates an office that provides medical services. The building contains one HVAC system, which is comprised of three furnaces, three air conditioning units, and duct work that runs throughout the building to distribute the hot or cold air throughout the building. One furnace in M's building breaks down, and M pays an amount to replace it with a new furnace. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount is paid to restore the building structure or any building system. The HVAC system, including the furnaces, is a building system under paragraph (e)(2)(ii)(B)(*1*) of this section. As the parts that provide the heating function in the system, the three furnaces, together, perform a discrete and critical function in the operation of the HVAC system and are therefore a major component of the HVAC system under paragraph (k)(6)(i)(A) of this section. However, the single furnace is not a significant portion of this major component of the HVAC system under paragraph (k)(6)(ii)(A) of this section, or a substantial structural part of the HVAC system under paragraph (k)(6)(ii)(B) of this section. Therefore, M is not required to treat the amount paid to replace the furnace as a restoration of the building under paragraph (k)(1)(vi) of this section.

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

Example 18. Not replacement of major component or substantial structural part; HVAC system. O owns an office building that it uses to provide services to customers. The building contains a HVAC system that incorporates ten roof-mounted units that provide heating and air conditioning for the building. The HVAC system also consists of controls for the entire system and duct work that distributes the heated or cooled air to the various spaces in the building's interior. O begins to experience climate control problems in various offices throughout the office building and consults with a contractor to determine the cause. The contractor recommends that O replace three of the roof-mounted heating and cooling units. O pays an amount to replace the three specified units. No work is performed on the other roof-mounted heating and cooling units, the duct work, or the controls. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount restores the building structure or any building system. The HVAC system, including the 10 roof-mounted heating and cooling units, is a building system under paragraph (e)(2)(ii)(B)(*1*) of this section. As the components that generate the heat and the air conditioning in the HVAC system, the 10 roof-mounted units, together, perform a discrete and critical function in the operation of the HVAC system and, therefore, are a major component of the HVAC system under paragraph (k)(6)(ii)(A) of this section. The three roof-mounted heating and cooling units are not a significant portion of a major component of the HVAC system under (k)(6)(ii)(A) of this section, or a substantial structural part of the HVAC system, under paragraph (k)(6)(ii)(B) of this section. Accordingly, O is not required to treat the amount paid to replace the three roof-mounted heating and cooling units as a restoration of the building under paragraph (k)(1)(iv) of this section.

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

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

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

Example 22. Replacement of major component or substantial structural part; plumbing system. S owns a building in which it conducts a retail business. The retail building has three floors. The retail building has men's and women's restrooms on two of the three floors. S decides to update the restrooms by paying an amount to replace the plumbing fixtures in all of the restrooms, including all the toilets and sinks, with modern style plumbing fixtures of similar quality and function. S does not replace the pipes connecting the fixtures to the building's plumbing system. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount restores the building structure or any building system. The plumbing system, including the plumbing fixtures, is a building system under paragraph (e)(2)(ii)(B)(*2*) of this section. All the toilets together perform a discrete and critical function in the operation of the plumbing system, and all the sinks, together, also perform a discrete and critical function in the operation of the plumbing system. Therefore, under paragraph (k)(6)(ii)(A) of this section, all the toilets comprise a major component of the plumbing system, and all the sinks comprise a major component of the plumbing system. Accordingly, S must treat the amount paid to replace all of the toilets and all of the sinks as a restoration of the building under paragraphs (k)(1)(vi) and (k)(2) of this section and must capitalize the amount paid as an improvement to the building under paragraph (d)(2) of this section.

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

Example 24. Replacement of major component or substantial structural part; plumbing system. (i) T owns and operates a hotel building. T decides that, to attract customers and to remain competitive, it needs to update the guest rooms in its facility. Accordingly, T pays amounts to replace the bathtubs, toilets, and sinks, and to repair, repaint, and retile the bathroom walls and floors, which is necessitated by the installation of the new plumbing components. The replacement bathtubs, toilets, sinks, and tile are new and in a different style, but are similar in function and quality to the replaced items. T also pays amounts to replace certain section 1245 property, such as the guest room furniture, carpeting, drapes, table lamps, and partition walls separating the bathroom area. T completes this work on two floors at a time, closing those floors and leaving the rest of the hotel open for business. In Year 1, T pays amounts to perform the updates for 4 of the 20 hotel room floors and expects to complete the renovation of the remaining rooms over the next two years.

