DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–168745–03]

RIN 1545–BE18

Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that explain how section 263(a) of the Internal Revenue Code (Code) applies to amounts paid to acquire, produce, or improve tangible property. The proposed regulations clarify and expand the standards in the current regulations under section 263(a), as well as provide some bright-line tests (for example, a 12-month rule for acquisitions and a repair allowance for improvements). The proposed regulations will affect all taxpayers that acquire, produce, or improve tangible property. This document also provides a notice of public hearing on the proposed regulations.

DATES: Written or electronic comments must be received by November 20, 2006. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for Tuesday, December 19, 2006, at 10 a.m., must be received by November 28, 2006.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–168745–03), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Alternatively, comments may be sent electronically, via the IRS Internet site at *http://www.irs.gov/regs* or via the Federal eRulemaking Portal at *http://www.regulations.gov* (IRS–REG–168745–03). The public hearing will be held in the auditorium of the New Carrollton Federal Building, 5000 Ellin Road, Lanham, MD 20706 at 10 a.m.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Kimberly L. Koch, (202) 622–7739; concerning submission of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Richard A. Hurst at *Richard.A.Hurst@irscounsel.treas.gov* or at (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

In recent years, much debate has focused on the extent to which section 263(a) of the Code requires taxpayers to capitalize as an improvement amounts paid to restore property to its former working condition; that is, whether, or the extent to which, the amounts paid to restore or improve the property are capital expenditures or deductible ordinary and necessary repair and maintenance expenses. There has been controversy, for example, regarding what tests to apply for determining capitalization or expensing, how to apply the tests, and the appropriate unit of property with respect to which to apply the tests. On January 20, 2004, the IRS and Treasury Department published Notice 2004–6 (2004–3 I.R.B. 308), announcing an intention to propose regulations providing guidance in this area. The notice identified issues under consideration by the IRS and Treasury Department and invited public comment on whether these or other issues should be addressed in the regulations and, if so, what specific rules and principles should be provided. To respond to various comments and provide a more comprehensive set of rules regarding tangible property, the proposed regulations include the treatment of amounts paid to acquire or produce tangible property.

Explanation of Provisions

I. Introduction

The proposed regulations under section 263(a) of the Code set forth the general statutory principles of capitalization and provide that capital expenditures generally include amounts paid to sell, acquire, produce, or improve tangible property. The proposed regulations, if promulgated as final regulations, would replace current §§ 1.263(a)–1, 1.263(a)–2, and 1.263(a)–3 of the Income Tax Regulations. The treatment of amounts paid to acquire or create intangibles was addressed with the publication of §§ 1.263(a)–4 and 1.263(a)–5 in the **Federal Register** on January 5, 2004 (TD 9107; 69 FR 436).

Certain sections of the current regulations under section 263(a) are proposed to be removed entirely and are not restated in the proposed regulations. Section 1.263(a)–1(c) of the current regulations lists several Code and regulation sections to which the capitalization provisions do not apply. Section 1.263(a)–3 (election to deduct or capitalize certain expenditures) lists several Code sections under which a taxpayer may elect to treat certain capital expenditures as either deductible or deferred expenses, or to treat deductible expenses as capital expenditures. These two sections have not been carried over to the proposed regulations because the lists of items in these sections are outdated. This language is intended to have the same general effect as current §§ 1.263(a)–1(c) and 1.263(a)–3, without citing to specific Code and regulation sections that may have been repealed and without omitting specific Code and regulation sections that may have been added.

Certain portions of § 1.263(a)–2 of the current regulations (examples of capital expenditures) also are not restated in the proposed regulations, or are incorporated into other sections of the proposed regulations. Section 1.263(a)–2(a) of the current regulations (the cost of acquisition of property with a useful life substantially beyond the taxable year) is incorporated into and expanded upon in § 1.263(a)–2 of the proposed regulations (amounts paid to acquire or produce tangible property). Section 1.263(a)–2(b) of the current regulations (amounts expended for securing a copyright and plates) is proposed to be removed because these amounts are now addressed by § 1.263(a)–4(d)(5) and section 263A. The rules in § 1.263(a)–2(c) of the current regulations (the cost of defending or perfecting title to property) are addressed in § 1.263(a)–4(d)(9) of the current regulations with regard to intangibles and in § 1.263(a)–2(d)(2) of the proposed regulations with regard to tangible property. Section 1.263(a)–2(d) of the current regulations (amounts expended for architect's services) is proposed to be removed because those amounts are now included in section 263A. The rules in § 1.263(a)–2(f) and (g) of the current regulations (relating to certain capital contributions) essentially are restated in § 1.263(a)–1(b) of the proposed regulations. Finally, § 1.263(a)–2(h) of the current regulations (the cost of goodwill in connection with the acquisition of the assets of a going concern) is proposed to be removed because this cost is now addressed by § 1.263(a)–4(c)(1)(x).

Taking into account the provisions that are proposed to be removed and other modifications to the current regulations noted above, the remaining guidance in the current regulations is contained in § 1.263(a)–1(a) and (b) of the proposed regulations. Section 1.263(a)–01(a) of the current regulations restates the statutory rules from section 263(a), which are carried over in § 1.263(a)–1(a) of the proposed regulations. The rules in § 1.263(a)–1(b) of the current regulations address amounts paid to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, and amounts paid to adapt property to a new or different use. They also address the treatment of those capitalized expenditures, for example, as a charge to capital account or basis. These rules are incorporated into and expanded upon in § 1.263(a)–3 of the proposed regulations. The proposed regulations also revise § 1.162–4 of the current regulations (allowing a deduction for the cost of incidental repairs) to provide rules consistent with § 1.263(a)–3 of the proposed regulations (requiring capitalization of amounts paid to improve property).

The proposed regulations do not address amounts paid to acquire or create intangible interests in land, such as easements, life estates, mineral interests, timber rights, zoning variances, or other intangible interests in land. The IRS and Treasury Department request comments on whether these and similar amounts, or certain of these amounts, should be addressed in the final regulations and, if so, what rules should be provided. The proposed regulations also do not address the treatment of software development costs.

II. General Principle of Capitalization

A. Overview

The proposed regulations require capitalization of amounts paid to acquire, produce, or improve tangible real and personal property, including amounts paid to facilitate the acquisition of tangible property. The proposed regulations do not address amounts paid to facilitate an acquisition of a trade or business because those amounts are addressed in § 1.263(a)–5 of the current regulations.

The proposed regulations clarify that they do not change the treatment of any amount that is specifically provided for under any provision of the Code or regulations other than section 162(a) or section 212 and the regulations under those sections. This rule applies regardless of whether that specific provision is more or less favorable to the taxpayer than the treatment in the proposed regulations. Thus, where another section of the Code or regulations prescribes a specific treatment of an amount, the provisions of that section apply and not the rules contained in the proposed regulations. This rule is the same as that contained in §§ 1.263(a)–4(b)(4) and 1.263(a)–5(j) of the current regulations. The proposed regulations, for example, do not preclude taxpayers from deducting the cost of certain depreciable business assets under section 179. On the other hand, the proposed regulations do not exempt taxpayers from applying the uniform capitalization rules under section 263A when applicable, nor do they exempt taxpayers from complying with the timing rules regarding incurring a liability under section 461 (including economic performance).

The rule clarifying that the proposed regulations do not change the treatment of any other amount that is specifically provided for under any other provision of the Code or regulations provides an exception for the treatment of any amount that is specifically provided for under section 162(a) or section 212 or the regulations under those sections. Thus, the proposed regulations override any conflicting provisions in the regulations under sections 162(a) and 212. For this reason, the proposed regulations amend the current rule for deductible repairs under § 1.162–4 to provide 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 of the proposed regulations. The proposed regulations, however, do not amend or remove any other provisions of the current regulations under section 162(a), including §§ 1.162–6 (regarding professional expenses) and 1.162–12 (regarding certain expenses of farmers). Section 1.162–6 permits a deduction for amounts paid for books, furniture, and professional instruments and equipment, the useful life of which is short, while § 1.162–12 permits a deduction for the cost of ordinary tools of short life or small cost. The rules in current §§ 1.162–6 and 1.162–12 are consistent with the rules in the proposed regulations and are not revised.

B. Amounts Paid To Sell Property

The proposed regulations provide that, except in the case of dealers in property, commissions and other transaction costs paid to facilitate the sale of property generally must be capitalized and treated as a reduction in the amount realized. Dealers in property include taxpayers that maintain and sell inventories and taxpayers that produce property for sale in the ordinary course of business, for example, the home construction business. The language in this section is slightly broader than the current language of § 1.263(a)–2(e), which refers only to commissions paid in selling securities. However, the language in the proposed regulations is consistent with case law that generally treats all transaction costs paid in connection with the sale of any property as capitalized and offset against the amount realized. See, *Wilson* v. *Commissioner*, 49 T.C. 406, 414 (1968); rev'd on other grounds, 412 F.2d 314 (6th Cir. 1969) (''The rule is thoroughly engrained that commissions and similar charges must be treated as capital expenditures which reduce the selling price when gain or loss is computed on the transaction''); *Frick* v. *Commissioner*, T.C. Memo 1983–733, aff'd without opinion, 774 F.2d 1168 (7th Cir. 1985) (''Fees paid in connection with the disposition of real property are capital expenditures and are deductible from the selling price in determining gain or loss on the ultimate disposition''); *Hindes* v. *United States*, 246 F. Supp. 147, 150 (W.D. Tex. 1965); affd. in part, revd. in part on other grounds, 371 F.2d 650 (5th Cir. 1967) (''Fees and expenses paid in connection with the acquisition or disposition of property, real or personal, are capital expenditures, and, in the case of a taxpayer not engaged in the business of buying and selling real estate, are deductible from the selling price in determining gain or loss on the ultimate disposition''). The sales cost rule in the proposed regulations, however, applies only to transaction costs and does not include other amounts that might be paid for the purpose of selling property, such as amounts paid to repair or improve the property in preparation for a sale. The treatment of those amounts is governed by the general rules under § 1.263(a)–3 of the proposed regulations relating to improvements.

III. Amounts Paid To Acquire or Produce Tangible Property

A. In General

The current regulations under section 263(a) require capitalization of amounts paid for the acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year. See § 1.263(a)–2(a) of the current regulations. The proposed regulations are consistent with this rule, but treat amounts paid to construct or erect property as production costs. Specifically, the proposed regulations require capitalization of amounts paid for property having a useful life substantially beyond the taxable year, including land and land improvements, buildings, machinery and equipment, and furniture and fixtures, and a unit of property (as determined under § 1.263(a)–3(d)(2)), having a useful life substantially beyond the taxable year. See § 1.263(a)–2(d) of the proposed regulations. Thus, § 1.263(a)–2 of the proposed regulations requires capitalization of amounts paid for property that is not itself a unit of property, such as property (not treated as a material or supply under § 1.162–3) that is intended to be used as a component in the repair or improvement of a unit of property. Additionally, the current regulations at § 1.263(a)–1(b) list inventory costs as capital expenditures under § 1.263(a)–1(a). Therefore, § 1.263(a)–2 of the proposed regulations also requires capitalization of amounts paid to acquire real or personal property for resale and to produce real or personal property for sale.

The proposed regulations provide that the terms *amounts paid* and *payment* mean, in the case of a taxpayer using an accrual method of accounting, a liability incurred (within the meaning of § 1.446–1(c)(1)(ii)). The definitions of real and tangible personal property are intended to be the same as the definitions used for depreciation purposes as derived from the language in the regulations at § 1.48–1. Thus, for purposes of the proposed regulations, tangible personal property means any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items that are structural components of buildings or structures). See, *Whiteco Indus., Inc.* v. *Commissioner*, 65 T.C. 664 (1975) (applying six factors in determining whether property is an inherently permanent structure). Under the proposed regulations, the definitions of building and structural components are the definitions provided in § 1.48–1(e). The IRS and Treasury Department considered other definitions of real and tangible personal property, including the definitions in the regulations under section 263A(f), but believe that the definitions used for depreciation purposes are the definitions most consistent with the purposes of the proposed regulations.

The definition of produce in § 1.263(a)–2(b)(4) of the proposed regulations is intended to be the same as the definition used for purposes of section 263A(g)(1) and § 1.263A–2(a)(1)(i), except that improvements are separately defined in § 1.263(a)–3 of the proposed regulations. The costs that are required to be capitalized to property produced or to any improvement are the costs that must be capitalized under section 263A. Thus, for example, all direct materials and direct labor, and all indirect costs that directly benefit or are incurred by reason of production/improvement activities are required to be capitalized to the property being produced or improved.

The proposed regulations require taxpayers to capitalize an amount paid to defend or perfect title to tangible property. This rule is consistent with the current regulations at § 1.263(a)–2(c) and parallels the rule in § 1.263(a)–4(d)(9) with regard to intangible property. The proposed regulations also require capitalization of amounts paid to facilitate the acquisition of real or personal property. The IRS and Treasury Department request comments on whether any specific guidance is needed with regard to employee compensation and overhead costs that facilitate the acquisition of tangible property and, if so, what that guidance should provide. The proposed regulations do not address transaction costs related to the production or improvement of tangible property because those costs are subject to capitalization under section 263A.

B. Materials and Supplies

As noted in section II.A. above, the proposed regulations generally do not change the treatment of any amount that is specifically provided for under any provision of the Code or regulations other than section 162(a) or section 212 and the regulations under those sections. However, with regard to section 162(a), the proposed regulations provide an exception for amounts paid for materials and supplies that are properly treated as deductions or deferred expenses, as appropriate, under § 1.162–3. Thus, the proposed regulations do not change the treatment of materials and supplies under § 1.162–3, including property that is treated as a material and supply that is not incidental under Rev. Proc. 2002–28 (2002–1 C.B. 815) (regarding the use of the cash method by certain qualifying small business taxpayers), Rev. Proc. 2002–12 (2002–1 C.B. 374) (regarding smallwares), and Rev. Proc. 2001–10 (2001–1 C.B 272) (regarding inventory of certain qualifying taxpayers).

C. 12-Month Rule

The current regulations under sections 263(a), 446, and 461 require taxpayers to capitalize amounts paid to acquire property having a useful life substantially beyond the taxable year. See §§ 1.263(a)–2(a), 1.446–1(c)(1)(ii), and 1.461–1(a)(2)(i) of the current regulations. Section 1.263(a)–2(d) of the proposed regulations retains this general rule. Some courts have adopted a 12-month rule for determining whether property has a useful life substantially beyond the taxable year. See *Mennuto* v. *Commissioner*, 56 T.C. 910 (1971), acq. (1973–2 C.B. 2); *Zelco, Inc.* v. *Commissioner*, 331 F.2d 418 (1st Cir. 1964); *International Shoe Co.* v. *Commissioner*, 38 B.T.A. 81 (1938). Under the 12-month rule adopted by some courts, a taxpayer may deduct currently an amount paid for a benefit or paid for property having a useful life that does not extend beyond one year. This rule was adopted in the regulations relating to intangibles. See § 1.263(a)–4(f). The proposed regulations provide a similar 12-month rule for amounts paid to acquire or produce certain tangible property.

The proposed regulations generally provide that an amount (including transaction costs) paid for the acquisition or production of a unit of property with an economic useful life of 12 months or less is not a capital expenditure. The unit of property and economic useful life determinations are made under the rules described in § 1.263(a)–3 for improved property. The 12-month rule generally applies unless the taxpayer elects not to apply the 12-month rule, which election may be made with regard to each unit of property that the taxpayer acquires or produces. An election not to apply the 12-month rule may not be revoked. Taxpayers that have elected to use the original tire capitalization method of accounting for the cost of certain tires under Rev. Proc. 2002–27 (2002–1 C.B. 802), must use that method for the original and replacement tires of all their qualifying vehicles. See section 5.01 of Rev. Proc. 2002–27. Therefore, taxpayers that use that method cannot use the 12-month rule provided under the proposed regulations to deduct amounts paid to acquire original or replacement tires.

The proposed regulations clarify the interaction of the 12-month rule with the timing rules contained in section 461 of the Code. Nothing in the proposed regulations is intended to change the application of section 461, including the application of the economic performance rules in section 461(h). This coordination rule is the same as that provided in the regulations under section 263(a) relating to intangibles. See § 1.263(a)–4(f). In the case of a taxpayer using an accrual method of accounting, section 461 requires that an item be incurred before it is taken into account through capitalization or deduction. For example, under § 1.461–1(a)(2), a liability generally is not incurred until the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Thus, the 12-month rule provided by the proposed regulations does not permit an accrual method taxpayer to deduct an amount paid for tangible property if the amount has not been incurred under section 461 (for example, if the taxpayer does not have a fixed liability to acquire the property). The proposed regulations contain examples illustrating the interaction of the 12-month rule with section 461.

The proposed regulations provide that, upon a sale or other disposition, property to which a taxpayer applies the 12-month rule is not treated as a capital asset under section 1221 or as property used in the trade or business under section 1231. Thus, 12-month property is not of a character subject to depreciation and any amount realized upon disposition of 12-month property is ordinary income to the taxpayer.

The IRS and Treasury Department do not believe that it is appropriate to apply the 12-month rule to certain types of property. Thus, the proposed regulations provide that the 12-month rule does not apply to property that is or will be included in property produced for sale or property acquired for resale, improvements to a unit of property, land, or a component of a unit of property.

D. De Minimis Rule

In Notice 2004–6, the IRS and Treasury Department requested comments on whether the regulations should provide a *de minimis* rule. Because the notice refers to the application of section 263(a) to amounts paid to repair, improve, or rehabilitate tangible property, most commentators focused on a *de minimis* rule for the cost of repairs rather than the cost to acquire property. However, one commentator requested that the regulations specifically provide a *de minimis* rule for acquisition costs, but allow taxpayers to continue to use their current method if they have reached a working agreement with their IRS examining agent regarding a *de minimis* rule.

The IRS and Treasury Department recognize that for regulatory or financial accounting purposes, taxpayers often have a policy for deducting an amount paid below a certain dollar threshold for the acquisition of tangible property (*de minimis* rule). For Federal income tax purposes, the taxpayer generally would be required to capitalize the amount paid if the property has a useful life substantially beyond the taxable year. However, in this context some courts have permitted the use of a *de minimis* rule for Federal income tax purposes. See *Union Pacific R.R. Co.* v. *United States*, 524 F.2d 1343 (Ct. Cl. 1975) (permitting the use of the taxpayer's $500 *de minimis* rule, which was in accordance with the Interstate Commerce Commission (ICC) minimum rule and generally accepted accounting principles); *Cincinnati, N.O. & Tex. Pac. Ry.* v. *United States*, 424 F.2d 563 (Ct. Cl. 1970) (same). But see *Alacare Home Health Services, Inc.* v. *Commissioner*, T.C. Memo 2001–149 (disallowing the taxpayer's use of a $500 *de minimis* rule because it distorted income).

The proposed regulations do not include a *de minimis* rule for acquisition costs. However, the IRS and Treasury Department recognize that taxpayers often reach an agreement with IRS examining agents that, as an administrative matter, based on risk analysis and/or materiality, the IRS examining agents do not select certain items for review such as the acquisition of tangible assets with a small cost. This often is referred to by taxpayers and IRS examining agents as a *de minimis* rule. The absence of a *de minimis* rule in the proposed regulations is not intended to change this practice.

The IRS and Treasury Department considered including a *de minimis* rule in the proposed regulations. The *de minimis* rule considered would have provided that taxpayers are not required to capitalize certain *de minimis* amounts paid for the acquisition or production of a unit of property. Under the rule considered, if a taxpayer had written accounting procedures in place treating as an expense on its applicable financial statement (AFS) amounts paid for property costing less than a certain dollar amount, and treated the amounts paid during the taxable year as an expense on its AFS in accordance with those written accounting procedures, the taxpayer would not have been required to capitalize those amounts if they did not exceed a certain dollar threshold. A taxpayer that did not meet these criteria (for example, a taxpayer that did not have an AFS) would not have been required to capitalize amounts paid for a unit of property that did not exceed the established dollar threshold. Because taxpayers without an AFS generally are smaller than taxpayers with an AFS, the dollar threshold for the *de minimis* rule that would have applied to them would have been lower than the threshold for taxpayers with an AFS (although the *de minimis* rule for taxpayers with an AFS also would have been limited to the amount treated as an expense on their AFS). The *de minimis* rule considered by the IRS and Treasury Department would not have applied to inventory property, improvements, land, or a component of a unit of property.

The *de minimis* rule considered also would have provided that property to which a taxpayer applies the *de minimis* rule is treated upon sale or disposition similar to section 179 property. Thus, *de minimis* property would have been property of a character subject to depreciation and amounts paid that were not capitalized under the *de minimis* rule would have been treated as amortization subject to recapture under section 1245. Thus, gain on disposition of the property would have been ordinary income to the taxpayer to the extent of the amount treated as amortization for purposes of section 1245.

The IRS and Treasury Department decided to not include a *de minimis* rule in the proposed regulations but instead to request comments on whether such a rule should be included in the final regulations or whether to continue to rely on the current administrative practice of IRS examining agents. Therefore, the IRS and Treasury Department request comments on whether a *de minimis* rule for acquisition costs should be included in the final regulations, and, if so, whether the *de minimis* rule should be the rule described above and what dollar thresholds are appropriate.

The IRS and Treasury Department also request comments on the scope of costs that should be included in a *de minimis* rule if one is provided in the final regulations and on the character of *de minimis* rule property. For example, the *de minimis* rule considered by the IRS and Treasury Department would have applied to the aggregate of amounts paid for the acquisition or production (including any amounts paid to facilitate the acquisition or production) of a unit of property and including amounts paid for improvements prior to the unit of property being placed in service. If a *de minimis* rule should be provided in the final regulations, the IRS and Treasury Department request comments on what, if any, type of rule should be provided to prevent a distortion of income when taxpayers acquire a large number of assets, each of which individually is within the *de minimis* rule (for example, the purchase by a taxpayer of 2,000 personal computers).

If a *de minimis* rule for acquisition costs should be provided in the final regulations, the IRS and Treasury Department request comments on whether the rule should permit IRS examining agents and taxpayers to agree to the use of higher *de minimis* thresholds on the basis of materiality and risk analysis and, if so, under what circumstances a higher threshold should be allowed. The IRS and Treasury Department also request comments on whether, if a *de minimis* rule should be provided in the final regulations, changes to begin using a *de minimis* rule or changes to a higher dollar amount within a *de minimis* rule should be treated as changes in a method of accounting.

E. Recovery of Costs When Property Is Used in a Repair

As noted in section III.A. of this preamble, § 1.263(a)–2 of the proposed regulations generally requires capitalization of amounts paid for the acquisition or production of property having a useful life substantially beyond the taxable year. Thus, § 1.263(a)–2(d) of the proposed regulations applies to property that is not itself a unit of property, such as property (not treated as a material or supply under § 1.162–3) that is intended to be used as a component in the repair or improvement of a unit of property. It must be determined whether the subsequent use of the component property results in an improvement to the unit of property under § 1.263(a)–3 or an otherwise deductible repair or maintenance cost under § 1.162–4. Even if the subsequent use of the component is an otherwise deductible expense under § 1.162–4, the amount paid nonetheless may be required to be capitalized. For example, it must be determined whether the amount paid for the component property is required to be capitalized under section 263A as an indirect cost that directly benefits or is incurred by reason of property produced or acquired for resale. The proposed regulations illustrate this concept in an example of a manufacturer that replaces one window in a building. The taxpayer initially must capitalize under § 1.263(a)–2(d) amounts paid to acquire the window. The replacement of the window subsequently is determined to be a repair to the building rather than an improvement. Amounts paid for the repair (or an allocable portion thereof) must then be capitalized under section 263A to the inventory that the taxpayer produces to the extent that the repair directly benefits or is incurred by reason of the taxpayer's production activities.

IV. Amounts Paid To Improve Tangible Property

A. In General

In response to Notice 2004–6, the IRS and Treasury Department received several comments on the issues that should be addressed in the proposed regulations to provide guidance on amounts paid to repair, improve, and rehabilitate tangible property. These comments have been taken into account in drafting § 1.263(a)–3 of the proposed regulations. That section addresses amounts paid to improve tangible property and includes the following provisions: (1) Rules for determining the appropriate unit of property to which the improvement provisions apply; (2) general rules for improvements; (3) rules for determining whether an amount paid materially increases the value of the unit of property; (4) rules for determining whether an amount paid restores the unit of property; and (5) an optional repair allowance method.

B. Unit of Property Rules

1. In General

A threshold issue in applying the improvement rules under § 1.263(a)–3 of the proposed regulations is determining the appropriate unit of property to which the rules should be applied. For example, to determine whether an amount paid materially increases the value of property, it is necessary to know what property is at issue. The smaller the unit of property, the more likely it is that amounts paid in connection with that unit of property will materially increase the value of, or restore, the property. Taxpayers and the IRS frequently disagree on the unit of property to which the capitalization rules should be applied. Thus, the unit of property rules in the proposed regulations are intended to provide guidance in determining whether an amount paid improves the unit of property under § 1.263(a)–3. The unit of property rules also apply for purposes of § 1.263(a)–1 of the proposed regulations (which references the rules in §§ 1.263(a)–2 and 1.263(a)–3 of the proposed regulations) and § 1.263(a)–2 of the proposed regulations (for example, with regard to the 12-month rule). The unit of property rules in the proposed regulations apply only for purposes of section 263(a) and §§ 1.263(a)–1, 1.263(a)–2, and 1.263(a)–3 of the proposed regulations, and not any other Code or regulation section. For example, no inference is intended that these unit of property rules have any application for section 263A(f) interest capitalization purposes.

The current regulations under section 263(a) do not provide any guidance on determining the appropriate unit of property. Some courts have addressed the unit of property issue under section 263(a), but their holdings are based on the particular facts of each case and do not contain rules that are generally applicable for purposes of section 263(a). See, *FedEx Corp.* v. *United States,* 291 F. Supp. 2d 699 (W.D. Tenn. 2003), aff'd, 412 F.3d 617 (6th Cir. 2005) (concluding that an aircraft, and not the aircraft engine, was the appropriate unit of property); *Smith* v. *Commissioner,* 300 F.3d 1023 (9th Cir. 2002) (concluding that an aluminum reduction cell, rather than entire cell line, was the appropriate unit of property); *Ingram Industries, Inc.* v. *Commissioner,* T.C. Memo 2000–323 (concluding that a towboat, and not the towboat engine, was the appropriate unit of property); *LaSalle Trucking Co.* v. *Commissioner,* T.C. Memo 1963–274 (concluding that truck engines, tanks, and cabs were each separate units of property).

In *FedEx,* the court ruled on whether an aircraft engine or the entire aircraft was the appropriate unit of property for determining whether the costs of engine shop visits (ESVs) must be treated as capital expenditures. Relying on the opinions in *Ingram* and *Smith,* the court concluded that the following four factors were relevant in determining the appropriate unit of property: (1) Whether the taxpayer and the industry treat the component part as a part of a larger unit of property for regulatory, market, management, or accounting purposes; (2) whether the economic useful life of the component part is coextensive with the economic useful life of the larger unit of property; (3) whether the larger unit of property and the smaller unit of property can function without each other; and (4) whether the component part can be and is maintained while affixed to the larger unit of property. Applying these factors to aircraft engines, the court concluded that the engines should not be considered a unit of property separate and apart from the airplane.

In Notice 2004–6, the IRS and Treasury Department requested comments on the relevance of various unit of property factors derived from *FedEx* and other cases that addressed the unit of property issue. The factors listed in Notice 2004–6 included: (1) Whether the property is manufactured, marketed, or purchased separately; (2) whether the property is treated as a separate unit by a regulatory agency, in industry practice, or by the taxpayer in its books and records; (3) whether the property is designed to be easily removed from a larger assembly, is regularly or periodically replaced, or is one of a fungible set of interchangeable or rotable assets; (4) whether the property must be removed from a larger assembly to be fixed or improved; (5)

whether the property has a different economic life than the larger assembly; (6) whether the property is subject to a separate warranty; (7) whether the property serves a discrete purpose or functions independently from a larger assembly; or (8) whether the property serves a dual purpose function.

The IRS and Treasury Department received nine comments on the unit of property issue, four of which specifically recommended that the proposed regulations adopt the factors used by the court in *FedEx.* These factors essentially are contained in factors 1, 2, 4, 5, and 7 of Notice 2004–6. Several of the factors listed in Notice 2004–6 have been incorporated into the proposed regulations. However, the IRS and Treasury Department determined that some factors were not relevant for certain types of property. For example, the factors listed in Notice 2004–6 primarily derive from case law that addresses tangible personal property; therefore, the factors were not as helpful in determining the appropriate unit of property for real property, such as land. Further, some types of property lend themselves to specific unit of property rules, such as buildings and property owned by taxpayers in a regulated industry. The IRS and Treasury Department believe that the administrative burden associated with determining the appropriate unit of property can be reduced for both the IRS and taxpayers by identifying specific rules reflecting an approach appropriate for the taxpayer's industry and the type of property at issue. Therefore, the proposed regulations provide different unit of property rules for four categories of property, rather than prescribing one rule for all types of property.

The unit of property rules in the proposed regulations apply to all real and personal property other than network assets. For purposes of the unit of property rules, *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. Network assets include, for example, trunk and feeder lines, pole lines, and buried conduit. They do not include property that would be included as a structural component of a building under § 1.263(a)–3(d)(2)(iv) of the proposed regulations, nor do they include separate property that is adjacent to, but not part of a network asset, such as bridges, culverts, or tunnels. The proposed regulations do not affect current guidance that addresses the unit of property or capitalization rules for network assets, such as Rev. Proc. 2001–46 (2001–2 C.B. 263) (track maintenance allowance method for Class I railroads); Rev. Proc. 2002–65 (2002–2 C.B. 700) (track maintenance allowance method for Class II and III railroads); and Rev. Proc. 2003–63 (2003–2 C.B. 304) (safe harbor unit of property rule for cable television distribution systems). The IRS and Treasury Department request comments on the relevant rules for determining the appropriate unit of property for network assets. Additionally, the IRS and Treasury Department request comments on whether to include rules for network assets in final regulations, or whether to develop for network assets industry-specific guidance that is similar to the above referenced revenue procedures.

With the exception of network assets, the four categories of property in the proposed regulations are intended to cover all real and personal property. In addition to the four categories of property, the unit of property rules provide for an initial unit of property determination, which, except with regard to buildings and structural components, is made prior to categorizing the property. The initial unit of property determination is based on the functional interdependence test in § 1.263A–10(a)(2), relating to the capitalization of interest. The initial unit of property determination is intended to be a common-sense approach to defining the largest possible unit of property as a starting point for analyzing the rules under one of the four relevant unit of property categories. After the initial unit of property is determined, the additional unit of property rules are intended to result in a determination that either confirms the initial unit of property as the unit of property, or that separates one or more components of the initial unit of property into separate units of property.

Some commentators suggested that the functional interdependence test under § 1.263A–10(a)(2) regarding interest capitalization should be the sole test for determining the appropriate unit of property. The IRS and Treasury Department believe that the functional interdependence test is a relevant, but not dispositive factor. The purpose of that test under § 1.263A–10(a)(2) is to calculate the appropriate unit of property for determining the accumulated production expenditures at the beginning and end of the production period. The preamble that accompanied the promulgation of § 1.263A–10 discusses the reasoning for adopting a broad formulation of the unit of property definition and states that ''this concept of single property may differ from the concept of single or separate property that taxpayers use for other purposes (*e.g.*, for computing amounts of depreciation deductions or separately tracking the bases of assets).'' TD 8584 (59 FR 67,187; 1995–1 C.B. 20, 25; Dec. 29, 1994).

In contrast to the unit of property rules in § 1.263A–10(a)(2), the purpose of the unit of property rules under section 263(a) is to provide a starting point for determining whether an amount paid materially increases the value of, or restores, the unit of property. Thus, § 1.263A–10(a)(2) has a different purpose than the proposed regulations under section 263(a). Further, in determining the appropriate unit of property for purposes of section 263(a), the functional interdependence test does not always produce appropriate results. For example, a taxpayer might argue that application of that test results in an entire complex of structures and machinery, such as an entire power plant, being treated as a single unit of property. The IRS and Treasury Department do not believe that result is correct for purposes of section 263(a).

After the initial unit of property determination is made, the unit of property analysis continues with determining the appropriate category of property and applying the rules in that category. The proposed regulations provide specific rules for four categories of property: (1) Property owned by taxpayers in a regulated industry; (2) buildings and structural components; (3) other personal property; and (4) other real property. The unit of property determination made under the applicable category is then subject to an additional rule in § 1.263(a)-3(d)(2)(vii) regarding treatment for other Federal income tax purposes. The rules for each of the four categories are explained below.

2. Category I: Taxpayers in Regulated Industries

The first unit of property category in the proposed regulations is property owned by taxpayers in a regulated industry. The proposed regulations provide that if the taxpayer is in an industry for which a Federal regulator has a uniform system of accounts (USOA) identifying a particular unit of property, the taxpayer must use the same unit of property for Federal income tax purposes, regardless of whether the taxpayer is subject to the regulatory accounting rules of the Federal regulator and regardless of whether the property is particular to that industry. This rule derives from one of the factors cited by the court in *FedEx* for determining the appropriate unit of property—whether the taxpayer and the industry treat the component part as part of the larger unit of property for regulatory, market, management, or accounting purposes. Thus, this rule ties into the regulatory accounting element of the *FedEx* factor, as well as the general concept of industry practice. The IRS and Treasury Department are aware of three Federal regulators that provide a USOA: (1) The Federal Energy Regulatory Commission (FERC); (2) the Federal Communications Commission (FCC); and (3) the Surface Transportation Board (STB). Accordingly, this unit of property category applies to taxpayers such as power companies, telecommunications companies, and railroads.

The IRS and Treasury Department determined that the regulatory accounting rule should be applied similarly to all taxpayers in industries for which a Federal regulator provides a USOA, regardless of whether the taxpayer is subject to the regulatory accounting rules of the Federal regulator. This rule is consistent with the general standard of using industry practice to determine the appropriate unit of property. Further, it results in all taxpayers within a specific industry being treated the same for Federal income tax purposes, without regard to whether a particular taxpayer is subject to the accounting rules of the Federal regulator. The rule is limited to the regulator's USOA and does not apply to other Federal regulatory rules, such as rules concerning safety or health. The proposed regulations apply only to USOA provided by Federal regulators and do not apply to USOA issued by any state or local agencies. Rules of state and local agencies may be different than Federal regulatory rules and can vary widely within an industry depending on the taxpayer's location.

Four of the commentators on this aspect of Notice 2004–6 recommended adopting the four factors cited in *FedEx*, from which the regulated industry rule was derived. None of the commentators specifically objected to a regulatory accounting rule, although one commentator suggested that where cost recovery is determined for non-tax purposes by a Federal or state agency, the regulations should provide a special election that may be made on an annual basis under which the taxpayer may use the same unit of property for tax purposes as it must use for regulatory purposes. The IRS and Treasury Department believe the unit of property inquiry should result in one clear determination that will be used consistently by the taxpayer unless the underlying facts change and, therefore, do not believe an annual election is appropriate.

3. Category II: Buildings and Structural Components

In general, a building and its structural components must be treated as one unit of property. This rule is based on the definitions of *building* and *structural component* in the regulations under section 48. The repair allowance regulations under the Class Life Asset Depreciation Range (CLADR) system also provide that a building and its structural components generally are a single unit of property. See § 1.167(a)–11(d)(2)(vi). The IRS and Treasury Department believe that these definitions are useful in determining the appropriate unit of property for buildings and structural components. One commentator specifically requested that the proposed regulations use the definition of building under § 1.48–1(e) to determine a unit of property. The proposed regulations rely on the definition of building under § 1.48–1(e). Property located inside a building that is not a structural component of the building must be analyzed under one of the other three unit of property categories; for example, machinery and equipment inside a factory must be analyzed under Category III (the other personal property category).

This Category II is the only category to which the initial unit of property determination does not apply. Applying the functional interdependence test to a building would raise issues in cases where certain floors or portions of a building are placed in service independently of another. The IRS and Treasury Department believe that, unless the additional rule in § 1.263(a)–3(d)(2)(vii) of the proposed regulations (regarding treatment for other Federal income tax purposes) applies to require a component of a building to be treated as a separate unit of property, the building and its structural components should be the unit of property. The IRS and Treasury Department recognize, however, that it is not always appropriate to treat the entire building as the unit of property. For example, a taxpayer who owns a unit in a condominium building, whether the unit is used for personal or investment purposes, should not treat the entire building as the unit of property. Therefore, the IRS and Treasury request comments on how the unit of property rules should apply to condominiums, cooperatives, and similar types of property.

4. Category III: Other Personal Property

The unit of property determination for personal property not included in Category I (taxpayers in a regulated industry) is a facts and circumstances test, based on four exclusive factors, none of which is dispositive or weighs more heavily than the others.

a. Factor 1: Marketplace Treatment Factor

The first exclusive factor is whether the component is (1) marketed separately to or acquired or leased separately by the taxpayer (from a party other than the seller/lessor of the property of which the component is a part) at the time it is initially acquired or leased; (2) subject to a separate warranty contract (from a party other than the seller/lessor of the property of which the component is a part); (3) subject to a separate maintenance manual or written maintenance policy; (4) appraised separately; or (5) sold or leased separately by the taxpayer to another party. This factor contains a number of items intended to determine the treatment in the marketplace of the component as a separate unit of property.

Whether the component is acquired separately was a factor addressed by the courts in *FedEx* and *Ingram*, and is also part of the CLADR repair allowance regulations under section 167 and the unit of property determination for interest capitalization in § 1.263A–10. In *FedEx*, the court discussed this issue in the context of whether the taxpayer and the industry treat the component part as part of the larger unit of property for regulatory, market, management, or accounting purposes. In finding that the aircraft engines were not purchased separately, the court relied on the fact that the engines and aircraft were designed to be compatible and were generally acquired by the taxpayer at the same time. The court disregarded the fact that the taxpayer purchased the engines and airframes from different sellers when the aircraft were initially acquired. The IRS and Treasury Department believe that the acquisition of a component from a different seller at the time the larger property is acquired should be a relevant factor, and that the same rule should apply if the taxpayer leases the component from a different party than the seller of the larger property.

The IRS and Treasury Department recognize that this factor may produce different results depending on whether the property is new or used. When a taxpayer acquires or leases used property, it is possible that items that were separate units of property when purchased new will be treated as one unit of property because the initial purchaser has assembled the units into one functional item that it sells or leases. The IRS and Treasury Department considered whether it was appropriate to have a factor that could treat new and used property differently, and decided that the difference reasonably reflects the substance of the transactions—where the taxpayer acquires or leases a component from a different party from whom it acquires or leases the larger property, the taxpayer typically is conducting different, but related, transactions with separately negotiated terms.

Whether the component is subject to a separate warranty contract, maintenance manual, or written maintenance policy was cited as a factor in *FedEx* and is adopted as part of the marketplace treatment factor in the proposed regulations. The warranty contract factor applies only to a warranty that is provided by a party other than the seller/lessor of the larger property. It is not intended to apply to a warranty provided by the sellor/lessor that may contain separate warranties (for example, for different time periods) on various components of the larger property. Whether the property is manufactured separately was a possible factor cited in Notice 2004–6. The proposed regulations do not specifically adopt this factor because components that are subject to a separate warranty or maintenance procedures also are likely to be manufactured separately. The *FedEx* case used as a factor whether the component was appraised or valued separately and the CLADR repair allowance regulations under section 167 addressed whether the component was sold separately to another party. The proposed regulations adopt these tests as part of the marketplace factor.