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

Example 25. Not replacement of major component or substantial structural part; windows. U owns a large office building that it uses to provide office space for employees that manage U's operations. The building has 300 exterior windows that represent 25 percent of the total surface area of the building. In Year 1, U pays an amount to replace 100 of the exterior windows that had become damaged. At the time of these replacements, U has no plans to replace any other windows in the near future. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount restores the building structure or any building system. The exterior windows are part of the building structure as defined under paragraph (e)(2)(ii)(A) of this section. The 300 exterior windows perform a discrete and critical function in the operation of the building structure and are, therefore, a major component of the building structure under paragraph (k)(6)(i)(A) of this section. However, the 100 windows do not comprise a significant portion of this major component of the building structure under paragraph (k)(6)(ii)(A) of this section or a substantial structural part of the building structure under paragraph (k)(6)(ii)(B) of this section. Therefore, under paragraph (k)(6) of this section, the replacement of the 100 windows does not constitute the replacement of a major component or substantial structural part of the building, and U is not required to treat the amount paid to replace the 100 windows as restoration of the building under paragraph (k)(1)(iv) of this section.

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

Example 27. Replacement of substantial structural part; windows. Assume the same facts as *Example 25,* except that the building is a modern design and the 300 windows represent 90 percent of the total surface area of the building. U replaces 100 of the 300 windows on the building. The 300 exterior windows perform a discrete and critical function in the operation of the building structure and are, therefore, a major component of the building structure under paragraph (k)(6)(i)(A) of this section. The 100 windows do not comprise a significant portion of this major component of the building structure under paragraph (k)(6)(ii)(A) of this section, however, they do comprise a substantial structural part of the building structure under paragraph (k)(6)(ii)(B) of this section. Therefore, under paragraph (k)(6) of this section, the replacement of the 100 windows comprise the replacement of a substantial structural part of the building structure. Accordingly, U must treat the amount paid to replace the 100 windows as a restoration of the building unit of property under paragraphs (k)(1)(vi) and (k)(2) of this section and must capitalize the amount paid as an improvement to the building under paragraph (d)(2) of this section.

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

Example 29. Replacement of major component or substantial structural part; floors. Assume the same facts as *Example 28,* except that V decides to refresh the appearance of all the public areas of the hotel building by replacing all the floors in the public areas. To that end, V pays an amount to replace all the wood floors in all the public areas of the hotel building with new wood floors. The public areas include the lobby, the hallways, the meeting rooms, the ballrooms, and other public rooms throughout the hotel interiors. The public areas comprise approximately 40 percent of the square footage of the entire hotel building. All the floors in the hotel building comprise a major component of the building structure because they perform a discrete and critical function in the operation of the building structure. The floors in all the public areas of the hotel comprise a significant portion of a major component (that is, all the building floors) of the building structure. Therefore, under paragraph (k)(6)(ii)(A) of this section, the replacement of all the public area floors constitutes the replacement of a major component of the building structure. Accordingly, V must treat the amount paid to replace the public area floors as a restoration of the building unit of property under paragraphs (k)(1)(vi) and (k)(2) of this section and must capitalize the amounts as an improvement to the building under paragraph (d)(2) of this section.

Example 30. Replacement with no disposition. (i) X owns an office building with four elevators serving all floors in the building. X replaces one of the elevators. The elevator is a structural component of the office building. X chooses to apply Prop. Reg. § 1.168(i)–8 to taxable years beginning on or after January 1, 2012, and before the applicability date of the final regulations. In accordance with Prop. Reg. § 1.168(i)–8(c)(4)(ii)(A) (September 19, 2013), the office building (including its structural components) is the asset for tax disposition purposes. X does not treat the structural components of the office building as assets under Prop. Reg. § 1.168(i)–8(c)(4)(iii) (September 19, 2013). X also does not make the partial disposition election provided under Prop. Reg. § 1.168(i)–8(d)(2) (September 19, 2013), for the elevator. Thus, the retirement of the replaced elevator is not a disposition under section 168, and no loss is taken into account for purposes of paragraph (k)(1)(i) of this section.