The IRS and Treasury Department believe that it is important that all the criteria in this factor be taken into account together when weighing this factor with the other three factors. Some criteria may be stronger indicators warranting treatment of the component as a separate unit of property than others. The IRS and Treasury Department acknowledge that several of the criteria within this factor do not work well for property produced by the taxpayer, and request comments regarding how and whether a marketplace factor should apply to self-constructed property.

b. Factor 2: Industry Practice and Financial Accounting Factor

The second exclusive factor in this Category III is whether the component is treated as a separate unit of property in industry practice or by the taxpayer in its books and records. This factor was cited by the court in *FedEx.* The IRS and Treasury Department believe that the taxpayer's treatment of the component as separate in its books and records is a relevant factor in determining whether the component should be treated as a separate unit of property in the proposed regulations. In particular, if the taxpayer's books and records assign different economic useful lives to the component and the larger property, this factor would weigh heavily toward treating the component as a separate unit of property.

The IRS and Treasury Department considered whether to use as a factor whether the component has a different economic useful life than the property of which it is a part. This factor was cited by the courts in *Smith, Ingram,* and *FedEx.* However, for this factor to be useful, the regulations would need to define economic useful life. The proposed regulations at § 1.263(a)–3(f) (with regard to restoration of a unit of property) provide a definition of economic useful life, which has different meanings depending on whether a taxpayer has an AFS. If the unit of property rules adopted this definition, the economic useful life test under this factor would produce different results depending on whether the taxpayer has an AFS. These different results are not justified in this context. Further, a taxpayer's treatment of the component in its books and records under this Factor 2 includes any useful life determinations of the component and the property of which the component is a part in the books and records. Therefore, the economic useful life factor was not specifically adopted as a separate factor.

c. Factor 3: Rotable Part Factor

The third exclusive factor in the other personal property category is whether the taxpayer treats the component as a rotable part. A rotable part is defined as a part that is removeable from property, repaired or improved, and either immediately reinstalled on other property or stored for later installation. This factor was cited by the courts in *Smith* and *LaSalle*. The court in *FedEx* ignored this factor, but considered as a separate concept whether the component can be and is maintained while affixed to the larger unit. The IRS and Treasury Department considered this separate concept as well, but believe that the rotable part factor incorporates this concept from *FedEx.* As the examples in the proposed regulations illustrate, this factor focuses on the particular taxpayer's treatment of the property as a rotable part in determining whether the rotable is a separate unit of property. Therefore, for example, if the rotable part is a separate unit of property to the taxpayer and the taxpayer incorporates the rotable into other property for resale, the rotable part will not necessarily be a separate unit of property to the purchaser.

Two commentators stated that the treatment of a component as a rotable part is of limited or no relevance. While treatment of minor parts as rotable would not weigh heavily toward separate unit of property treatment, the IRS and Treasury Department believe that the treatment of major components as rotable is a relevant factor in determining whether a component is a separate unit of property, particularly when the economic useful life of the larger property is limited by the expected useful life of the rotable part. Many taxpayers do not maintain an inventory of rotable spares for their major components. Although it is understood that the purpose for maintaining an inventory of rotables is to minimize the time that the larger property is out of service, treatment of a major component as a rotable has consequences that tend to be indicative of a separate unit of property. For example, in the case of a taxpayer that does not maintain an inventory of rotable spare parts, if a major component of the larger property breaks down, then the entire larger property must be taken out of service while the major component is being repaired. This is indicative of the larger property and the component collectively being treated as one unit of property. Conversely, a taxpayer that does maintain an inventory of rotable spare parts for a major component is able to continue to use the larger property without regard to the time required to repair the broken down component. In this instance, the IRS and Treasury Department believe that continued use of the larger property is indicative of separate unit of property treatment for the rotable part. In addition, rotables being depreciated as rotable spare parts is indicative of separate treatment because the components are depreciated separately from the larger property.

In the request for comments, Notice 2004–6 combined several other factors with the rotables factor, including whether a component is designed to be easily removed from a larger assembly, is regularly or periodically replaced, or is one of a fungible set of interchangeable assets. These factors are broader than the rotables factor in the proposed regulations and would sweep in many minor components that rarely, if ever, would be appropriately considered a separate unit of property. Further, these factors are duplicative of the rotables part factor, because a rotable generally meets all of these factors. The IRS and Treasury Department believe that these factors are not more helpful in determining whether a component is a separate unit of property than the rotables factor described in the proposed regulations. Therefore, the proposed regulations do not include these other factors.

d. Factor 4: Function Factor

The fourth and final factor in Category III is whether the property of which the component is a part generally functions for its intended use without the component property. This factor was cited by the court in *FedEx* and is similar to the discrete purpose test under the CLADR repair allowance regulations. It is also similar to the functional interdependence test under § 1.263A–10(a)(2) and the rules in these proposed regulations regarding the initial unit of property determination. As noted in the discussion of the initial unit of property determination, the IRS and Treasury Department agree with commentators that the functional interdependence test is a relevant, although not dispositive, factor in the unit of property analysis. Although the proposed regulations use the functional interdependence test to determine the initial unit of property, the functional interdependence test in that context is merely a starting point in determining the appropriate unit of property, rather than a specific factor to be considered. Providing this version of the functional interdependence test as a specific factor gives appropriate weight to that test in the unit of property analysis for other personal property.

5. Category IV: Other Real Property

The unit of property determination for real property not included in Category I or II is based on a facts and circumstances test. The property subject to this category is primarily land and land improvements owned or leased by taxpayers not in a regulated industry. This category does not list specific factors because land and land improvements are such unique assets that specific factors cannot uniformly provide appropriate results. Thus, the unit of property determination for property in this category may be based on some, all, or none of the factors listed in Category III for personal property, or may be based on other factors. The IRS and Treasury Department request comments on whether additional guidance is needed for this category of property and, if so, what unit of property guidance would be appropriate.

6. Additional Rule for Unit of Property

After determining the initial unit of property and applying the unit of property rules under the appropriate category, the additional rule in § 1.263(a)–3(d)(2)(vii) must be applied. Under this rule, if a taxpayer properly treats a component as a separate unit of property for any Federal income tax purpose, the taxpayer must treat the component as a separate unit of property for purposes of § 1.263(a)–3. The purpose of this rule is to prevent taxpayers from taking inconsistent positions by arguing that a component of property is a unit of property for one tax purpose and that it is not a separate unit of property for capitalization purposes. For example, if a taxpayer does a cost segregation study on a building and properly identifies separate section 1245 property, the taxpayer must treat that separate property as the unit of property for capitalization purposes.

As a further example, if a taxpayer properly recognizes a loss under section 165, or under another applicable provision, from a retirement of a component of property or from the worthlessness or abandonment of a component of property, the taxpayer must treat the component as a separate unit of property. A loss arising under another applicable provision in this context includes a loss arising under (1) § 1.167(a)–8 or 1.167(a)–11, as applicable, from a retirement of a component of property if the component is not subject to section 168 (MACRS property) or former section 168 (ACRS property); (2) § 1.167(a)–8(a) from a retirement of a component of property if the component is MACRS or ACRS property (applying § 1.167(a)–8(a) as though the retirement is a normal retirement from a single asset account) unless the component is a structural component or the component is in a mass asset account (ACRS property) or a general asset account (MACRS property); or (3) § 1.168(i)–1(e) from the disposition of a component of property if the component is MACRS property and in a general asset account. No inference is intended that this rule in the proposed regulations requires or allows taxpayers that are using a unit of property for purposes of the proposed regulations to use the same unit of property for purposes of any Code or regulation section other than section 263(a) and §§ 1.263(a)–1, 1.263(a)–2, and 1.263(a)–3 of the proposed regulations.

This rule is intended to prevent taxpayers from taking a loss deduction on a component of a unit of property, and then deducting the cost of the replaced component as a repair. The application of this rule results in the replacement component being treated as a separate unit of property, thus requiring capitalization under § 1.263(a)–2 of amounts paid to acquire or produce the replacement component. The IRS and Treasury Department believe that taxpayers must be consistent in the treatment of a unit of property for capitalization (other than interest capitalization), depreciation, and loss deduction purposes. The IRS and Treasury Department recognize that the language of this consistency rule is very broad, and request comments regarding circumstances in which this rule should not apply.

V. Improvements in General

Section 1.263(a)–1(b) of the current regulations provides that an amount must be capitalized if it (1) adds to the value, or substantially prolongs the useful life, of property owned by the taxpayer, or (2) adapts the property to a new or different use. Notice 2004–6 requested comments on what general principles of capitalization should apply to amounts paid to repair or improve tangible property. Commentators were almost unanimous in their suggestion that the current principles of value, useful life, and new or different use be retained. The IRS and Treasury Department agree with the commentators that the current guidelines generally are appropriate. However, the current regulations require a subjective inquiry into the application of the particular facts at issue, which often results in disagreements between taxpayers and the IRS. Accordingly, the proposed regulations attempt to clarify and expand the standards in the current regulations by setting forth rules to determine whether there has been a material increase in value (including adapting property to a new or different use) and to determine whether there has been a restoration of property (the useful life rules). In addition, the proposed regulations provide objective rules for improvements in an optional repair allowance method.

The proposed regulations generally provide that a taxpayer must capitalize the aggregate of related amounts paid that improve a unit of property, whether the improvements are made by the taxpayer or a third party. The aggregate of related amounts does not encompass otherwise deductible repair costs unless those costs directly benefit or are incurred by reason of a capital improvement. Instead, the aggregation language is intended to include amounts paid for an entire project, including removal costs and other project costs, regardless of whether amounts are paid to more than one party or whether the work spans more than one taxable year. The proposed regulations do not affect the treatment of amounts paid to retire and remove a unit of property in connection with the installation or production of a replacement asset. See Rev. Rul. 2000–7 (2000–1 C.B. 712).

Several commentators suggested that the proposed regulations provide that the relevant distinction between capital improvements and deductible repairs is whether the amounts were paid to put the property in ordinarily efficient operating condition or to keep the property in ordinarily efficient operating condition. See *Estate of Walling* v. *Commissioner*, 373 F.2d 190 (3d Cir. 1967); *Illinois Merchants Trust Co.* v. *Commissioner*, 4 B.T.A. 103 (1926), acq. (V–2 C.B. 2); Rev. Rul. 2001–4 (2001–1 C.B. 295). The improvement rules in the proposed regulations are consistent with the put versus keep standard, to the extent that standard is relevant. An amount paid may be a capital expenditure even if it does not put the property in ordinarily efficient operating condition because not all repair or improvement costs affect the functionality of the property. Thus, amounts paid that keep property in ordinarily efficient operating condition are not necessarily deductible repair costs, particularly if the useful life is extended. On the other hand, amounts that put property in ordinarily efficient operating condition are likely to be amounts paid prior to the property's being placed in service or to ameliorate a pre-existing condition or defect. Amounts paid in these later situations would be capital expenditures under either the value rule or the restoration rule in the proposed regulations.

Some commentators suggested that the frequency of the expenditure should be considered, noting that an expenditure being regularly incurred on a cyclical basis should be a strong indication of deductible maintenance. The IRS and Treasury Department considered this comment but concluded that the frequency of the expenditure was too vague a standard to be administrable. Further, the IRS and Treasury Department believe that the proposed regulations provide appropriate guidance on cyclical maintenance by clarifying other rules, such as the appropriate comparison rule for adding value and the rules relating to prolonging economic useful life.

In accordance with several comments received in response to Notice 2004–6, the proposed regulations provide that a Federal, state, or local regulator's requirement that a taxpayer perform certain repairs or maintenance is not relevant in determining whether the amount paid improves the unit of property. Several courts have held that amounts paid to bring property into compliance with government regulations were capital expenditures, in part because they made the taxpayer's property more valuable for use in its trade or business. See, *Swig Investment Co.* v. *United States*, 98 F.3d 1359 (Fed. Cir. 1996) (replacing cornices and parapets on hotel to comply with city earthquake ordinance); *Teitelbaum* v. *Commissioner*, 294 F.2d 541 (7th Cir. 1961) (converting electrical system from direct current to alternating current to comply with city ordinance); *RKO Theatres, Inc.* v. *United States*, 163 F. Supp. 598 (Ct. Cl. 1958) (installing fire-proof doors and fire escapes to comply with city code); *Hotel Sulgrave, Inc.* v. *Commissioner*, 21 T.C. 619 (1954) (installing sprinkler system to comply with city code). In each case, however, the court did not rely entirely on regulatory compliance as a basis for requiring capitalization. For example, in *Hotel Sulgrave* and *RKO Theatres*, both involving the installation of certain equipment to comply with city fire codes, the courts emphasized that the work involved the addition of property with a useful life extending beyond the taxable year. Moreover, both *Swig* and *Teitelbaum* involved expenditures for the replacement of major structural components of a building (parapets and cornices in *Swig* and an electrical system in *Teitelbaum*) with upgraded components. Thus, in all these cases, even without the legal compulsion to make these changes, the taxpayers' amounts paid would have constituted capital expenditures.

In contrast to the cases discussed above, both the courts and the IRS have permitted a current deduction for some government mandated expenditures. For example, in *Midland Empire Packing Co.* v. *Commissioner*, 14 T.C. 635 (1950), acq. (1950–2 C.B. 3), the court allowed the taxpayer to deduct the costs of applying a concrete liner to its basement walls to satisfy Federal meat inspectors. Similarly, the IRS has permitted taxpayers to treat as otherwise deductible repairs amounts paid to remediate certain environmental contamination and to replace certain waste storage tanks to comply with applicable state and Federal regulations. See Rev. Rul. 94–38 (1994–1 C.B. 35); Rev. Rul. 98–25 (1998–1 C.B. 998). The IRS specifically recognized in Rev. Rul. 2001–4 (2001–1 C.B. 295) that the requirement of a regulatory authority to make certain repairs or to perform certain maintenance on an asset to continue operating the asset does not mean that the work performed must be capitalized. Thus, the proposed regulations reiterate that statement in Rev. Rul. 2001–4 and provide that a legal compulsion to repair or maintain tangible property is not a relevant factor in the repair versus improvement analysis. The IRS and Treasury Department further believe that a new government requirement for existing property that mandates certain expenditures with respect to the property does not create an inherent defect in the property.

In response to several comments, the proposed regulations provide that if a taxpayer needs to replace part of a unit of property that cannot practicably be replaced with the same type of part, the replacement of the part with an improved but comparable part does not, by itself, result in an improvement to the unit of property. This rule is intended to apply in cases where the same replacement part is no longer available, generally because of technological advancements or product enhancements. This rule, however, is not intended to apply if, instead of replacing an obsolete part with the most similar comparable part available, the taxpayer replaces the part with one of a better quality than what would have sufficed.

The proposed regulations do not prescribe a plan of rehabilitation doctrine as traditionally described in the case law. That judicially-created doctrine provides that a taxpayer must capitalize otherwise deductible repair costs if they are incurred as part of a general plan of rehabilitation to the property. See, *Norwest Corp.* v. *Commissioner*, 108 T.C. 265 (1997); *Moss* v. *Commissioner*, 831 F.2d 833 (9th Cir. 1987); *United States* v. *Wehrli*, 400 F.2d 686 (10th Cir. 1968). Specifically, if an expenditure is made as part of a general plan of rehabilitation, modernization, and improvement of the property, the expenditure must be capitalized, even though, standing alone, the item may be classified as one of repair or maintenance. *Wehrli*, 400 F.2d at 689. Whether a general plan of rehabilitation exists, and whether a particular repair or maintenance item is part of it, are questions of fact to be determined based upon all the surrounding facts and circumstances, including, but not limited to, the purpose, nature, extent, and value of the work done. *Id.* at 690.

The issue of whether an amount paid must be capitalized under the plan of rehabilitation doctrine has been the subject of much litigation, with varying results. For example, some cases have limited application of the plan of rehabilitation doctrine to buildings that are not suitable for their intended use in the taxpayer's trade or business. See *Schroeder* v. *Commissioner*, T.C. Memo 1996–336; *Koanis* v. *Commissioner*, T.C. Memo 1978–184, aff'd mem., 639 F.2d 788 (9th Cir. 1981); *Keller Street Dev. Co.* v. *Commissioner*, 37 T.C. 559 (1961); acq., 1962–2 C.B. 5, aff'd in part, rev'd in part on other grounds, 323 F.2d 166 (9th Cir. 1963). Other courts, as well as the IRS, have viewed the plan of rehabilitation doctrine more broadly, emphasizing the planned aspect of the work done by the taxpayer, rather than the condition of the property. See *Mountain Fuel Supply Co.* v. *United States*, 449 F.2d 816 (10th Cir. 1971); *Wolfsen Land & Cattle Co.* v. *Commissioner*, 72 T.C. 1 (1979); Rev. Rul. 88–57 (1988–2 C.B. 36).

In Rev. Rul. 2001–4 (2001–1 C.B. 295), the IRS clarified its view of the plan of rehabilitation doctrine. In applying the plan of rehabilitation doctrine to the facts in Situation 3 of that ruling, the IRS noted that (1) the taxpayer planned to perform substantial capital improvements to upgrade the unit of property; (2) the repairs were incidental to the taxpayer's plan to upgrade the unit of property; and (3) the effect of all the work performed on the unit of property, including the repairs and maintenance work, was to materially increase the value or prolong the useful life of the unit of property. The ruling also notes that the existence of a written plan, by itself, is not sufficient to trigger the plan of rehabilitation doctrine. The ruling's interpretation of the plan of rehabilitation doctrine is consistent with the majority of cases applying that doctrine. See *California Casket Co.* v. *Commissioner*, 19 T.C. 32 (1952), acq., 1953–1 C.B. 3; *Stoeltzing* v. *Commissioner*, 266 F.2d 374 (3d Cir. 1959); *Bank of Houston* v. *Commissioner*, T.C.M. 1960–110.

The IRS and Treasury Department do not believe it is appropriate to capitalize as an improvement otherwise deductible repair costs solely because the taxpayer has a plan (written or otherwise) to perform periodic repairs or maintenance or solely because the taxpayer performs several repairs to the same property at one time. The IRS and Treasury Department believe that it is appropriate to capitalize otherwise deductible repair costs as part of an improvement only if the taxpayer improves a unit of property and the otherwise deductible repair costs directly benefit or are incurred by reason of the improvement to the property. Section 263A applies to these expenditures. Section 263A requires that all direct costs of an improvement and all indirect costs that directly benefit or are incurred by reason of the improvement must be capitalized. This application of section 263A to otherwise deductible repair costs in this context is consistent with the application of the plan of rehabilitation doctrine described in Rev. Rul. 2001–4. The proposed regulations provide that repairs that are made at the same time as an improvement, but that do not directly benefit or are not incurred by reason of the improvement, are not required to be capitalized under section 263(a).

VI. Value

A. In General

The proposed regulations provide that a taxpayer must capitalize amounts paid that materially increase the value of a unit of property and provide an exclusive list of five tests for determining whether an amount paid materially increases value. An amount paid must be capitalized if it meets any of the five tests. The first test is whether the amount paid ameliorates a 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. See *United Dairy Farmers, Inc.* v. *United States*, 267 F.3d 510 (6th Cir. 2001); *Dominion Resources, Inc.* v. *United States*, 219 F.3d 359 (4th Cir. 2000); *Jones* v. *Commissioner*, 242 F.2d 616 (5th Cir. 1957). This rule is consistent with the concept that amounts paid to put property into ordinarily efficient operating condition must be capitalized. This pre-existing defect rule applies regardless of whether the taxpayer was aware of the condition or defect at the time of acquisition or production. The IRS and Treasury Department considered but rejected as too subjective the idea of providing different treatment based on the taxpayer's prior knowledge of the condition or defect. The IRS and Treasury Department request comments on whether, and in what circumstances, the pre-existing defect rule should take into account the condition of the property in the hands of a transferor. For example, if an individual transfers property to a corporation in exchange for stock in a transaction under section 351, should the pre-existing defect rule take into account the condition of the property when acquired by the individual, rather than the condition of the property when received by the corporation?

The second test for materially increasing value is whether the work was performed prior to the date the property is placed in service by the taxpayer. This test essentially restates the concept that amounts paid to put property into ordinarily efficient operating condition must be capitalized. The IRS and Treasury Department believe that if the property cannot be placed in service prior to work being performed, that work necessarily increases the value of the property.

The third value test is whether the amounts paid adapt the property to a new or different use. The commentators agreed that this factor should remain a standard for capitalization. The new or different use standard is unchanged from the current regulations, but it is included in the value section of the proposed regulations, rather than as its own standard. The new or different use test is not intended to apply to amounts paid to prepare a unit of property for sale (for example, painting a house).

The fourth value test is whether the amount paid results in a betterment or material addition to the unit of property. The betterment language is consistent with the statutory language of section 263(a)(1) as well as the current regulations at § 1.263(a)-1(a)(1). A betterment is an improvement that does more than restore to a former good condition. The betterment test is intended to capture amounts paid that are qualitative improvements to the property that make the property better and more valuable than mere repairs would do, such as using upgraded materials when materials comparable to the original were available and would have sufficed. However, the betterment test is not intended to be a fair market value test.

The fifth test in the value section of the proposed regulations is whether the amount paid results in a material increase in capacity, productivity, efficiency, or quality of output of the unit of property. These standards are consistent with case law under the current regulations.

The proposed regulations provide an exception to the value tests if the original economic useful life of the unit of property is 12 months or less and the taxpayer does not elect to capitalize amounts paid for the property. The purpose of this rule is to not require capitalization under the value rules for improvements made to 12-month property. This exception, however, does not apply to the restoration rule for determining whether an amount paid improves property. Thus, for example, if a taxpayer performs work on 12-month property that prolongs the economic useful life of the property, the amount paid must be capitalized.

The proposed regulations do not adopt an increase in fair market value as a standard for capitalization. In response to Notice 2004–6, most commentators stated that value means fair market value. However, in practice, taxpayers generally do not measure, and would have no reason to measure, the fair market value of a unit of property prior to some condition necessitating the expenditure. Further, taxpayers generally have no reason to measure the fair market value of a unit of property after the work is performed. The IRS and Treasury Department did not want to propose regulations with a standard that required taxpayers to have property appraised solely for the purpose of applying a capitalization standard. In fact, the courts rarely have applied a strict increase in fair market value standard. Usually, the courts rely on some surrogate for fair market value to determine whether value is increased. For example, courts have looked to the amount of the expenditure versus (1) the cost of the property (see *Stoeltzing* v. *Commissioner*, 266 F.2d 374 (3d Cir. 1959)); (2) the cost of comparable new property (see *LaSalle Trucking Co.* v. *Commissioner*, T.C. Memo 1963–274); and (3) the cost of comparable used property (see *Ingram Industries, Inc.* v. *Commissioner*, T.C. Memo 2000–323). Courts have considered fair market value only in a few cases when property has been appraised for some other purpose (see *Jones* v. *United States*, 279 F. Supp. 772, 774 (D. Del. 1968)), or when property has been appraised in the course of the litigation (see *FedEx*, 291 F. Supp. 2d at 706–707).

Additionally, the fair market value of property may change over time without regard to the use, upkeep, or improvements made by the taxpayer, due to other factors such as supply and demand or changes in style, trends, technologies, etc. For example, land may increase in fair market value over time without the taxpayer performing any activities to improve it. Conversely, amounts paid to make substantial improvements to a unit of property may not always increase fair market value, or may not increase the fair market value by the full amount paid for the improvements. See, *Harrah's Club* v. *United States*, 661 F.2d 203 (Ct. Cl. 1981) (amount paid to restore antique automobiles must be capitalized even though restoration did not increase fair market value by the amount paid for the restoration). Attempting to adjust fair market value for factors like these further complicates any possible comparison. The IRS and Treasury Department believe that the fair market value standard is too subjective and impractical, particularly because most repairs also increase the fair market value of property if the value is compared immediately before and after the work is performed. Therefore, the IRS and Treasury Department do not believe that fair market value is an appropriate standard. The value factors in the proposed regulations are intended to be objective indications of work performed that generally would increase the fair market value of the unit of property. Whether amounts paid materially increase the value of a unit of property requires an analysis of the purpose, the physical nature, and the effect of the work for which the amounts were paid, and not an analysis of the fair market value of the property or the level of monetary expenditures.

Some commentators requested that the regulations provide a bright line rule defining a material increase in value with respect to a specified percentage increase, for example a twenty-five percent increase in capacity. The IRS and Treasury Department do not believe that providing a fixed percentage as a presumption of what is a material increase would be an appropriate safe harbor. Although perhaps measurable, the same fixed percentage increase in capacity would not work well as a rule applicable to all types of property. A twenty-five percent increase in capacity may be a reasonable litmus test for determining whether there has been a material increase in value for certain types of property. However, for many types of property, a much smaller increase in capacity may be an extraordinary, or in some cases impossible, improvement. For example, an increase in the square footage of a 50,000 square foot building by 5 percent would be a rather large improvement that should be capitalized. Therefore, the determination of whether an increase in capacity, productivity, efficiency, or quality is a material increase in value should be based on all the facts and circumstances.

B. Appropriate Comparison

Notice 2004–6 requested comments on the proper starting point for comparing whether an expenditure materially increases the value of property. Almost all the commentators suggested that the proposed regulations adopt the test set forth in *Plainfield-Union Water Co.* v. *Commissioner*, 39 T.C. 333 (1962), nonacq. on other grounds (1964–2 C.B. 8) (the Plainfield-Union test). In that case, the court noted that almost any properly performed repair adds value as compared with the situation existing immediately prior to that repair. The proper test, the court said, is whether the expenditure materially enhances the value of the property as compared with the status of the property prior to the condition necessitating the expenditure. The court also noted that the test is appropriate even when the expenditure does not arise from a sudden, unexpected, or unusual external circumstance.

The IRS and Treasury Department agree with this application of the Plainfield-Union test and believe that the test is appropriately applied to cases of normal wear and tear as well as cases when the expenditure arises from a sudden, unexpected, or unusual external circumstance. The proposed regulations adopt the Plainfield-Union test for cases in which a particular event necessitates the expenditure and clarify that when the event necessitating the expenditure is normal wear and tear, the condition of the property immediately prior to the event necessitating the expenditure is the condition of the property after the last time the taxpayer corrected the effects of normal wear and tear 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. This comparison rule for wear and tear is intended to apply when a taxpayer engages in regular, cyclical maintenance of a unit of property to correct the effects of normal wear and tear. Although wear and tear begins affecting the condition of property as soon as it is placed in service, the proposed regulations do not adopt the placed-in-service date as the appropriate comparison point. Although the placed-in-service date would be the appropriate comparison point when the taxpayer first corrects the effects of normal wear and tear, the IRS and Treasury Department believe that the condition of the property after the previous maintenance cycle is the appropriate comparison point for each subsequent maintenance cycle.

The Plainfield-Union test works well when the amount paid is necessitated by a specific event (like amounts paid to repair damage or amounts paid to maintain property by correcting the effects of wear and tear). However, the test does not work in a pure improvement setting; that is, when a taxpayer decides to improve property without any event causing the taxpayer to perform the work to restore the property to a former good condition. Therefore, the proposed regulations do not apply the Plainfield-Union test to the first three value factors (pre-existing defects, work performed prior to the property being placed in service, and adapting the property to a new or different use). These factors are more appropriately analyzed on an absolute, rather than relative basis. Similarly, the test does not work well for betterments, which by definition are improvements that do more than restore property to a former good condition.

VII. Restoration

The proposed regulations provide that a taxpayer must capitalize amounts paid to restore property. The restoration language is from section 263(a)(2) and § 1.263(a)–1(a)(2) of the current regulations and generally has been viewed as a rule requiring the capitalization of amounts paid that substantially prolong the useful life of the property. See § 1.263(a)–1(b). This section of the proposed regulations defines economic useful life and what it means to substantially prolong economic useful life.

The comments received in response to Notice 2004–6 varied greatly with regard to useful life, with two commentators specifically suggesting that the concept of useful life be eliminated from the regulations. The other commentators suggested that economic useful life be defined as the period of time over which the property is expected to be useful to the taxpayer, taking into account the various factors listed in § 1.167(a)–1(b). The proposed regulations adopt this definition of economic useful life for taxpayers that do not have an AFS. Economic useful life is not determined by reference to the recovery period under section 168 for the property.

For a taxpayer that has an AFS, the economic useful life of the property is presumed to be the same as the useful life used by the taxpayer for purposes of determining depreciation in its AFS. The IRS and Treasury Department believe that the economic useful life definition is subjective and difficult to apply; therefore, this rule provides certainty for taxpayers with an AFS. The regulations provide an exception to this rule for situations in which a taxpayer does not assign a useful life to certain property in its AFS, even though the property has a useful life of more than one year. For example, a taxpayer may treat amounts paid for a unit of property as an expense in its AFS if the property is used in a specific research project and has no alternative future uses. Additionally, many taxpayers have a policy of treating as an expense in their AFS an amount paid for tangible property below a certain dollar threshold, despite the fact that the property has a useful life of more than one year. This type of property does not have a useful life for purposes of determining depreciation in the taxpayer's AFS, even though it may have a useful life of more than one year. Therefore, the IRS and Treasury Department believe that in these situations it is appropriate for taxpayers to use the economic useful life definition that applies to taxpayers without an AFS.

One commentator stated that the useful life used for book depreciation purposes is not appropriate for tax purposes because the book useful life takes into account factors that do not measure the inherent useful life, but rather the period over which the property is expected to be useful (on average) to the taxpayer. The IRS and Treasury Department believe it is appropriate to take into account the period over which the property may reasonably be expected to be useful to the taxpayer, as required by taxpayers without an AFS, rather than the inherent useful life of the property.

The proposed regulations also provide four rules for determining when an amount paid substantially prolongs economic useful life. The first rule requires capitalization when the amount paid extends the period over which the property may reasonably be expected to be useful to the taxpayer beyond the end of the taxable year immediately succeeding the taxable year in which the economic useful life of the property was originally expected to cease. One commentator suggested that the regulations provide a safe harbor bright line rule to define whether an amount substantially prolongs the useful life. The IRS and Treasury Department believe that a one year rule is an appropriate bright line. Therefore, the regulations require capitalization when the amount paid extends the original useful life of the property by more than one taxable year. The IRS and Treasury Department believe that a one year rule is a more appropriate bright line than a rule based on a percentage of the useful life, because the one-year rule corresponds with the 12-month safe harbor rule for the acquisition or production of property.

The second rule requires capitalization if a major component or a substantial structural part of the unit of property is replaced and notes that the replacement of a relatively minor portion of the physical structure of the unit of property or a relatively minor portion of any of its major parts does not constitute the replacement of a major component or substantial structural part of the unit of property. It is possible, however, for amounts paid to replace a relatively minor portion of the physical structure of the unit of property or a relatively minor portion of any of its major parts to substantially prolong the economic useful life of the property if the property is near the end of its economic useful life, in which case the amounts paid nevertheless must be capitalized. The rule is not intended to require capitalization if a major component is replaced with a similar, used component that has not been rebuilt, for example, if the engine in a car is replaced with a used engine with similar mileage obtained from a junkyard, or a component of property subject to a warranty or maintenance agreement is replaced with a used part that has been repaired.

Although the replacement of minor parts does not usually prolong the economic useful life of most property, the replacement of most or all minor parts for some types of property may be the equivalent of rebuilding the property, particularly in cases in which the property consists almost entirely of minor parts. Therefore, the third rule provides that amounts paid that restore a unit of property (or a major component or substantial structural part of the unit of property) to a like-new condition substantially prolong the useful life. The IRS and Treasury Department intend that this test be applied to situations in which the property undergoes the equivalent of being rebuilt. Merely reconditioning a property by dismantling the property, and cleaning and inspecting components, is not the equivalent of rebuilding. All or almost all major and minor parts of the unit of property (or the major component or substantial structural part of the unit of property) must be returned to the original manufacturers' specifications.

The fourth rule relates to the restoration of a unit of property after the taxpayer has properly deducted a casualty loss under section 165 with respect to the property. Section 165(a) allows a taxpayer to deduct any loss sustained during the taxable year and not compensated for by insurance or otherwise. Generally, any loss arising from a fire, storm, shipwreck, or other casualty is allowable as a deduction under section 165(a). Section 1.165–7(a)(1). The amount of the deduction is the difference between the fair market value of the property before and after the casualty, to the extent the amount does not exceed the property's adjusted basis. Section 1.165–7(b)(1). A casualty loss deduction under section 165(a) results in a decrease in the taxpayer's basis in the property.

The courts have distinguished between losses that are deductible as casualties under section 165(a) and incidental repair costs that are deductible under section 162(a) as ordinary and necessary business expenses. In general, if property is lost, destroyed, or abandoned as a result of a casualty, a loss deduction under section 165(a) is appropriate; however, if property is simply damaged in a casualty and expenditures are made to repair the property in a manner that does not permanently improve or better it or prolong its useful life, those expenditures are business expenses deductible under section 162(a). *Hensler* v. *Commissioner*, 73 T.C. 168, 179 (1979); *see* also *Hubinger* v. *Commissioner*, 36 F.2d 724, 726 (2d Cir. 1929) (expenses resulting from ''trifling accidental causes'' are deductible only under section 162(a) and not under section 165(a)); *Atlantic Greyhound Corp.* v. *United States*, 111 F. Supp. 953 (1953) (''the provisions for deductions of 'ordinary and necessary expenses' and 'casualty losses' would seem to be mutually exclusive, for the normal connotation of one negates, at least by implication, the idea of the other''). Thus, the mere fact that the damage results from a casualty is not controlling; instead, the nature of the damage resulting from the casualty is relevant in determining whether the expenditure should be treated as a loss or deduction.

The IRS and Treasury Department believe that when a taxpayer properly deducts a casualty loss, the nature of the damage resulting from the casualty is such that any repairs done to restore the property after the casualty should not be treated as ordinary and necessary repair costs. Thus, the proposed regulations provide that any amounts paid to repair property after a casualty loss must be capitalized.

Commentators stated that amounts paid at any point during the property's economic useful life that do not change the function, design, *etc.,* but enable property to be used for its expected useful life should not be determined to extend the useful life. The IRS and Treasury Department believe that there are circumstances in which amounts paid that merely restore property to a former good condition may properly be capitalized as substantially prolonging useful life, for example, when repairs are made to property after a casualty loss. As another example, work performed at the end of the economic useful life of the unit of property may extend the property's useful life. Additionally, replacement of a major component or a substantial structural part of a unit of property extends the useful life, particularly when the expected life of the component is coterminous with the economic useful life of the unit of property, and the economic useful life of the unit of property is in fact limited by the period over which the component is expected to be useful. Thus, the proposed regulations do not adopt the commentators' suggestion.

VIII. Repair Allowance Method

A. In General

The primary focus of the proposed regulations is to provide guidance that distinguishes deductible repair expenses from capital expenditures. However, because this remains inherently a facts-and-circumstances based determination, the IRS and Treasury Department requested comments in Notice 2004–6 on whether the regulations should provide a repair allowance. Six commentators suggested the regulations should provide a repair allowance or other *de minimis* rules for repair expenditures. Two commentators specifically proposed a repair allowance system modeled on the former CLADR repair allowance system. The proposed regulations adopt these suggestions and provide an optional repair allowance method, similar to the CLADR repair allowance, to create objective rules in this area. Although some commentators additionally requested other *de minimis* rules for repair expenditures as well, the IRS and Treasury Department believe that a repair allowance is an appropriate safe harbor for repair expenditures. Therefore, the proposed regulations do not provide a safe harbor other than the repair allowance.

Under the repair allowance in the proposed regulations, the taxpayer compares the amounts paid for materials and labor during the taxable year to repair, maintain, or improve repair allowance property to the repair allowance amount. The amounts paid are deductible under section 162 to the extent of the repair allowance amount, and any excess amounts paid are capitalized. Under the proposed repair allowance method, a repair allowance amount is determined separately for each MACRS class. The repair allowance amount for a particular class is determined by multiplying the repair allowance percentage in effect for that class by the average unadjusted basis of repair allowance property in that class. For buildings that are repair allowance property, the repair allowance method is applied separately to each building. This rule is consistent with the rule for buildings under the CLADR repair allowance system.

B. Capitalized Amount

The excess of amounts paid to repair, maintain, or improve all the repair allowance property in a MACRS class over the repair allowance amount for the class must be capitalized (the capitalized amount). The capitalized amount includes the taxpayer's direct costs of repairing, maintaining, or improving repair allowance property in a particular MACRS class. In addition, the taxpayer must add to the capitalized amount any allocable indirect costs of producing the repair allowance property in the MACRS class, which must be capitalized in accordance with the taxpayer's method of accounting for section 263A costs. Except with regard to repair allowance property that is depreciated under section 168(g) or repair allowance property that is public utility property (for which separate rules are provided), the proposed regulations permit taxpayers to choose one of two methods of treating the capitalized amount. The first method is to treat the capitalized amount as a separate single asset and to depreciate the asset in accordance with that MACRS class. The second method is to allocate the capitalized amount for a particular MACRS class to all repair allowance property in the particular MACRS class in proportion to the unadjusted basis of the property in that MACRS class as of the beginning of the taxable year. Under either the single asset method or the allocation method, the capitalized amount is treated as a section 168(i)(6) improvement and is treated as placed in service by the taxpayer on the last day of the first half of the taxable year in which the amount is paid, before application of the convention under section 168(d). For example, the capitalized amount for a calendar year taxpayer would be treated as placed in service on June 30 of the taxable year.

Because the single asset treatment does not permit taxpayers to recognize a gain or loss on the disposition of repair allowance property, the IRS and Treasury Department request comments on whether, in the final regulations, taxpayers should be permitted to change to the allocation treatment for the taxable year of disposition and if so, what record keeping rules or other rules should be required for taxpayers to make that change. With regard to the allocation treatment, the IRS and Treasury Department request comments on whether the allocation should be based on an amount other than the unadjusted basis as of the beginning of the taxable year, such as the unadjusted basis at the end of the taxable year or the average unadjusted basis.

C. Repair Allowance Property

Repair allowance property is defined in the proposed regulations as real or personal property subject to MACRS that is used in the taxpayer's trade or business or for the production of income. It also includes certain tangible property not otherwise subject to MACRS if the taxpayer, solely for purposes of the repair allowance method, classifies the property in the appropriate MACRS class in which the property would be included if the property were subject to MACRS. Taxpayers are not required to classify non-MACRS property (property placed in service before the effective date of section 168 and property for which the taxpayer properly elected out of section 168). Non-classified property will not be repair allowance property eligible for the repair allowance method. Certain types of property are not included in repair allowance property, including any property for which the taxpayer has elected to use the CLADR repair allowance method and property for which the taxpayer uses the method of accounting provided in Rev. Proc. 2001–46 (2001–2 C.B. 263) or Rev. Proc. 2002–65 (2002–2 C.B. 700) (both with regard to railroad track). Thus, the repair allowance in the proposed regulations does not repeal the CLADR repair allowance, nor does it prohibit taxpayers from using the repair allowance method in these regulations for repair allowance property, while continuing to use the CLADR repair allowance for other property.