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

Example 31. Replacement with disposition. The facts are the same as in *Example 30,* except X makes the partial disposition election provided under paragraph Prop. Reg. § 1.168(i)–8(d)(2) (September 19, 2013), for the elevator. Although the office building (including its structural components) is the asset for disposition purposes, the result of X making the partial disposition election for the elevator is that the retirement of the replaced elevator is a disposition. Thus, depreciation for the retired elevator ceases at the time of its retirement (taking into account the applicable convention), and X recognizes a loss upon this retirement. Accordingly, X must treat the amount paid to replace the elevator as a restoration of the building under paragraphs (k)(1)(i) and (k)(2) of this section and must capitalize the amount paid as an improvement to the building under paragraph (d)(2) of this section. In addition, the replacement elevator is treated as a separate asset for tax disposition purposes pursuant to Prop. Reg. § 1.168(i)–8(c)(4)(ii)(D) (September 19, 2013), and for depreciation purposes pursuant to section 168(i)(6).

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

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

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

Example 1. New or different use; change in building use. A is a manufacturer and owns a manufacturing building that it has used for manufacturing since Year 1, when A placed it in service. In Year 30, A pays an amount to convert its manufacturing building into a showroom for its business. To convert the facility, A removes and replaces various structural components to provide a better layout for the showroom and its offices. A also repaints the building interiors as part of the conversion. When building materials are removed and replaced, A uses comparable and commercially available replacement materials. Under paragraphs (l)(2) and (e)(2)(ii) of this section, an amount is paid to improve A's manufacturing building if the amount adapts the building structure or any designated building system to a new or different use. Under paragraph (l)(1) of this section, the amount paid to convert the manufacturing building into a showroom adapts the building structure to a new or different use because the conversion to a showroom is not consistent with A's ordinary use of the building structure at the time it was placed in service. Therefore, A must capitalize the amount paid to convert the building into a showroom as an improvement to the building under paragraphs (d)(3) and (l) of this section.

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

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

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

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

(ii) Under paragraphs (l)(2) and (e)(2)(ii) of this section, an amount is paid to improve E's building if it adapts the building structure or any of the building systems to a new or different use. Under paragraph (l)(1) of this section, the amount paid to convert part of the retail drug store building structure into a medical clinic adapts the building structure to a new and different use, because the use of the building structure to provide clinical medical services is not consistent with E's intended ordinary use of the building structure at the time it was placed in service. Similarly, the amounts paid to add to the plumbing system and the electrical systems to support the new medical services is not consistent with E's intended ordinary use of these systems when the systems were placed in service. Therefore, E must treat the amount paid for the conversion of the building structure, plumbing system, and electrical system as an improvement to the building and capitalize the amount under paragraphs (d)(3) and (l) of this section.

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

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

Example 7. Not a new or different use; part of building. (i) G owns a hospital with various departments dedicated to the provision of clinical medical care. To better accommodate its patients' needs, G decides to modify the emergency room space to provide both emergency care and outpatient surgery. To modify the space, G pays amounts to move interior walls, add additional wiring and outlets, replace floor tiles and doors, and repaint the walls. To complete the outpatient surgery center, G also pays amounts to install miscellaneous medical equipment necessary for the provision of surgical services. Assume the medical equipment is section 1245 property, and G treats the amounts paid for those units of property as costs of acquiring new units of property under § 1.263(a)–2.

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

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

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

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

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

Example 1. Taxpayer subject to regulatory accounting rules of FERC. W is an electric utility company that operates a power plant that generates electricity and that owns and operates network assets to transmit and distribute the electricity to its customers. W is subject to the regulatory accounting rules of FERC, and W uses the regulatory accounting method under paragraph (m) of this section. W does not capitalize on its books and records for regulatory accounting purposes the cost of repairs and maintenance performed on its turbines or its network assets. Under the regulatory accounting method, W may not capitalize for Federal income tax purposes amounts paid for repairs performed on its turbines or its network assets.