D. Excluded Additions

Repair allowance property also does not include excluded additions, the cost of which must be capitalized. The CLADR repair allowance system has a similar rule. Under the CLADR repair allowance system, excluded additions are defined as any expenditures (1) that increase by 25% or more the productivity or capacity of an existing identifiable unit of property over its productivity or capacity when first acquired; (2) that modify an existing identifiable unit of property for a substantially different use; (3) for an additional identifiable unit of property or a replacement of an identifiable unit of property that was retired; (4) for a replacement of a part in or a component or portion of an existing identifiable unit of property if such part, component, or portion is for replacement of a part, component or portion which was retired in a retirement upon which gain or loss was recognized; (5) in the case of a building or other structure, for additional cubic or linear space; and (6) in the case of those units of property of pipelines, electric utilities, telephone companies, and telegraph companies consisting of lines, cables, and poles, for replacement of 5% or more of the unit of property with respect to which the replacement is made.

One commentator suggested that the proposed regulations should not have excluded additions similar to those in the CLADR repair allowance because they are too qualitative and difficult to administer. The IRS and Treasury Department agree that some of the items listed as excluded additions under the CLADR system are too subjective and do not provide the kind of objective determination the proposed repair allowance is intended to provide. For this reason, the proposed regulations limit the excluded additions to amounts paid (1) For the acquisition or production of a specific unit of property; (2) for work that ameliorates a 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; (3) for work performed prior to the date the unit of property is placed in service by the taxpayer (without regard to any applicable convention under section 168(d)); (4) that adapts the unit of property to a new or different use; or (5) that increases the cubic or square space of a building.

Thus, the proposed regulations adopt excluded additions 2, 3, and 5 in the CLADR repair allowance. These excluded additions are also listed in § 1.263(a)–3(e)(1) of the proposed regulations as factors that indicate a material increase in value. The regulations do not adopt excluded addition 1 in the CLADR repair allowance because an increase in productivity or capacity of 25% or more may be too difficult to measure. The regulations do not specifically cite excluded addition 4 from the CLADR repair allowance; however, if a part, component, or portion of a unit of property is retired in a retirement upon which gain or loss properly was recognized, the replacement of that component is a separate unit of property under § 1.263(a)–3(d)(2) of the proposed regulations and thus is addressed by excluded addition 1 of the proposed regulations. Excluded addition 6 in the CLADR repair allowance addresses network assets and was not adopted in the proposed regulations pending comments on how the final regulations should address the unit of property rules relating to network assets.

In addition to the three excluded additions that the proposed regulations carry over from the CLADR repair allowance, the excluded additions in the proposed regulations include amounts paid for work that ameliorates a pre-existing condition or defect and for work performed prior to the date the unit of property is placed in service by the taxpayer. These two excluded additions also are listed as factors in § 1.263(a)–3(e)(1) of the proposed regulations that indicate a material increase value. The IRS and Treasury Department believe that the excluded additions provided in the repair allowance in the proposed regulations are more objective than those in the CLADR regulations and are easier to verify.

E. Leased Property

Like the repair allowance under CLADR, repair allowance property does not include property leased by the taxpayer from another party. One commentator suggested that the repair allowance apply to leased property. The IRS and Treasury Department recognize that taxpayers that lease property confront the same issues as owners in distinguishing deductible repairs from capital improvements. However, the application of the repair allowance method to leased property raises several difficult issues. The IRS and Treasury Department request comments on whether the repair allowance method should be extended to leased property and, if so, how the following issues should be resolved: (1) How should the unadjusted basis of leased property be determined? Should fair market value be used instead of unadjusted basis and, if so, how and when should fair market value be determined? (2) How should the regulations be drafted to prevent abuse between related lessors and lessees? (3) How should the regulations be drafted to prevent both the lessor and lessee from using the repair allowance method for the same property? (4) How should the regulations address qualified lessee construction allowances for short-term leases under section 110? (5) What is the proper treatment of the capitalized amount for leased property under the repair allowance? (6) Should lessees be permitted to classify the leased property to a MACRS class and use one of the treatments of the capitalized amount in the proposed regulations? (7) Should the capitalized amount be allocated to individual leases and amortized over the remaining term of each lease and, if so, how should that allocation be made? (8) If the taxpayer has a number of leases with varying lease terms, should the capitalized amount be allocated to certain groups of leases and amortized over the average remaining term of the leases and if so, how should the leases be grouped? (9) Are there any other issues with regard to the application of a repair allowance to leased property that need to be addressed?

F. Network Assets

The definition of repair allowance property in the proposed regulations does not specifically exclude network assets. However, application of the repair allowance requires a determination of the appropriate unit of property, in particular with regard to identifying excluded additions. The unit of property determination with regard to network assets is not addressed in the proposed regulations and is an issue on which the IRS and Treasury Department have requested comments. Therefore, the IRS and Treasury Department anticipate that final regulations specifically will include network assets as repair allowance property if appropriate unit of property rules can be determined. If appropriate unit of property rules cannot be determined for network assets, the IRS and Treasury Department request comments on whether to develop industry-specific guidance on how the repair allowance method should apply (in particular, how excluded additions should be determined) with regard to network assets in a particular industry.

G. Repair Allowance Percentages

The repair allowance percentages under the CLADR repair allowance were determined by the Treasury Department's Office of Industrial Economics, which is no longer in existence. The percentages were published in various revenue procedures (most recently in Rev. Proc. 83–35 (1983–1 C.B. 745)), made obsolete by Rev. Proc. 87–56 (1987–2 C.B. 674) with regard to property subject to section 168, and were revised and supplemented periodically. The proposed regulations create a new repair allowance percentage for each MACRS class. These rates are based on the principle that a taxpayer will spend 50% of the property's unadjusted basis on repairs over the property's MACRS recovery period. Thus, the repair allowance percentages for a particular MACRS class in the proposed regulations were computed by: (1) Dividing 100% by the number of years in the recovery period for the MACRS class, which represents the portion of the property's unadjusted basis that is allocable to each year of the recovery period, and; (2) multiplying the result by 50%. For example, if a taxpayer has repair allowance property in a MACRS class with a 5 year recovery period, 100% divided by 5 is 20%, which represents the portion of the property's unadjusted basis that is allocable to each year of the recovery period. Multiplying the 20% amount by 50% results in a repair allowance percentage of 10% for that MACRS class.

The IRS and Treasury Department request comments on whether the repair allowance percentages should be different than those provided in the proposed regulations, whether the rates in Rev. Proc. 83–35 should be used, and whether the final regulations should permit taxpayers to choose between repair allowance percentages in Rev. Proc. 83–35 and the final regulations. The IRS and Treasury Department also request comments on whether a separate repair allowance percentage should be provided for certain types of property, such as repair allowance property subject to section 168(g) (for example, a percentage that reflects the recovery period under the alternative depreciation system in section 168(g) rather than the MACRS recovery period under section 168). Finally, the IRS and Treasury Department request comments on whether industries should be permitted to request guidance through the Industry Issue Resolution program to establish different repair allowance percentages for their particular industry.

H. Manner of Electing and Manner of Revoking Election

The proposed regulations reserve the issue of how a taxpayer will elect the repair allowance method. Two commentators suggested that taxpayers be permitted to elect the repair allowance on a year by year basis. The IRS and Treasury Department disagree with this suggestion. The repair allowance method is a method of accounting under section 446(e) and should be used consistently by taxpayers. Allowing a year by year election would complicate a taxpayer's recordkeeping and would create a burden on IRS examining agents when auditing a taxpayer's compliance with the repair allowance method. Therefore, the IRS and Treasury Department do not expect to permit a year by year election. However, even though the repair allowance method is a method of accounting under section 446(e), the IRS and Treasury Department expect to provide that taxpayers may elect the repair allowance method prospectively without having to file an application for change in accounting method and that the election be done on a cutoff basis. Procedures for electing the repair allowance method will be provided either in the final regulations or in published guidance in the Internal Revenue Bulletin.

The proposed regulations provide that the repair allowance method, if elected, must be elected for all repair allowance property. A taxpayer may revoke an election made under the repair allowance method only by obtaining the Commissioner's consent. Procedures for obtaining the Commissioner's consent to revoke an election will be provided either in the final regulations or in published guidance in the Internal Revenue Bulletin. The IRS and Treasury Department expect to provide that a taxpayer that revokes an election may not re-elect the repair allowance method for a period of at least five taxable years, beginning with the year of the revocation unless, based on a showing of unusual and compelling circumstances, consent is specifically granted by the Commissioner to re-elect the repair allowance at an earlier time. The IRS and Treasury Department request comments on the appropriateness of the five year waiting period, as well as on the circumstances that should be considered unusual and compelling so that the Commissioner would grant consent to re-elect the repair allowance prior to expiration of the five year waiting period.

I. Recordkeeping

The proposed regulations do not impose any specific recordkeeping requirements. However, under section 6001, taxpayers are required to keep books and records sufficient to establish the amounts used to compute a deduction under the repair allowance method. For example, taxpayers must maintain books and records reasonably sufficient to determine (1) The total amounts paid (other than amounts paid for excluded additions) during the taxpayer year for the repair, maintenance, or improvement of repair allowance property in the specific MACRS class; (2) the unadjusted basis of all repair allowance property in the specific MACRS class at the beginning and the end of the taxable year; (3) the repair allowance percentages used for the specific MACRS class for the taxable year; and (4) the treatment of the capitalized amounts (whether capitalized as a single asset or allocated to all repair allowance property in the specific MACRS class).

Proposed Effective Date

These regulations are proposed to apply to taxable years beginning on or after the date the final regulations are published in the **Federal Register**. The final regulations will provide rules applicable to taxpayers that seek to change a method of accounting to comply with the rules contained in the final regulations. Taxpayers may not change a method of accounting in reliance upon the rules contained in the proposed regulations until the rules are published as final regulations in the **Federal Register**.

The IRS and Treasury Department anticipate that, except as otherwise provided (for example, in the repair allowance section), the final regulations will provide that a taxpayer seeking to change to a method of accounting provided in the final regulations must follow the applicable procedures for obtaining the Commissioner's automatic consent to a change in accounting method. Generally, a change in method of accounting is made using an adjustment under section 481(a). However, the IRS and Treasury Department are concerned about the potential administrative burden on taxpayers and the IRS that may result from section 481(a) adjustments that originate many years prior to the effective date of the final regulations. The IRS and Treasury Department request comments on whether there are circumstances in which it is appropriate to permit a change in method of accounting to be made using a cut-off basis instead of a section 481(a) adjustment. Finally, the IRS and Treasury Department request comments on any additional terms and conditions for changes in methods of accounting that would be helpful to taxpayers in adopting the rules contained in these proposed regulations.

Special Analyses

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

Comments and Public Hearing

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

A public hearing has been scheduled for Tuesday, December 19, 2006, at 10 a.m., in the auditorium of the New Carrollton Federal Building, 5000 Ellin Road, Lanham, MD 20706. Due to building security procedures, visitors must enter at the main front entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by November 28, 2006. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

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

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.162–4 is revised to read as follows:

§ 1.162–4 Repairs.

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

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

§ 1.263(a)–0 Table of contents. * * *

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

* * * * *

Par. 4. Sections 1.263(a)–1 through 1.263(a)–3 are 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 in the form of a deduction for depreciation, amortization, or depletion.

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

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

(2) An amount paid to improve real or personal 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 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.

(6) 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.

(c) *Amounts paid to sell property*—(1) *In general.* Commissions and other transaction costs paid to facilitate the sale of property generally must be capitalized. However, in the case of dealers in property, amounts paid to facilitate the sale of property are treated as ordinary and necessary business expenses. 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) *Treatment of capitalized amount.* Amounts capitalized under paragraph (c)(1) of this section are treated as a reduction in the amount realized and generally are taken into account either in the taxable year in which the sale occurs or in the taxable year in which the sale is abandoned if a loss deduction is permissible. The capitalized amount is not added to the basis of the property and is not treated as an intangible under § 1.263(a)–4.

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

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

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

Example 3. Sales costs of personal property used in the trade or business. X is a farmer and owns a truck for use in X's trade or business. X decides to sell the truck and on November 15, 2008, X pays to advertise the sale of the truck in the local news media. On February 15, 2009, X sells the truck to Y. X is required to capitalize in 2008 the amount paid to advertise the sale of the truck and, in 2009, is required to offset the amount paid against the amount realized from the sale of the truck.

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, 2009, X decides on that date not to sell the truck and takes the truck off the market. X is required to capitalize in 2008 the amount paid to advertise the sale of the truck. However, X may treat the amount paid as a loss under section 165 in 2009 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 X does not use the truck in X's trade or business, but instead uses it for personal purposes. X decides to sell the truck and on November 15, 2008, X pays to advertise the sale of the truck in the local news media. On February 15, 2009, X sells the truck to Y. X is required to capitalize in 2008 the amount paid to advertise the sale of the truck and, in 2009, is required to offset the amount paid against the amount realized from the sale of the truck.

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

(d) *Amount paid.* For purposes of this section, the terms *amounts paid* and *payment* mean, in the case of a taxpayer using an accrual method of accounting, 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.

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

(f) *Accounting method changes.* [Reserved]

§ 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 real or personal property. See § 1.263(a)–3 for the treatment of amounts paid to improve tangible property, § 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 an acquisition of a trade or business, a change in capital structure of a business entity, and certain other transactions.

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

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

(4) *Produce. Produce* means construct, build, install, manufacture, develop, create, raise, or grow. See § 1.263(a)–3 for capitalization rules applicable to amounts paid to improve property.

(c) *Coordination with other provisions of the Internal Revenue Code*—(1) *In general.* Nothing in this section changes the treatment of any amount that is specifically provided for under any provision of the Internal Revenue Code or regulations other than section 162(a) or section 212 and the regulations under those sections.

(2) *Materials and supplies.* Nothing in this section changes the treatment of amounts paid for materials and supplies that are properly treated as deductions or deferred expenses, as appropriate, under § 1.162–3.

(d) *Acquired or produced tangible property*—(1) *In general*—(i) *Requirement of capitalization.* A taxpayer must capitalize amounts paid to acquire or produce real or personal property having a useful life substantially beyond the taxable year, including land and land improvements, buildings, machinery and equipment, and furniture and fixtures, and a unit of property (as determined under § 1.263(a)–3(d)(2)), having a useful life substantially beyond the taxable year. A taxpayer also must capitalize amounts paid to acquire real or personal property for resale and to produce real or personal property for sale. See section 263A for the scope of costs required to be capitalized to property produced by the taxpayer or to property acquired for resale.

(ii) *Examples.* The following examples illustrate the rule of this paragraph (d)(1):

Example 1. Acquisition of personal property—coordination with § 1.162–3. X, an airline, operates a fleet of aircraft. X purchases and maintains in stock for repairs to its aircraft a great number of different expendable flight equipment spare parts (including cartridges, canisters, cylinders, and disks), based in part on the manufacturer's recommendations and in part on the airline's experience. The expendable flight equipment spare parts are carried on hand by X until they are installed in the particular type of aircraft for which purchased. The expendable flight equipment spare parts are of a type normally not repaired and reused. As these parts are taken from stock and used to repair aircraft, the stock supply is replenished by X purchasing new parts. In 2008, X purchases expendable flight equipment spare parts. X properly treats the amount paid for the expendable flight equipment spare parts as a deferred expense under § 1.162–3. Nothing in this section changes the treatment of the original acquisition cost as a deferred expense.

Example 2. Acquisition of personal property—coordination with § 1.162–3. X, an industrial laundry business, leases many products, including garments, linens, shop towels, continuous roll towels, and mops (rental items). X maintains a supply of rental items on hand to replace worn or damaged items. The rental items have useful lives of 12 months or less. In 2008, X purchases a large quantity of rental items. The amount paid for the rental items is properly treated by X as a deferred expense under § 1.162–3. Nothing in this section changes the treatment of the original acquisition cost as a deferred expense.

Example 3. Acquisition of personal property. In 2008, X purchases new cash registers, which have a useful life substantially beyond the taxable year, for use in its retail store located in a leased space in a shopping mall. X must capitalize under this paragraph (d)(1) the amount paid to purchase each cash register.

Example 4. Relocation and installation of personal property. Assume the same facts as in *Example 3*, except that X's lease expires in 2009 and X decides to relocate its retail store to a different building. In addition to various other costs, X pays $5,000 to move the cash registers and $1,000 to reinstall them in the other store. X is not required to capitalize under this paragraph (d)(1) the $5,000 amount paid for moving the cash registers; however, X must capitalize under this paragraph (d)(1) the $1,000 amount paid to reinstall the cash registers in its other store because, under paragraph (b)(4) of this section, installation costs are production costs.

Example 5. Acquisition of land. X purchases a parcel of undeveloped real estate. X must capitalize under this paragraph (d)(1) the amount paid to acquire the real estate. See § 1.263(a)–2(d)(3) for the treatment of amounts paid to facilitate the acquisition of real property.

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

Example 7. Acquisition of property for resale. X purchases goods for resale. X must capitalize under this paragraph (d)(1) the amounts paid to acquire the goods. See section 263A for the treatment of amounts paid to acquire property for resale.

Example 8. Production of property for sale. X produces goods for sale. X must capitalize under this paragraph (d)(1) the amount paid to produce the goods. See section 263A for the treatment of amounts paid to produce property.

Example 9. Production of building. X constructs a building. X must capitalize under this paragraph (d)(1) the amount paid to construct the building. See section 263A for the treatment of amounts paid to produce real property.

Example 10. Acquisition of assets constituting a trade or business. Y owns tangible and intangible assets that constitute a trade or business. X purchases all the assets of Y in a taxable transaction. X must capitalize under this paragraph (d)(1) the amount paid for the tangible assets of Y. See § 1.263(a)–4 for the treatment of amounts paid to acquire intangibles and § 1.263(a)–5 for the treatment of amounts paid to facilitate the acquisition of assets that constitute a trade or business. See section 1060 for special allocation rules for certain asset acquisitions.

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

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

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

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

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

(3) *Transaction costs*—(i) *In general.* A taxpayer must capitalize amounts paid to facilitate the acquisition of real or personal property, including shipping costs, bidding costs, sales and transfer taxes, legal and accounting fees, title fees, engineering fees, survey costs, inspection costs, appraisal fees, recording fees, application fees, commissions, and compensation for the services of a qualified intermediary or other facilitator of an exchange under section 1031. See § 1.263(a)–5 for the treatment of amounts paid to facilitate the acquisition of assets that constitute a trade or business. See section 263A for the scope of costs required to be capitalized to property produced by the taxpayer or to property acquired for resale.

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

Example 1. Legal fees, taxes, and commissions to facilitate an acquisition. X purchases a building and pays legal fees, sales taxes, and sales commissions to facilitate the acquisition. X must capitalize the amounts paid for legal fees, sales taxes, and sales commissions.

Example 2. Moving costs to facilitate an acquisition. X purchases all the assets of Y and, in connection with the purchase, hires a transportation company to move storage tanks from Y's plant to X's plant. X must capitalize the amount paid to move the tanks from Y's plant to X's plant because the amount paid facilitates the acquisition of the storage tanks.

(4) *12-month rule*—(i) *In general.* Except as otherwise provided in this paragraph (d)(4), an amount paid for the acquisition or production (including any amount paid to facilitate the acquisition or production) of a unit of property (as determined under § 1.263(a)–3(d)(2)) with an economic useful life (as defined in § 1.263(a)–3(f)(2)) of 12 months or less is not a capital expenditure under paragraph (d) of this section.

(ii) *Coordination with section 461.* In the case of a taxpayer using an accrual method of accounting, the rules of this paragraph (d)(4) do not affect the determination of whether a liability is incurred during the taxable year, including the determination of whether economic performance has occurred with respect to the liability. See § 1.461–4 for rules relating to economic performance.

(iii) *Exceptions to 12-month rule.* The 12-month rule in paragraph (d)(4)(i) of this section does not apply to the following:

(A) Amounts paid for property that is or will be included in property produced for sale or property acquired for resale;

(B) Amounts paid to improve property under § 1.263(a)–3;

(C) Amounts paid for land; and

(D) Amounts paid for any component of a unit of property.

(iv) *Character of property subject to 12-month rule.* Property to which a taxpayer applies the 12-month rule contained in paragraph (d)(4)(i) of this section is not treated upon sale or disposition as a capital asset under section 1221 or as property used in the trade or business under section 1231.

(v) *Election to capitalize.* A taxpayer may elect not to apply the 12-month rule contained in paragraph (d)(4)(i) of this section with regard to a unit of property. An election made under this paragraph (d)(4)(v) applies to any unit of property during the taxable year to which paragraph (d)(4)(i) of this section would apply (but for the election under this paragraph (d)(4)(v)). A taxpayer makes the election by treating the amount paid as a capital expenditure in its timely filed original Federal income tax return (including extensions) for the taxable year in which the amount is paid. In the case of a pass-through entity, the election is made by the pass-through entity, and not by the shareholders, partners, etc. An election may not be made through the filing of an application for change in accounting method or by an amended Federal income tax return and an election may not be revoked.

(vi) *Examples.* The rules of this paragraph (d)(4) are illustrated by the following examples, in which it is assumed (unless otherwise stated) that the taxpayer is a calendar year, accrual method taxpayer that has not elected out of the 12-month rule under paragraph (d)(4)(v) of this section with regard to the unit of property, and that none of the property is materials and supplies under § 1.162–3:

Example 1. Production cost. X corporation manufactures and sells aluminum storm windows and doors. To conduct its business, X purchases strips of aluminum called extrusions and applies paint electrostatically to the extrusions through a complex process. In 2008, X installs a leaching pit to provide a draining area for liquid waste produced in the process of painting the extrusions. X previously had dumped this waste into a creek bed, but the local water department ordered it to cease this practice. The economic useful life of the leaching pit is 12 months, after which time the factory will be connected to the local sewer system. Assume that the leaching pit is the unit of property, as determined under § 1.263(a)–3(d)(2). X is not required to capitalize under paragraph (d) of this section the amount paid to produce the leaching pit because the useful life of the leaching pit is 12 months or less. However, under section 263A, all indirect costs, including otherwise deductible costs, that directly benefit or are incurred by reason of the taxpayer's manufacturing activities must be capitalized to the property produced for sale. Therefore, because the amounts paid for the leaching pit are incurred by reason of X's manufacturing operations, the amounts paid must be capitalized under section 263A to the property produced for sale by X.

Example 2. Acquisition or production cost. X purchases or produces jigs, dies, molds, and patterns for use in the manufacture of motor vehicles and motor vehicle parts. The economic useful life of the jigs, dies, molds, and patterns is 12 months. Assume each jig, die, mold, and pattern is a separate unit of property, as determined under § 1.263(a)–3(d)(2). X is not required to capitalize under paragraph (d) of this section the amounts paid to produce or purchase the jigs, dies, molds, and patterns because the economic useful life is 12 months or less. However, under section 263A, all indirect costs, including otherwise deductible costs, that directly benefit or are incurred by reason of the taxpayer's manufacturing activities must be capitalized to the property produced for sale. Therefore, because the amounts paid for the jigs, dies, molds, and patterns are incurred by reason of X's manufacturing operations, the amounts paid must be capitalized under section 263A to the property produced for sale by X.

Example 3. Acquisition or production cost. Assume the same facts as in *Example 2,* but the economic useful life of the jigs, dies, molds, and patterns is 3 years. X is required to capitalize under paragraph (d) of this section the amounts paid to produce or purchase the jigs, dies, molds, and patterns because the economic useful life is more than 12 months.

Example 4. Acquisition cost. X corporation is an interstate motor carrier. On December 1, 2008, X purchases, pays for, and takes delivery of truck tires with an economic useful life of 12 months. Assume X does not use the original tire capitalization method described in Rev. Proc. 2002–27 (2002–1 C.B. 802) (see § 601.601(d)(2) of this chapter). Also assume that each tire is a separate unit of property, as determined under § 1.263(a)–3(d)(2). X is not required under paragraph (d) of this section to capitalize the amount paid for the tires because the economic useful life of the tires is 12 months or less.

Example 5. Transaction costs. Assume the same facts as in *Example 4*, but in addition to the amount paid for the tires, X also pays sales tax and delivery charges for the tires. X is not required to capitalize under paragraph (d) of this section the sales tax and delivery charges because they were paid to facilitate the acquisition of property with an economic useful life of 12 months or less.

Example 6. Coordination with section 461 fixed liability rule. Assume the same facts as in *Example 4,* except that instead of purchasing the tires on December 1, 2008, X enters into a contract with the tire manufacturer on that date to purchase tires from the manufacturer in 2009. X purchases, pays for, and takes delivery of the tires on March 31, 2009. X does not incur a liability under section 461 for the tires in 2008 because X does not have a fixed liability with respect to the tires until 2009. When X incurs the amount in 2009, X is not required under paragraph (d) of this section to capitalize that amount.

Example 7. Coordination with section 461 economic performance rule. Assume the same facts as in *Example 4,* except that the tires are not delivered to X until March 31, 2009. X does not incur a liability under section 461 for the tires in 2008 because economic performance does not occur with respect to the liability until the property is provided to X in 2009. See § 1.461–4(d)(2). When X incurs the amount in 2009, X is not required under paragraph (d) of this section to capitalize that amount.

Example 8. Election not to capitalize. Assume the same facts as in *Example 4,* except that X elects under paragraph (d)(4)(v) of this section not to apply the 12-month rule contained in paragraph (d)(4)(i) of this section to the tires purchased on December 1, 2008. X must capitalize under paragraph (d) of this section the amount paid for the tires.

Example 9. Exception to 12-month rule ‘‘ property acquired for resale. Assume the same facts as in *Example 4,* except that X purchases the tires for resale. The 12-month rule in paragraph (d)(4)(i) of this section does not apply because the tires are property acquired for resale. Thus, X is required under paragraph (d) of this section to capitalize the amount paid for the tires.

Example 10. Exception to 12-month rule—component of property. Assume the same facts as in *Example 4,* except that the tires are the first set of tires to be installed on a truck tractor acquired by X and X uses the original tire capitalization method described in Rev. Proc. 2002–27 (see § 601.601(d)(2) of this chapter) so that the truck tractor (including the tires) is the unit of property, as determined under § 1.263(a)–3(d)(2). Also assume that the truck tractor has an economic useful life of more than 12 months and that the invoice for the acquisition of the truck tractor separately states the cost of tires and various other components of the truck tractor. X is required under paragraph (d) of this section to capitalize the amount paid for the truck tractor because the economic useful life of the truck tractor is more than 12 months. Further, X may not use the 12-month rule to currently deduct the amount paid for the tires or any other component of the truck tractor, regardless that some components may have an economic useful life of 12 months or less and regardless that the cost of individual components is separately stated in the invoice.

(e) *Treatment of capital expenditures.* Amounts required to be capitalized under this section are capital expenditures and must be taken into account through a charge to capital account or basis, or in the case of property that is inventory in the hands of a taxpayer, through inclusion in inventory costs. See section 263A for the treatment of amounts referred to in this section as well as other amounts paid in connection with the production of real property and personal property, including films, sound recordings, video tapes, books, or similar properties.

(f) *Recovery of capitalized amounts*—(1) *In general.* Amounts that are capitalized under this section are recovered through depreciation, cost of goods sold, or by an adjustment to basis at the time the property is placed in service, sold, used, or otherwise disposed of by the taxpayer. Cost recovery is determined by the applicable Internal Revenue Code and regulation provisions relating to the use, sale, or disposition of property. For example, §§ 1.162–4 and 1.263(a)–3 determine whether amounts capitalized under this section § 1.263(a)–2 for property that is used to replace a component of a unit of property are repair or maintenance expenses or capitalized as an improvement to the unit of property.

(2) *Examples.* The following examples illustrate the rule of this paragraph (f)(1) and assume that the taxpayer does not treat the acquired property as materials and supplies under § 1.162–3:

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 the refrigerator is the unit of property, as determined under § 1.263(a)–3(d)(2). Section 1.263(a)–2(d) requires capitalization of amounts paid for the acquisition, delivery, and installation of the refrigerator. Under this paragraph (f), the capitalized amounts are recovered through depreciation when the refrigerator is placed in service by X.

Example 2. Recovery when property used in a repair. Assume the same facts as in *Example 1,* except that a window in one of the apartments needs to be replaced. X pays for the acquisition, delivery, and installation of a new window. Assume the window is a structural component of the apartment building and that the apartment building is the unit of property, as determined under § 1.263(a)–3(d)(2). Section 1.263(a)–2(d) requires capitalization of amounts paid for the acquisition and delivery of the window because the window is property with a useful life substantially beyond the end of the taxable year. Assume the replacement of the old window with the new one does not improve the apartment building under § 1.263(a)–3. Under this paragraph (f), the capitalized amounts paid to acquire the window are recovered as ordinary and necessary repair expenses under § 1.162–4 when the window is used in the repair by its installation in the apartment building.

Example 3. Recovery when property used in a repair; coordination with section 263A. Assume the same facts as in *Example 2,* except that the window that is replaced is in an office in a plant where X manufactures widgets for sale. Section 1.263(a)–2(d) requires capitalization of amounts paid to produce inventory. Under section 263A, all indirect costs, including otherwise deductible repair costs that directly benefit or are incurred by reason of the production of inventory must be capitalized to the inventory produced. Although the repair cost otherwise would be deductible as an expense under § 1.162–4, X must determine whether the cost of the repair, or an allocable portion thereof, is required to be capitalized to the inventory produced as an indirect expense that directly benefits or is incurred by reason of the production activities. Any portion of the repair capitalized to inventory is recovered through cost of goods at the time the property is sold or otherwise disposed of in accordance with the taxpayer's method of accounting for inventories.

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

(h) *Accounting method changes.* [Reserved]

§ 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 contains definitions. Paragraph (c) of this section contains rules for coordinating this section with other provisions of the Internal Revenue Code. Paragraph (d) of this section provides rules for determining the treatment of amounts paid to improve tangible property, including rules for determining the appropriate unit of property. Paragraph (e) of this section contains rules for determining whether amounts paid materially increase the value of the unit of property. Paragraph (f) of this section contains rules for determining whether amounts paid restore the unit of property. Paragraph (g) of this section describes an optional repair allowance method.

(b) *Definitions.* For purposes 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. Personal property* means tangible personal property as defined in § 1.48–1(c).

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

(c) *Coordination with other provisions of the Internal Revenue Code*—(1) *In general.* Nothing in this section changes the treatment of any amount that is specifically provided for under any provision of the Internal Revenue Code or regulations (other than section 162(a) or section 212 and the regulations under those sections).

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

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

(d) *Improved property*—(1) *Capitalization rule.* Except as provided in the repair allowance method in paragraph (g) of this section, a taxpayer must capitalize the aggregate of related amounts paid to improve a unit of property (including a unit of property for which the acquisition or production costs were deducted under the 12-month rule in § 1.263(a)–2(d)(4)), whether the improvements are made by the taxpayer or by a third party. See section 263A for the scope of costs required to be capitalized to property produced by the taxpayer or to property acquired for resale; section 1016 for adding capitalized amounts to the basis of the unit of property; and section 168(i)(6) for the treatment of additions or improvements to a unit of property. For purposes of this paragraph (d), a unit of property is improved if the amounts paid—

(i) Materially increase the value of the unit of property (see paragraph (e) of this section); or

(ii) Restore the unit of property (see paragraph (f) of this section).

(2) *Determining the appropriate unit of property*—(i) *In general.* The unit of property rules in this paragraph (d)(2) apply only for purposes of section 263(a) and §§ 1.263(a)–1, 1.263(a)–2, and 1.263(a)–3, and not any other Internal Revenue Code or regulation section. Under this paragraph (d)(2), the appropriate unit of property is initially determined by applying the rules in paragraph (d)(2)(ii) of this section, except as provided in paragraph (d)(2)(iv) of this section (relating to buildings and structural components). The initial unit of property determination is further analyzed in accordance with the appropriate hierarchical category described in one of paragraphs (d)(2)(iii) through (d)(2)(vi) of this section and by applying the additional rule in paragraph (d)(2)(vii) of this section. The specific rules contained in paragraphs (d)(2)(iii) through (d)(2)(vii) of this section dictate whether one or more components of the initial unit of property determination must be treated as separate units of property.

This paragraph (d)(2) applies to all real and personal property, other than network assets. For purposes of this paragraph (d)(2), *network assets* means railroad track, oil and gas pipelines, water and sewage pipelines, power transmission and distribution lines, and telephone and cable lines that are owned or leased by taxpayers in each of those respective industries. The term includes, for example, trunk and feeder lines, pole lines, and buried conduit. It does not include property that would be included as a structural component of a building under paragraph (d)(2)(iv), nor does it include separate property that is adjacent to, but not part of a network asset, such as bridges, culverts, or tunnels.

(ii) *Initial unit of property determination.* Except for property described in paragraph (d)(2)(iv) of this section (regarding buildings and structural components), the unit of property determination under this paragraph (d)(2) begins by identifying property that consists entirely of components that are functionally interdependent. 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. For purposes of this section, property that is aggregated and subject to a general asset account election may not be treated as a single unit of property.

(iii) *Category I: Taxpayers in regulated industries.* In the case of a taxpayer engaged in a trade or business in a regulated industry, the unit of property is the USOA (uniform system of accounts) unit of property. For purposes of this section, a regulated industry is an industry for which a Federal regulator (including any Federal department, agency, commission, board, or similar entity) has a USOA identifying a particular unit of property (USOA unit of property). This rule applies to any taxpayer engaged in a trade or business in the regulated industry, regardless of whether the taxpayer is subject to the regulatory accounting rules of the Federal regulator. The unit of property determination made under this paragraph (d)(2)(iii) is subject to paragraph (d)(2)(vii) of this section, which may require one or more components to be treated as separate units of property.

(iv) *Category II: Buildings and structural components.* In the case of a building (as defined in § 1.48–1(e)(1)) other than that described in paragraph (d)(2)(iii) of this section, the building and its structural components (as defined in § 1.48–1(e)(2)) are a single unit of property. The unit of property determination made under this paragraph (d)(2)(iv) is subject to paragraph (d)(2)(vii) of this section, which may require one or more components to be treated as separate units of property.

(v) *Category III: Other personal property.* In the case of personal property other than that described in paragraph (d)(2)(iii) of this section, the unit of property determination must be made on the basis of the four factors listed in this paragraph (d)(2)(v). These four factors are the exclusive factors under this paragraph (d)(2)(v). No one factor is determinative and it is not intended that a determination be made on the basis of the number of factors indicating that a component is, or is not, a separate unit of property. The unit of property determination made under this paragraph (d)(2)(v) is subject to paragraph (d)(2)(vii) of this section, which may require one or more components to be treated as separate units of property. The following factors must be taken into account:

(A) Whether the component is—

(*1*) Marketed separately to the taxpayer by a party other than the seller/lessor of the property of which the component is a part at the time the property is initially acquired or leased;

(*2*) Acquired or leased separately by the taxpayer from a party other than the seller/lessor of the property of which the component is a part at the time the property is initially acquired or leased;

(*3*) Subject to a separate warranty contract (from a party other than the seller/lessor of the property of which the component is a part);

(*4*) Subject to a separate maintenance manual or written maintenance policy;

(*5*) Appraised separately; or

(*6*) Sold or leased separately by the taxpayer to another party;

(B) Whether the component is treated as a separate unit of property in industry practice or by the taxpayer in its books and records;

(C) Whether the taxpayer treats the component as a rotable part (a part that is removable from property, repaired or improved, and either immediately reinstalled on other property or stored for later installation); and

(D) Whether the property of which the component is a part generally functions for its intended use without the component property.

(vi) *Category IV: Other real property.* In the case of real property other than that described in paragraphs (d)(2)(iii) and (d)(2)(iv) of this section, the unit of property determination must be made on the basis of all the facts and circumstances. The unit of property determination made under this paragraph (d)(2)(vi) is subject to paragraph (d)(2)(vii) of this section, which may require one or more components to be treated as separate units of property.

(vii) *Additional rule.* If the taxpayer properly treats a component as a separate unit of property for any Federal income tax purpose, the taxpayer must treat the component as a separate unit of property for purposes of this paragraph (d)(2). For purposes of paragraph (d)(2), the term *any Federal income tax purpose* includes, but is not limited to, the use of different placed-in-service dates (other than the use of a new placed-in-service date for an improvement (as determined under this section) to the unit of property or a different placed-in-service date for a particular floor of a building) or different classes of property as set forth in section 168(e) (MACRS classes), for the component and the property of which the component is a part. If the taxpayer properly recognizes a loss under section 165, or under another applicable provision, from a retirement of a component of property or from the worthlessness or abandonment of a component of property, the taxpayer must treat the component as a separate unit of property for purposes of this paragraph (d)(2). Therefore, any property that replaces the component also will be treated as a separate unit of property. See § 1.263(a)–2(d)(1). For purposes of this paragraph (d)(2), merely claiming a tax credit related to tangible property does not constitute treatment of that property as a separate unit of property for a Federal income tax purpose.

(viii) *Examples.* The rules of this paragraph (d)(2) are illustrated by the following examples, in which it is assumed (unless otherwise stated) that the taxpayer has not made a general asset account election with regard to the property and that paragraph (d)(2)(vii) of this section does not require the use of a different unit of property:

Example 1. Category I. X is an electric utility company that operates a power plant to generate electricity. X's operation previously was regulated by the Federal Energy Regulatory Commission (FERC) but, for various reasons, is no longer subject to regulation by FERC. Under FERC's USOA, each turbine, economizer, generator, and pulverizer is treated as a separate unit of property for regulatory accounting purposes. The initial unit of property determined under paragraph (d)(2)(ii) of this section is the entire power plant, which consists entirely of components that are functionally interdependent. The power plant must next be analyzed under paragraph (d)(2)(iii) of this section because X is engaged in a trade or business in an industry for which a Federal regulator has a USOA. Under the rules in that paragraph, X must treat each turbine, economizer, generator, and pulverizer as a separate unit of property for determining whether an amount paid improves the unit of property for Federal income tax purposes.

Example 2. Category I. X is a Class I railroad. All Class I railroads are regulated by the Surface Transportation Board (STB). Under STB's USOA, each locomotive and each freight car is treated as a separate unit of property for regulatory accounting purposes. Although each locomotive consists of various components, such as an engine, generators, batteries, trucks, etc., those components are functionally interdependent. Thus, the locomotive is an initial unit of property as determined under paragraph (d)(2)(ii) of this section. Similarly, each freight car consists entirely of functionally interdependent components and, thus, each freight car is an initial unit of property under paragraph (d)(2)(ii) of this section. Each locomotive and freight car must next be analyzed under paragraph (d)(2)(iii) of this section because X is engaged in a trade or business in an industry for which a Federal regulator has a USOA. Under the rules in that paragraph, X must treat each locomotive and each freight car as a separate unit of property for determining whether an amount paid improves the unit of property for Federal income tax purposes.