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

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

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

(n) *Election to capitalize repair and maintenance costs*—(1) *In general.* A taxpayer may elect to treat amounts paid during the taxable year for repair and maintenance (as defined under § 1.162–4) to tangible property as amounts paid to improve that property under this section and as an asset subject to the allowance for depreciation if the taxpayer incurs these amounts in carrying on the taxpayer's trade or business and if the taxpayer treats these amounts as capital expenditures on its books and records regularly used in computing income (''books and records''). A taxpayer that elects to apply this paragraph (n) in a taxable year must apply this paragraph to all amounts paid for repair and maintenance to tangible property that it treats as capital expenditures on its books and records in that taxable year. Any amounts for which this election is made shall not be treated as amounts paid for repair or maintenance under § 1.162–4.

(2) *Time and manner of election.* A taxpayer makes this election under this paragraph (n) by attaching a statement to the taxpayer's timely filed original Federal tax return (including extensions) for the taxable year in which the taxpayer pays amounts described under paragraph (n)(1) of this paragraph. See §§ 301.9100–1 through 301.9100–3 of this chapter for the provisions governing extensions of time to make regulatory elections. The statement must be titled ''Section 1.263(a)–3(n) Election'' and include the taxpayer's name, address, taxpayer identification number, and a statement that the taxpayer is making the election to capitalize repair and maintenance costs under § 1.263(a)–3(n). In the case of a consolidated group filing a consolidated income tax return, the election is made for each member of the consolidated group by the common parent, and the statement must also include the names and taxpayer identification numbers of each member for which the election is made. In the case of an S corporation or a partnership, the election is made by the S corporation or partnership and not by the shareholders or partners. A taxpayer making this election for a taxable year must treat any amounts paid for repairs and maintenance during the taxable year that are capitalized on the taxpayer's books and records as improvements to tangible property. The taxpayer must begin to depreciate the cost of such improvements amounts when they are placed in service by the taxpayer under the applicable provisions of the Code and regulations. An election may not be made through the filing of an application for change in accounting method or, before obtaining the Commissioner's consent to make a late election, by filing an amended Federal tax return. The time and manner of electing to capitalize repair and maintenance costs under this paragraph (n) may be modified through guidance of general applicability (see §§ 601.601(d)(2) and 601.602 of this chapter).

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

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

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

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

Example 2. No election to capitalize routine maintenance. Assume the same facts as *Example 1,* except in Year 8, Q pays amounts to perform scheduled maintenance for a second time on the towboat engines. On its books and records, Q treats the amounts paid for this scheduled maintenance as capital expenditures. However, in Year 8, Q decides not to make the election to capitalize the amounts paid for scheduled maintenance under paragraph (n) of this section. Because Q does not make the election under paragraph (n) for Year 8, Q may apply the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section to the amounts paid in Year 8, and not treat these amounts as capital expenditures. Because the election is made for each taxable year, there is no effect on the scheduled maintenance costs capitalized by Q on its Federal tax return for Year 4.

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

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

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

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

(q) *Accounting method changes.* Except as otherwise provided in this section, a change to comply with this section is a change in method of accounting to which the provisions of sections 446 and 481 and the accompanying regulations apply. A taxpayer seeking to change to a method of accounting permitted in this section must secure the consent of the Commissioner in accordance with § 1.446–1(e) and follow the administrative procedures issued under § 1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to change its accounting method.

(r) *Effective/applicability date*—(1) *In general.* Except for paragraphs (h), (m), and (n) of this section, this section applies to taxable years beginning on or after January 1, 2014. Paragraphs (h), (m), and (n) of this section apply to amounts paid in taxable years beginning on or after January 1, 2014. Except as provided in paragraphs (r)(2) and (r)(3) of this section, § 1.263(a)–3 as contained in 26 CFR part 1 edition revised as of

April 1, 2011, applies to taxable years beginning before January 1, 2014.

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

(ii) *Transition rule for certain elections on 2012 or 2013 returns.* If under paragraph (r)(2)(i) of this section, a taxpayer chooses to make the election to apply the safe harbor for small taxpayers under paragraph (h) of this section or the election to capitalize repair and maintenance costs under paragraph (n) of this section for amounts paid in its taxable year beginning on or after January 1, 2012, and ending on or before September 19, 2013 (applicable taxable year), and the taxpayer did not make the election specified in paragraph (h)(6) or paragraph (n)(2) of this section on its timely filed original Federal tax return for the applicable taxable year, the taxpayer must make the election specified in paragraph (h)(6) or paragraph (n)(2) of this section for the applicable taxable year by filing an amended Federal tax return (including the required statements) for the applicable taxable year on or before 180 days from the due date including extensions of the taxpayer's Federal tax return for the applicable taxable year, notwithstanding that the taxpayer may not have extended the due date.

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

§ 1.263(a)–3T [Removed]

■ **Par. 25.** Section 1.263(a)–3T is removed.

■ **Par. 26.** Section 1.263(a)–6 is added to read as follows:

§ 1.263(a)–6 Election to deduct or capitalize certain expenditures.

(a) *In general.* Under certain provisions of the Internal Revenue Code (Code), taxpayers may elect to treat capital expenditures as deductible expenses or as deferred expenses, or to treat deductible expenses as capital expenditures.

(b) *Election provisions.* The sections referred to in paragraph (a) of this section include:

(1) Section 173 (circulation expenditures);

(2) Section 174 (research and experimental expenditures);

(3) Section 175 (soil and water conservation expenditures; endangered species recovery expenditures);

(4) Section 179 (election to expense certain depreciable business assets);

(5) Section 179A (deduction for clean-fuel vehicles and certain refueling property);

(6) Section 179B (deduction for capital costs incurred in complying with environmental protection agency sulfur regulations);

(7) Section 179C (election to expense certain refineries);

(8) Section 179D (energy efficient commercial buildings deduction);

(9) Section 179E (election to expense advanced mine safety equipment);

(10) Section 180 (expenditures by farmers for fertilizer);

(11) Section 181 (treatment of certain qualified film and television productions);

(12) Section 190 (expenditures to remove architectural and transportation barriers to the handicapped and elderly);

(13) Section 193 (tertiary injectants);

(14) Section 194 (treatment of reforestation expenditures);

(15) Section 195 (start-up expenditures);

(16) Section 198 (expensing of environmental remediation costs);

(17) Section 198A (expensing of qualified disaster expenses);

(18) Section 248 (organization expenditures of a corporation);

(19) Section 266 (carrying charges);

(20) Section 616 (development expenditures); and

(21) Section 709 (organization and syndication fees of a partnership).

(c) *Effective/applicability date*—(1) *In general.* This section applies to taxable years beginning on or after January 1, 2014. Except as provided in paragraphs (c)(2) and (c)(3) of this section, § 1.263(a)–3 as contained in 26 CFR part 1 edition revised as of April 1, 2011, applies to taxable years beginning before January 1, 2014. For the effective dates of the enumerated election provisions, see those Code sections and the regulations under those sections.

(2) *Early application of this section.* A taxpayer may choose to apply this section to taxable years beginning on or after January 1, 2012.

(3) *Optional application of TD 9564.* A taxpayer may choose to apply § 1.263(a)–6T as contained in TD 9564 (76 FR 81060) December 27, 2011, to taxable years beginning on or after January 1, 2012, and before January 1, 2014.

§ 1.263(a)–6T [Removed]

■ **Par. 27.** Section 1.263(a)–6T is removed.

■ **Par. 28.** Section 1.263A–0 is amended by adding new entries in the outline for § 1.263A–1(k) and (l) to read as follows:

§ 1.263A–0 Outline of the Regulations under Section 263A.

* * * * *

§ 1.263A–1 Uniform Capitalization of Costs.