Example 3. Category I. Assume the same facts as in Example 2, except that X is a Class II railroad. The STB does not regulate Class II railroads. However, because X is engaged in a trade or business in an industry (the railroad industry) for which a Federal regulator has a USOA, the rules in paragraph (d)(2)(iii) of this section apply, regardless of whether X is subject to those rules. Based on these facts, X must treat each locomotive and each freight car as a separate unit of property for determining whether an amount paid improves the unit of property for Federal income tax purposes.

Example 4. Category I. X is a telecommunications company regulated by the Federal Communications Commission (FCC) and subject to a USOA for telephone companies. The assets of X include a telephone central office switching center, which contains numerous switches and various other switching equipment that all work together to provide telephone service to customers. The initial unit of property determined under paragraph (d)(2)(ii) of this section is the central office switching center, which consists entirely of components that are functionally interdependent. The telecommunications system must next be analyzed under paragraph (d)(2)(iii) of this section because X is engaged in a trade or business in an industry for which a Federal regulator has a USOA. Under the rules in that paragraph, X must treat each switch and/or piece of equipment as defined in the USOA of the FCC and used in the central office operation as a separate unit of property for determining whether an amount paid improves the unit of property for Federal income tax purposes.

Example 5. Category II. X owns a manufacturing building containing various types of manufacturing equipment that are not structural components of the manufacturing building. Because the property is a building, as defined in § 1.48–1(e)(1), paragraph (d)(2)(ii) of this section does not apply and the property must be analyzed under paragraph (d)(2)(iv) of this section. Under the rules in that paragraph, X must treat the manufacturing building and its structural components as a single unit of property for determining whether an amount paid improves the unit of property for Federal income tax purposes. The appropriate unit of property determination for the manufacturing equipment must be made separately under paragraph (d)(2)(v) of this section.

Example 6. Category III; additional rule. Assume the same facts as in *Example 5,* except that X does a cost segregation study of the manufacturing building and properly determines that refrigeration equipment used to create a walk-in freezer in the manufacturing building is section 1245 property as defined in section 1245(a)(3). The refrigeration equipment is not part of the HVAC system that relates to the general operation or maintenance of the building. For Federal income tax purposes, X properly treats the refrigeration equipment as a separate unit of property for depreciation purposes. The rules of paragraph (d)(2)(v) of this section apply to determine whether the refrigeration equipment, or some smaller component, is the appropriate unit of property. In this example, assume that no components of the refrigeration equipment meet any of the facts and circumstances listed in paragraph (d)(2)(v) of this section. Based on these facts, X must treat the refrigeration equipment as the unit of property for determining whether an amount paid improves the unit of property for Federal income tax purposes.

Example 7. Category III; additional rule. Assume the same facts as in *Example 6,* except that the refrigeration equipment for the walk-in freezer ceases to function. X decides not to repair the refrigeration equipment, but to replace it altogether. X abandons the refrigeration equipment for the walk-in freezer and properly recognizes a loss under section 165 from the abandonment of the refrigeration equipment. Therefore, X must treat the refrigeration equipment for the walk-in freezer as a separate unit of property for determining whether amounts paid to replace the equipment must be capitalized for Federal income tax purposes. See § 1.263(a)–2(d)(1).

Example 8. Category III. (i) X is a commercial airline engaged in the business of transporting passengers and freight throughout the United States and abroad. To conduct its business, X owns or leases various types of aircraft. X purchases the aircraft engine separately at the time the aircraft is acquired. The engine is subject to a separate warranty and written maintenance policy provided by the engine manufacturer. For financial accounting purposes, X accounts for each type of aircraft by maintaining separate accounts on its books for each type of airframe and engine in its fleet. To perform maintenance on an engine, X removes the engine from the aircraft and replaces it with another used engine that has returned from a maintenance visit.

(ii) The initial unit of property determined under paragraph (d)(2)(ii) of this section is the aircraft (and not the entire fleet of aircraft), which consists entirely of components that are functionally interdependent. The aircraft must next be analyzed under one of paragraphs (d)(2)(iii) through (d)(2)(vi) of this section. Although X is engaged in a trade or business in an industry regulated by the Federal Aviation Administration (FAA), the FAA does not have a USOA. Therefore, the rules of paragraph (d)(2)(iii) of this section do not apply to X; instead, the rules of paragraph (d)(2)(v) of this section apply to determine whether the entire aircraft, or the engine, is the appropriate unit of property. In this *Example 8,* the aircraft engine is acquired separately, is subject to a separate warranty and maintenance policy, is treated separately for financial accounting purposes, and is rotable. Based on these facts, X must treat the engine as the unit of property for determining whether an amount paid improves the engine for Federal income tax purposes. X must treat the aircraft without the engine as a unit of property for determining whether an amount paid improves the aircraft for Federal income tax purposes.

Example 9. Category III. X is a corporation that owns a small aircraft for use in its trade or business. X performs required maintenance on its aircraft engines. The aircraft engine is not marketed, purchased, leased, appraised, or sold separately, but it is subject to a separate warranty and written maintenance policy provided by the engine manufacturer. For financial accounting purposes, X does not maintain separate accounts on its books for individual engines. X does not treat the engine as a rotable part. The initial unit of property determined under paragraph (d)(2)(ii) of this section is the aircraft, which consists entirely of components that are functionally interdependent. The aircraft must next be analyzed under paragraph (d)(2)(v) of this section to determine whether the entire aircraft, or the engine, is the appropriate unit of property. Based on these facts, the engine is not a separate unit of property. Therefore, X must treat the aircraft, including the aircraft engine, as the unit of property for determining whether an amount paid improves the unit of property for Federal income tax purposes.

Example 10. Category III. X is a towboat operator that owns and leases a fleet of towboats. X performs maintenance on its towboat engines every 3 to 4 years, in accordance with the engine manufacturer's maintenance manuals. Towboat engines are not marketed, purchased, leased, appraised, or sold separately; however, the engines are subject to a separate warranty and written maintenance policy provided by the engine manufacturer. For financial accounting purposes, X does not maintain separate accounts on its books for individual engines. X does not treat the engine as a rotable part. The initial unit of property determined under paragraph (d)(2)(ii) of this section is the towboat (and not the entire fleet of towboats), which consists entirely of components that are functionally interdependent. The towboat must next be analyzed under paragraph (d)(2)(v) of this section. Based on these facts, the engine is not a separate unit of property. Therefore, X must treat the towboat, including the towboat engine, as the unit of property for determining whether an amount paid improves the unit of property for Federal income tax purposes.

Example 11. Category III. X purchases a car to use in X's taxi service. The invoice received by X for the purchase of the car separately lists several options, including air conditioning, automatic transmission, antilock braking system, side impact air bags, power group, and special alloy wheels. Under paragraph (d)(2)(ii) of this section, the initial unit of property is the car because the options are functionally interdependent with the car. The options are not subject to separate warranties. X is an individual and does not keep books and records other than for tax purposes. For depreciation purposes, X properly treats the car and options as one unit of property. X does not treat any of the options as rotable parts. Based on these facts, the options are not separate units of property. X must treat the car, including the options, as the unit of property for determining whether an amount paid improves the unit of property for Federal income tax purposes.

Example 12. Category III. X is a common carrier that owns a fleet of fuel hauling trucks and periodically performs maintenance on its truck engines. The entire fleet of trucks is subject to a general asset account election, one for the truck trailers and one for the truck tractors. Under paragraph (d)(2)(ii) of this section, X may not treat the entire fleet as the unit of property. Instead, the initial units of property determined under paragraph (d)(2)(ii) of this section are each truck tractor and each truck trailer. Each tractor consists entirely of functionally interdependent components and each trailer consists entirely of functionally interdependent components. To determine whether the engine is a separate unit of property from the tractor, the factors in paragraph (d)(2)(v) of this section apply. The engines are marketed separately from the tractor and are subject to a separate warranty and written maintenance policy provided by the engine manufacturer. The engines are not treated as a separate unit of property in industry practice or by X in its books and records. The engine is removed from the tractor, repaired or improved, and stored for later installation on another tractor. Based on these facts, the engine is a separate unit of property. Therefore, X must treat the engine as the unit of property for determining whether an amount paid improves the unit of property for Federal income tax purposes.

Example 13. Category III. Assume the same facts as in *Example 12*, except that the inquiry is whether the oil filter in the tractor engine is a separate unit of property. The oil filter is not marketed, acquired, leased, appraised, or sold separately, nor is it subject to a separate warranty or maintenance manual. The filter is not treated as a separate unit of property in industry practice or by X in its books and records, nor is it treated as a rotable part. Based on these facts, the oil filter is not a separate unit of property. Therefore, X must treat the engine, including the oil filter, as the unit of property for determining whether an amount paid improves the unit of property for Federal income tax purposes.

Example 14. Category III. (i) X manufactures and sells computers and computer equipment. It also operates a separate computer maintenance business, for which X maintains pools of rotable spare parts that are primarily used to repair computer equipment purchased or leased by its customers. Most of X's computer maintenance business is conducted pursuant to standardized maintenance agreements that obligate X to provide all parts and labor, product upgrades, preventive maintenance, and telephone assistance necessary to keep a customer's computer operational for the duration of the contract (usually one year) in exchange for a predetermined fee. In its computer maintenance business, X sends technicians to its customer's location, who use the supply of rotable spare parts to diagnose problems in the customer's equipment, and then exchange the working parts for any malfunctioning parts. A customer's part that is identified as the cause of the malfunction is replaced with the identical functioning part from X's rotable spare parts pool. The malfunctioning part removed from the customer's equipment is then repaired and placed in X's rotable spare parts pool for continued use in the computer maintenance business.

(ii) Under paragraph (d)(2)(ii) of this section, X may not treat the entire pool of rotable spare parts as the unit of property. Instead, the initial unit of property determined under paragraph (d)(2)(ii) of this section is each rotable spare part because each part consists entirely of functionally interdependent components. Assume for purposes of this *Example 14* that paragraph (d)(2)(v) of this section does not require any components of the rotable spare parts to be treated as separate units of property. Based on these facts, the entire pool of spare parts is not the unit of property. Therefore, X must treat each rotable spare part as a unit of property for determining whether an amount paid improves the unit of property for Federal income tax purposes.

Example 15. Category III. (i) X is a dentist and operates a small dental clinic. On March 1, 2008, X purchases a new laptop computer, with a one-year warranty, for use in the dental business. On May 1, 2009, after the warranty has expired, the computer malfunctions and X contacts the manufacturer's computer maintenance shop for assistance. The maintenance shop sends a technician to X's dental clinic, who uses a supply of rotable spare parts to diagnose problems in X's computer. The technician determines that the circuit board must be replaced and exchanges X's malfunctioning circuit board with the identical functioning circuit board from the computer maintenance operation's rotable spare parts pool. The malfunctioning circuit board removed from X's computer is then repaired and placed in the manufacturer's rotable spare parts pool for continued use in the computer maintenance business.

(ii) The initial unit of property determined under paragraph (d)(2)(ii) of this section is the computer, which consists entirely of components (circuit board or motherboard, central processing unit or CPU, hard drive, RAM, keyboard, monitor, case, etc.) that are functionally interdependent. To determine whether the circuit board is a separate unit of property from the computer, the factors in paragraph (d)(2)(v) of this section apply. The circuit board was not marketed separately to X or acquired separately by X, nor is it subject to a separate warranty. The CPU, however, was marketed separately to the taxpayer, but not acquired separately. No component, including the circuit board and CPU of the laptop computer, is treated as a separate unit of property by X in its books and records, nor does X treat any component as a rotable part. The computer does not function for its intended use without the circuit board and the CPU. Based on these facts, neither the circuit board nor the CPU is a separate unit of property. X must treat the entire laptop computer, including the circuit board and CPU, as the unit of property for determining whether an amount paid improves the unit of property for Federal income tax purposes.

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

(4) *Unavailability of replacement parts.* For purposes of this section, if a taxpayer needs to replace part of a unit of property that cannot practicably be replaced with the same type of part (for example, because of technological advancements or product enhancements), the replacement of the part with an improved but comparable part does not, by itself, result in an improvement to the unit of property.

(5) *Repairs performed during an improvement*—(i) *In general.* Repairs 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. See section 263A for rules requiring capitalization of all direct costs of an improvement and all indirect costs that directly benefit or are incurred by reason of the improvement.

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

(e) *Value*—(1) *In general.* A taxpayer must capitalize amounts paid that materially increase the value of a unit of property. An amount paid materially increases the value of a unit of property only if it—

(i) Ameliorates a 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 work performed prior to the date the property is placed in service by the taxpayer (without regard to any applicable convention under section 168(d));

(iii) Adapts the unit of property to a new or different use (including a permanent structural alteration to the unit of property);

(iv) Results in a betterment (including a material increase in quality or strength) or a material addition (including an enlargement, expansion, or extension) to the unit of property; or

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

(2) *Exception.* Notwithstanding the rules in paragraph (e)(1)(i) through (e)(1)(v) of this section, an amount paid does not result in a material increase in value to a unit of property if the economic useful life (as defined in § 1.263(a)–3(f)(2)) of the unit of property is 12 months or less and the taxpayer did not elect to capitalize the amounts paid originally for the unit of property.

(3) *Appropriate comparison.* For purposes of paragraphs (e)(1)(iv) and (e)(1)(v) of this section, in cases in which a particular event necessitates an expenditure, the determination of whether the amount paid materially increases the value 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 event necessitating the expenditure. When the event necessitating the expenditure is normal wear and tear to the unit of property, the condition of the property immediately prior to the event 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.

(4) *Examples.* The following examples illustrate the rules of this paragraph (e) and assume that the amounts paid are not required to be capitalized under any other provision of this section (paragraph (f), for example):

Example 1. Pre-existing condition. In 2008, X purchased a store located on 10 acres of land that contained underground gasoline storage tanks left by prior occupants. The tanks had leaked, causing soil contamination. X was not aware of the contamination at the time of purchase. When X discovered the contamination, it incurred costs to remediate the soil. For purposes of this *Example 1*, assume the 10 acres of land is the appropriate unit of property. The amounts paid for soil remediation must be capitalized as an improvement to the land because they ameliorated a condition or defect that existed prior to the taxpayer's acquisition of the land. The comparison rule in paragraph (e)(3) of this section does not apply to these amounts paid.

Example 2. Not a pre-existing condition; repair performed during an improvement. (i) X owned land on which it constructed a building in 1969 for use as a bank. The building was constructed with asbestos-containing materials. The health dangers of asbestos were not widely known when the building was constructed. The presence of asbestos did not necessarily endanger the health of building occupants. The danger arises when asbestos-containing materials are damaged or disturbed, thereby releasing asbestos fibers into the air (where they can be inhaled). In 1971, Federal regulatory agencies designated asbestos a hazardous substance. In 2008, X determined it needed additional space in its building to accommodate additional operations at its branch and decided to remodel the building. However, any remodeling work could not be undertaken without disturbing the asbestos-containing materials. The governmental regulations required that asbestos be removed if any remodeling was undertaking that would disturb asbestos-containing materials. Therefore, X decided to remove the asbestos-containing materials from the building in coordination with the overall remodeling project.

(ii) For purposes of this *Example 2*, assume that the building is the appropriate unit of property and that the amounts paid to remodel are required to be capitalized under § 1.263(a)–3. The amounts paid to remove the asbestos are not required to be capitalized as a separate improvement under paragraph (e)(1)(i) of this section because the asbestos, although later determined to be unsafe under certain circumstances, was not an inherent defect to the property. The removal of the asbestos, by itself, also did not result in a material increase in value under paragraphs (e)(1)(ii) through (e)(1)(v) of this section. Under paragraph (d)(5)(i) of this section, repairs that do not directly benefit or are not incurred by reason of an improvement are not required to be capitalized under section 263(a). Under section 263A, all indirect costs, including otherwise deductible repair costs, that directly benefit or are incurred by reason of the improvement must be capitalized as part of the improvement. The amounts paid to remove the asbestos were incurred by reason of the remodeling project, which was an improvement. Therefore, X must capitalize under section 263A to the remodeling improvement amounts paid to remove the asbestos.

Example 3. Work performed prior to placing the property in service. In 2008, X purchased a building for use as a business office. The building was in a state of disrepair. In 2009, X incurred costs to repair cement steps; shore up parts of the first and second floors; replace electrical wiring; remove and replace old plumbing; and paint the outside and inside of the building. Assume all the work was performed on the building or its structural components. In 2010, X placed the building in service and began using the building as its business office. For purposes of this Example 3, assume the building and its structural components are the appropriate unit of property. The amounts paid must be capitalized as an improvement to the building because they were for work performed prior to X's placing the building in service. The comparison rule in paragraph (e)(3) of this section does not apply to these amounts paid.

Example 4. Work performed prior to placing the property in service. In January 2008, X purchased new machinery for use in an existing production line of its manufacturing business. After the machinery was installed, X performed critical testing on the machinery to ensure that it was operational. On November 1, 2008, the new machinery became operational and, thus, the machinery was placed in service on November 1, 2008 (although X continued to perform testing for quality control). The amounts paid must be capitalized as an improvement to the machinery because they were for work performed prior to X's placing the machinery in service. The comparison rule in paragraph (e)(3) of this section does not apply to these amounts paid.

Example 5. New or different use. X is an interior decorating company and manufactures its own designs. In 2008, X decides to stop manufacturing and converts the manufacturing facility into a showroom for X's business. To convert the facility, X removes certain load-bearing walls and builds new load-bearing walls to provide a better layout for the showroom and its offices. As part of building the new walls, X moves or replaces electrical, cable, and telephone wiring and paints the walls. X also repairs the floors, builds a fire escape, and performs small carpentry jobs related to making the showroom accessible, including installing ramps and widening doorways. For purposes of this *Example 5*, assume the building and its structural components are the unit of property and that the work is performed on the structural components. The amounts paid by X to convert the manufacturing facility into a showroom must be capitalized as an improvement to the building because they adapted the building to a new or different use. The comparison rule in paragraph (e)(3) of this section does not apply to these amounts paid.

Example 6. New or different use. X owned a building consisting of five separate retail stores, each of which it rented to different tenants. In 2008, two of the stores rented became vacant and remained vacant for several months. One of the remaining tenants agreed to expand its occupancy to the two vacant stores, which adjoined its own retail store. X incurred costs to break down walls between the existing stores and construct an additional rear entrance. For purposes of this *Example 6*, assume the building and its structural components are the appropriate unit of property. The amounts paid by X to convert three retail stores into one larger store must be capitalized because they resulted in a permanent structural alteration, and thus a new or different use, to the building. The comparison rule in paragraph (e)(3) of this section does not apply to these amounts paid.

Example 7. Not a new or different use. X owns a building for rental purposes and decides to sell it. In preparation of selling, X paints the interior walls, cleans the gutters, repairs cracks in the porch, and refinishes the hardwood floors. For purposes of this *Example 7*, assume the building and its structural components are the unit of property. Amounts paid for work done in anticipation of selling the building are not required to be capitalized unless the amounts paid materially increase the value as defined in paragraph (e)(3) of this section or prolong the economic useful life as defined in paragraph (f)(3). The amounts paid by X are not transaction costs paid to facilitate the sale of property under § 1.263(a)–1(c), nor do they materially increase the value of the building. Although the amounts were paid for the purpose of selling the building, the sale does not constitute a new or different use. Therefore, X is not required to capitalize as an improvement under paragraph (e) of this section the amounts paid for work performed on the building. The comparison rule in paragraph (e)(3) of this section does not apply to these amounts paid.

Example 8. Not a material increase in value. (i) X is a commercial airline engaged in the business of transporting passengers and freight throughout the United States and abroad. To conduct its business, X owns or leases various types of aircraft.