* * * * *

(k) Change in method of accounting.
(1) In general.
(2) Scope limitations.
(3) Audit protection.
(4) Section 481(a) adjustment.
(5) Time for requesting change.
(l) Effective/applicability date.
(1) In general.
(2) Mixed service costs; self-constructed tangible personal property produced on a routine and repetitive basis.
(3) Materials and supplies.
(i) In general
(ii) Early application of this section.
(iii) Optional application of TD 9564.

* * * * *

■ **Par. 29.** Section 1.263A–1 is amended by:

■ 1. Removing paragraphs (b)(14) and (m).

■ 2. Revising paragraphs (c)(4), (e)(2)(i)(A), (e)(3)(ii)(E) and (l).

The revisions read as follows:

§ 1.263A–1 Uniform capitalization of costs.

* * * * *

(c) * * *

(4) *Recovery of capitalized costs.* Costs that are capitalized under section 263A are recovered through depreciation, amortization, cost of goods sold, or by an adjustment to basis at the time the property is used, sold, placed in service, or otherwise disposed of by the taxpayer. Cost recovery is determined by the applicable Internal Revenue Code and regulation provisions relating to use, sale, or disposition of property.

* * * * *

(e) * * *

(2) * * *

(i) * * *

(A) *Direct material costs. Direct materials costs* include the cost of those materials that become an integral part of specific property produced and those materials that are consumed in the ordinary course of production and that can be identified or associated with particular units or groups of units of property produced. For example, a cost described in § 1.162–3, relating to the cost of a material or supply, may be a direct material cost.

* * * * *

(3) * * *

(ii) * * *

(E) *Indirect material costs. Indirect material costs* include the cost of materials that are not an integral part of specific property produced and the cost of materials that are consumed in the ordinary course of performing production or resale activities that cannot be identified or associated with particular units of property. Thus, for example, a cost described in § 1.162–3, relating to the cost of a material or supply, may be an indirect cost.

* * * * *

(l) *Effective/applicability dates*—(1) *In general.* Except as provided in paragraphs (l)(2) and (l)(3) of this section, the effective dates for this section are provided in paragraph (a)(2) of this section.

(2) *Mixed service costs; self-constructed tangible personal property produced on a routine and repetitive basis.* Paragraphs (h)(2)(i)(D), (k), and (l)(2) of this section apply for taxable years ending on or after August 2, 2005.

(3) *Materials and supplies*—(i) *In general.* The last sentence of paragraphs (e)(2)(i)(A) and (e)(2)(ii)(E) of this section, and paragraph (l)(3) of this section apply to amounts paid (to acquire or produce property) in taxable years beginning on or after January 1, 2014. Except as provided in paragraph (l)(3)(ii) or paragraph (l)(3)(iii) of this section, section 1.263A–1 as contained in 26 CFR part 1 edition revised as of April 1, 2011, applies to taxable years beginning before January 1, 2014.

(ii) *Early application of this section.* A taxpayer may choose to apply the last sentence of paragraphs (e)(2)(i)(A) and (e)(2)(ii)(E) of this section, and paragraph (l)(3) of this section to amounts paid (to acquire or produce property) in taxable years beginning on or after January 1, 2012.

(iii) *Optional application of TD 9564.* A taxpayer may choose to apply § 1.263A–1T(b)(14), the introductory phrase of § 1.263A–1T(c)(4), the last sentence of § 1.263A–1T(e)(2)(i)(A), the last sentence of § 1.263A–1T(e)(2)(ii)(E), § 1.263A–1T(l), and § 1.263A–1T(m)(2), as these provisions are contained in TD 9564 (76 FR 81060) December 27, 2011, to amounts paid (to acquire or produce property) in taxable years beginning on or after January 1, 2012, and before January 1, 2014.

§ 1.263A–1T [Removed]

■ **Par. 30.** Section 1.263A–1T is removed.

■ **Par. 31.** Section 1.1016–3 is amended by revising paragraphs (a)(1)(ii), (j)(1), and (j)(3) to read as follows:

§ 1.1016–3 Exhaustion, wear and tear, obsolescence, amortization, and depletion for periods since February 13, 1913.

(a) * * *

(1) * * *

(ii) The determination of the amount properly allowable for exhaustion, wear and tear, obsolescence, amortization, and depletion must be made on the basis of facts reasonably known to exist at the end of the taxable year. A taxpayer is not permitted to take advantage in a later year of the taxpayer's prior failure to take any such allowance or the taxpayer's taking an allowance plainly inadequate under the known facts in prior years. In the case of depreciation, if in prior years the taxpayer has consistently taken proper deductions under one method, the amount allowable for such prior years may not be increased, even though a greater amount would have been allowable under another proper method. For rules governing losses on retirement or disposition of depreciable property, including rules for determining basis, see § 1.167(a)–8, § 1.168(i)–1T(e), § 1.168(i)–8T, Prop. Reg. § 1.168(i)–1(e) (September 19, 2013), or Prop. Reg. § 1.168(i)–8 (September 19, 2013), as applicable. The application of this paragraph is illustrated by the following example (for purposes of this example, assume section 167(f)(1) as in effect on September 19, 2013, applies to taxable years beginning on or after January 1, 2014):

Example. On July 1, 2014, A, a calendar-year taxpayer, purchased and placed in service ''off-the-shelf'' computer software at a cost of $36,000. This computer software is not an amortizable section 197 intangible. Pursuant to section 167(f)(1), the useful life of the computer software is 36 months. It has no salvage value. Computer software placed in service in 2014 is not eligible for the additional first year depreciation deduction provided by section 168(k). A did not deduct any depreciation for the computer software for 2014 and deducted depreciation of $12,000 for the computer software for 2015. As a result, the total amount of depreciation allowed for the computer software as of December 31, 2015, was $12,000. However, the total amount of depreciation allowable for the computer software as of December 31, 2015, is $18,000 ($6,000 for 2014 + $12,000 for 2015). As a result, the unrecovered cost of the computer software as of December 31, 2015, is $18,000 (cost of $36,000 less the depreciation allowable of $18,000 as of December 31, 2015). Accordingly, depreciation for 2016 for the computer software is $12,000 (unrecovered cost of $18,000 divided by the remaining useful life of 18 months as of January 1, 2016, multiplied by 12 full months in 2016).

* * * * *

(j) *Effective/applicability dates*—(1) *In general.* Except as provided in paragraphs (j)(2) and (j)(3) of this section, this section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see § 1.1016–3 in effect prior to December 30, 2003 (§ 1.1016–3 as contained in 26 CFR part 1 edition revised as of April 1, 2003).

* * * * *

(3) *Application of § 1.1016–3T(a)(1)(ii)*—(i) *In general.* Paragraph (a)(1)(ii) of this section applies to taxable years beginning on or after January 1, 2014. Except as provided in paragraphs (j)(3)(ii) and (j)(3)(iii) of this section, § 1.1016–3(a)(1)(ii) as contained in 26 CFR part 1 edition revised as of April 1, 2011, applies to taxable years beginning before January 1, 2014.

(ii) *Early application of § 1.1016–3(a)(1)(ii).* A taxpayer may choose to apply paragraph (a)(1)(ii) of this section to taxable years beginning on or after January 1, 2012.

(iii) *Optional application of TD 9564.* A taxpayer may choose to apply § 1.1016–3T(a)(1)(ii) as contained in TD 9564 (76 FR 81060) December 27, 2011, to taxable years beginning on or after January 1, 2012, and before January 1, 2014.

§ 1.1016–3T [Removed]

■ **Par. 32.** Section 1.1016–3T is removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

■ **Par. 33.** The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

■ **Par. 34.** In § 602.101, paragraph (b) is amended by adding the following entries to the table in numerical order to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where Identified and described	Current OMB control No.
* * *	* *
1.263(a)–1	1545–2248
1.263(a)–3	1545–2248
* * *	* *

Beth Tucker,

Deputy Commissioner for Operations Support.

Approved: August 15, 2013.

Mark J. Mazur,

Assistant Secretary of the Treasury (Tax Policy).

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