As a condition of maintaining its airworthiness certification for these aircraft, X is required by the Federal Aviation Administration (FAA) to establish and adhere to a continuous maintenance program for each aircraft within its fleet. These programs, which are designed by X and the aircraft's manufacturer and approved by the FAA are incorporated into each aircraft's maintenance manual. The maintenance manuals require a variety of periodic maintenance visits at various intervals during the operating lives of each aircraft. One type of maintenance visit is an engine shop visit (ESV), which is performed on X's aircraft engines approximately every 4 years.

(ii) In 2004, X purchased a new aircraft and engine. In 2008, X performs its first ESV on the aircraft engine. The ESV includes some or all of the following activities: disassembly, cleaning, inspection, repair, replacement, reassembly, and testing. During the ESV, the engine is removed from the aircraft and shipped to an outside vendor who performs the ESV. When the engine arrives at the vendor, the engine is cleaned and externally inspected. Regardless of condition, it is thoroughly inspected visually and, as appropriate, further inspected using a number of non-destructive testing procedures. The engine is then disassembled into major parts and, if necessary, into smaller parts. If inspection or testing discloses a discrepancy in a part's conformity to the specifications in X's maintenance program, the part is repaired, or if necessary, replaced with a new or used serviceable part conforming to the specifications. If a part can be repaired, but not in time to be returned to the engine with which the part had arrived, the vendor first attempts to replace the part with a similar part from customer stock (used parts from X's aircraft that were replaced or exchanged and repaired during an earlier ESV and then stored for future use on X's aircraft). If a part is not available from customer stock, the part is exchanged with a used, serviceable part in the vendor's inventory. A part is replaced (generally with a used serviceable part) only if the part removed from X's engine cannot be repaired timely.

(iii) For purposes of this *Example 8*, assume the aircraft engine is the appropriate unit of property. To determine whether the ESV results in a material increase in value under paragraph (e)(1)(iv) or (e)(1)(v) of this section, the comparison rule in paragraph (e)(3) of this section applies. Because the event necessitating the ESV was normal wear and tear, and X had not previously performed an ESV on the engine, the relevant comparison is the condition of the property immediately after the ESV with the condition of the property when placed in service by X. Using this comparison, the ESV did not result in a material addition, betterment, or material increase in capacity, productivity, efficiency, or quality of output of the engine compared to the condition of the engine when placed in service, nor did it adapt the engine to a new or different use. Therefore, the amounts paid by X for the ESV did not result in a material increase in value to the engine. X is not required to capitalize as an improvement under paragraph (e) of this section amounts paid for the ESV.

Example 9. Betterment; regulatory requirement. X owned a hotel in City that included five foot high unreinforced terra cotta and concrete parapets with overhanging cornices around the entire roof perimeter. The parapets and cornices were in good condition. In 2008, City passed an ordinance setting higher safety standards for parapets and cornices because of the hazardous conditions caused by earthquakes. To comply with the ordinance, X replaced the old parapets and cornices with new ones made of glass fiber reinforced concrete, which made them lighter and stronger than the original ones. They were attached to the hotel using welded connections instead of wire supports, making them more resistant to damage from lateral movement. For purposes of this *Example 9*, assume the hotel building and its structural components are the appropriate unit of property. The event necessitating the expenditure was the 2008 City ordinance. Prior to the ordinance, the old parapets and cornices were in good condition, but were determined by City to create a potential hazard. After the expenditure, the new parapets and cornices significantly improved the structural soundness of the hotel. Therefore, the amounts paid by X to replace the parapets and cornices must be capitalized because they resulted in a betterment to the hotel. City's requirement that X correct the potential hazard to continue operating the hotel is not relevant in determining whether the amount paid improved the hotel. See paragraph (d)(3) of this section.

Example 10. Not a material increase in value; regulatory requirement. X owned a meat processing plant. In 2008, X discovered that oil was seeping through the concrete walls of the plant, creating a fire hazard. Federal meat inspectors advised X that it must correct the seepage problem or shut down its plant. To correct the problem, X incurred costs to add a concrete lining to the walls from the floor to a height of about four feet and also to add concrete to the floor of the plant. For purposes of this *Example 10*, assume the plant building and its structural components are the appropriate unit of property. The event necessitating the expenditure was the seepage of the oil. Prior to the seepage, the plant did not leak and was functioning for its intended use. The expenditure did not result in a material addition, betterment, or material increase in capacity, productivity, efficiency, or quality of output of the plant compared to the condition of the plant prior to the seepage of the oil, nor did it adapt the plant to a new or different use. Therefore, the amounts paid by X to correct the seepage do not materially increase the value of the plant. X is not required to capitalize as an improvement under paragraph (e) of this section amounts paid to correct the seepage problem. The Federal meat inspectors' requirement that X correct the seepage to continue operating the plant is not relevant in determining whether the amount paid improved the plant. See paragraph (d)(3) of this section.

Example 11. Not a material increase in value; replacement with same part. X owns a small retail shop. In 2008, a storm damaged the roof of X's shop by displacing numerous wooden shingles. X decides to replace all the wooden shingles on the roof and hired a contractor to replace all the shingles on the roof with new wooden shingles. No part of the sheathing, rafters, or joists was replaced. For purposes of this *Example 11*, assume the shop and its structural components are the appropriate unit of property. The event necessitating the expenditure was the storm. Prior to the storm, the retail shop was functioning for its intended use. The expenditure did not result in a material addition, betterment, or material increase in capacity, productivity, efficiency, or quality of output of the shop compared to the condition of the shop prior to the storm, nor did it adapt the shop to a new or different use. Therefore, the amounts paid by X to reshingle the roof with wooden shingles do not materially increase the value of the shop. X is not required to capitalize as an improvement under paragraph (e) of this section amounts paid to replace the shingles.

Example 12. Not a material increase in value; replacement with comparable part. Assume the same facts as in *Example 11*, except that wooden shingles are not available on the market. X decides to replace all the wooden shingles with comparable asphalt shingles. The amounts paid by X to reshingle the roof with asphalt shingles do not materially increase the value of the shop, even though the asphalt shingles may be an improvement over the wooden shingles. Because the wooden shingles could not practicably be replaced with new wooden shingles, the replacement of the old shingles with comparable asphalt shingles does not, by itself, result in an improvement to the shop. X is not required to capitalize as an improvement under paragraph (e) of this section amounts paid to replace the shingles.

Example 13. Betterment; replacement with improved parts. Assume the same facts as in *Example 11*, except that, instead of replacing the wooden shingles with asphalt shingles, X decides to replace all the wooden shingles with shingles made of lightweight composite materials that are maintenance-free and do not absorb moisture. The new shingles have a 50-year warranty and a Class A fire rating. X must capitalize as an improvement amounts paid to reshingle the roof because they result in a betterment to the shop.

Example 14. Material increase in capacity. X owns a factory building with a storage area on the second floor. In 2008, X replaces the columns and girders supporting the second floor to permit storage of supplies with a gross weight 50 percent greater than the previous load-carrying capacity of the storage area. For purposes of this *Example 14*, assume the factory building and its structural components are the appropriate unit of property. X must capitalize as an improvement amounts paid for the columns and girders because they result in a material increase in the load-carrying capacity of the building. The comparison rule in paragraph (e)(3) of this section does not apply to these amounts paid because the expenditure was not necessitated by a particular event.

Example 15. Material increase in capacity. In 2008, X purchased 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. To allow for ingress and egress and for the unloading of its barges, X needed to deepen the channel to a depth of 20 feet. X hired a contractor to dredge the channel to the required depth. For purposes of this *Example 15*, assume the channel is the appropriate unit of property. X must capitalize as an improvement amounts paid for the dredging because it resulted in a material increase in the capacity of the channel. The comparison rule in paragraph (e)(3) of this section does not apply to these amounts paid because the expenditure was not necessitated by a particular event.

Example 16. Not a material increase in capacity. Assume the same facts as in *Example 15,* except that the channel was susceptible to siltation and, by 2009, the channel depth had been reduced to 18 feet. X hired a contractor to redredge the channel to a depth of 20 feet. The event necessitating the expenditure was the siltation of the channel. Both prior to the siltation and after the redredging, the depth of the channel was 20 feet. Therefore, the amounts paid by X for redredging the channel did not materially increase the capacity of the unit of property. X is not required to capitalize as an improvement under paragraph (e) of this section amounts paid to redredge.

Example 17. Not a material increase in capacity. X owns a building used in its trade or business. The first floor has a drop-ceiling. X decides to remove the drop-ceiling and repaint the original ceiling. For purposes of this *Example 17*, assume the building and its structural components are the appropriate unit of property. The removal of the drop-ceiling does not create additional capacity in the building that was not there prior to the removal. Therefore, the amounts paid by X to remove the drop-ceiling and repaint the original ceiling did not materially increase the capacity of the unit of property. X is not required to capitalize as an improvement under paragraph (e) of this section amounts paid related to removing the drop-ceiling. The comparison rule in paragraph (e)(3) of this section does not apply to these amounts paid because the expenditure was not necessitated by a particular event.

(f) *Restoration*—(1) *In general.* A taxpayer must capitalize amounts paid that restore a unit of property. Amounts paid restore property if the amounts paid substantially (as defined in paragraph (f)(3) of this section) prolong the economic useful life of the unit of property.

(2) *Economic useful life*—(i) *Taxpayers with an applicable financial statement.* For taxpayers with an applicable financial statement (as defined in paragraph (f)(2)(iii) of this section), the economic useful life of a unit of property generally is presumed to be the same as the useful life used by the taxpayer for purposes of determining (at the time the property is originally acquired or produced by the taxpayer) depreciation in its applicable financial statement, regardless of any salvage value of the property. A taxpayer may rebut this presumption only if there is a clear and convincing basis that the economic useful life (as defined in paragraph (f)(2)(ii) of this section for taxpayers without an applicable financial statement) of the unit of property is significantly different than the useful life used by the taxpayer for purposes of determining depreciation in its applicable financial statement. If a taxpayer does not have an applicable financial statement at the time the property was originally acquired or produced, but does have an applicable financial statement at some later date, the economic useful life of the unit of property must be determined under paragraph (f)(2)(ii) 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 property having a useful life of one year or less, the economic useful life of the unit of property must be determined under paragraph (f)(2)(ii) of this section. For example, if a taxpayer has a policy of treating as an expense on its applicable financial statement amounts paid for property costing less than a certain dollar amount, notwithstanding that the property has a useful life of more than one year, the economic useful life of the property must be determined under paragraph (f)(2)(ii) of this section.

(ii) *Taxpayers without an applicable financial statement.* For taxpayers that do not have an applicable financial statement (as defined in paragraph (f)(2)(iii) of this section), 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. This period is determined by reference to the taxpayer's experience with similar property, taking into account present conditions and probable future developments. Factors to be considered in determining this period include, but are not limited to—

(A) Wear and tear and decay or decline from natural causes;

(B) The normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business;

(C) The climatic and other local conditions peculiar to the taxpayer's trade or business; and

(D) The taxpayer's policy as to repairs, renewals, and replacements.

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

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

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

(*1*) Credit purposes,

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

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

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

(3) *Substantially prolonging economic useful life*—(i) *In general.* An amount paid substantially prolongs the economic useful life of the unit of property if it extends 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 (or, if the taxpayer is not 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) beyond the end of the taxable year immediately succeeding the taxable year in which the economic useful life of the unit of property was originally expected to cease, or if the property's economic useful life was previously prolonged (as determined under this paragraph (e)(3)(i)), the end of the taxable year immediately succeeding the taxable year in which the prolonged economic useful life was expected to cease.

(ii) *Replacements.* Amounts paid will be deemed to substantially prolong the economic useful life of the unit of property if a major component or a substantial structural part of the unit of property is replaced with either a new part or a part that has been restored to like-new condition as described in paragraph (f)(3)(iii) of this section. Thus, the replacement of a part with another part that is not new or is not in like-new condition (for example, a used or reconditioned part) does not constitute the replacement of a major component or substantial structural part of the unit of property under this paragraph (f)(3)(ii). Further, replacement of a relatively minor portion of the physical structure of the unit of property or a relatively minor portion of any of its major parts, even if those parts are new, does not constitute the replacement of a major component or substantial structural part of the unit of property.

(iii) *Restoration to like-new condition.* Amounts paid will be deemed to substantially prolong the economic useful life of the unit of property if they result in the unit of property or a major component or substantial structural part of the unit of property being restored to a like-new condition (including bringing the unit of property or a major component or substantial structural part of the property to the status of new, rebuilt, remanufactured, or similar status under the terms of any Federal regulatory guideline or the manufacturer's original specifications).

(iv) *Restoration after a casualty loss.* Amounts paid will be deemed to substantially prolong the useful life of the unit of property if the taxpayer properly deducts a casualty loss under section 165 with respect to the unit of property and the amounts paid restore the unit of property to a condition that is the same or better than before the casualty.

(4) *Examples.* The following examples illustrate the rules of this paragraph (f) and, except as otherwise provided, assume that the amounts paid would not be required to be capitalized under any other provision of this section (paragraph (e), for example):

Example 1. Prolonged economic useful life. X is a Class I railroad that owns a fleet of locomotives. In 1989, X purchased a new locomotive with an economic useful life (as defined in paragraph (f)(2) of this section) of 22 years (from 1989–2011). X performs substantially the same cyclical maintenance on its locomotives approximately every 6 years. X performed cyclical maintenance on the locomotive in 1995, in 2001, and in 2007. Assume that the locomotive (which includes the engine) is the appropriate unit of property and that none of the cyclical maintenance projects resulted in a restoration under paragraph (f)(3)(ii) or (f)(3)(iii) of this section. Amounts paid for cyclical maintenance in 1995 and 2001 do not substantially prolong the economic useful life of the locomotive. However, the cyclical maintenance performed in 2007 will prolong the economic useful life of the locomotive to 2013, which is beyond the end of the next succeeding taxable year after the economic useful life of the locomotive ceases (2011). Therefore, under paragraphs (f)(1) and (f)(3)(i) of this section, X must capitalize as an improvement to the locomotive amounts paid for the cyclical maintenance performed in 2007, regardless of whether X was required to capitalize the amounts paid in previous years for cyclical maintenance.

Example 2. Economic useful life not prolonged. Assume the same facts as in *Example 1*, except that in 2009, X replaces a filter in the locomotive engine. X generally replaces this type of filter every 4 years. Although the filter itself would last beyond the end of the locomotive's economic useful life in 2011, the amount paid for the filter does not substantially prolong the economic useful life of the locomotive because the filter will not extend beyond 2009 the period over which the locomotive may reasonably be expected to be useful to X in its trade or business. Additionally, although the filter is a necessary component of the locomotive, the filter is not a substantial structural part or major component of the locomotive. Therefore, the amount paid to replace the filter does not substantially prolong the economic useful life of the locomotive.

Example 3. Minor part replacement. X owns a small retail shop. In 2008, a storm damaged the roof of X's shop by displacing numerous wooden shingles. X decides to replace all the wooden shingles on the roof and hires a contractor to replace all the shingles on the roof with new wooden shingles. No part of the sheathing, rafters, or joists was replaced. For purposes of this *Example 3*, assume the shop and its structural components are the appropriate unit of property. The replacement of the shingles did not extend the useful life of the shop under paragraph (f)(3)(i) of this section. The portion of the roof replaced is not a substantial structural part of the shop, nor does the replacement of the shingles restore to a like-new condition a major component or substantial structural part of the shop. Therefore, the amounts paid by X to reshingle the roof with wooden shingles do not substantially prolong the economic useful life of the shop.

Example 4. Major component or substantial structural part. Assume the same facts as in Example 3, except that when the contractor began work on the shingles, the contractor discovered that a major portion of the sheathing had rotted, and the rafters were weakened as well. The contractor replaced all the sheathing and a significant portion of the rafters. The roof (including the shingles, sheathing, rafters, and joists) is a substantial structural part of a building. The replacement of the shingles, sheathing, and rafters restored to a like-new condition a substantial structural part of the shop. Therefore, under paragraphs (f)(1) and (f)(3)(iii) of this section, X must capitalize as an improvement to the shop amounts paid to replace the roof of the shop.

Example 5. Not a major component or structural part. X uses a car in providing a taxi service. X purchased the car in 2008. Assume that the unit of property is the car. The car has an economic useful life of 5 years. In 2011, the battery dies and X takes the car to a repair shop, which replaces the battery. Although the battery itself may last beyond the end of the car's economic useful life, the amount paid for the battery does not substantially prolong the economic useful life of the car because the battery will not extend beyond 2013 the period over which the car may reasonably be expected to be useful to X in its trade or business. Although the battery is a necessary component of the car, the battery is not a substantial structural part or major component of the car. Therefore, the amount paid to replace the battery does not substantially prolong the economic useful life of the car.

Example 6. Major component or structural part. Assume the same facts as *Example 5*, except rather than the battery dying, the car overheats and causes so much damage that the engine has to be rebuilt. The engine is a major component of the car. Therefore, X is required to capitalize as an improvement to the car under paragraphs (f)(1) and (f)(3)(iii) of this section the amounts paid to rebuild the engine.

Example 7. Repair performed during an improvement; coordination with section 263A. Assume the same facts as *Example 6*, except that X has a broken taillight fixed at the same time that the engine was rebuilt. The repair to the taillight was not incurred because the engine was rebuilt, nor did it benefit the rebuild of the engine. The repair of the broken taillight is a deductible expense under § 1.162–4. Under section 263A, all indirect costs, including otherwise deductible repair and maintenance costs that directly benefit or are incurred by reason of the improvement must be capitalized as part of the improvement. Therefore, all amounts paid that are incurred by reason of the engine being rebuilt must be capitalized, including, for example, amounts paid for activities that would usually be deductible maintenance expenses, such as refilling the engine with oil and radiator fluid. Amounts paid to repair the broken taillight, however, are not incurred by reason of the engine being rebuilt, nor do the amounts paid directly benefit the engine rebuild, despite being repaired at the same time. Thus, X is not required to capitalize to the improvement of the car (the rebuild of the engine) the amounts paid to repair the broken taillight.

Example 8. Related amounts to replace major component or structural part. (i) X owns a retail gasoline station, consisting of a paved area used for automobile access to the pumps and parking areas, a building used to market gasoline, and a canopy covering the gasoline pumps. The premises also consists of underground storage tanks (USTs) that are connected by piping to the pumps and are part of the machinery used in the immediate retail sale of gas. The pumps also are connected to a monitoring unit in the building that allows the sales clerk to monitor the gasoline sales. To comply with regulations issued by the Environmental Protection Agency, X is required to remove and replace leaking USTs. In 2008, X hires a contractor to perform the removal and replacement, which consists of removing the old tanks and installing new tanks with leak detection systems. The removal of the old tanks includes removing the paving material covering the tanks, excavating a hole large enough to gain access to the old tanks, disconnecting any strapping and pipe connections to the old tanks, and lifting the old tanks out of the hole. Installation of the new tanks includes placement of a liner in the excavated hole, placement of the new tanks, installation of a leak detection system, installation of an overfill system, connection of the tank to the pipes leading to the pumps, backfilling of the hole, and replacement of the paving. X is also required to pay a permit fee to the county to undertake the installation of the new tanks.

(ii) X pays the permit fee to the county on October 15, 2008. The contractor performs all of the required work and, on November 1, 2008, bills X for the costs of removing the old USTs. On November 15, 2008, the contractor bills X for the remainder of the work. Assume the fuel distribution system is the appropriate unit of property. The USTs are major components of the fuel distribution system. Therefore, under paragraphs (f)(1) and (f)(3)(ii) of this section, X must capitalize as an improvement to the fuel distribution system the aggregate of related amounts paid to replace the USTs, which related amounts include the amount paid to the county, the amount paid to remove the old USTs, and the amount paid to install the new USTs (regardless that the amounts were separately invoiced and paid to two different parties).

Example 9. Major component or substantial structural part. X is a common carrier that owns a fleet of petroleum hauling trucks. In 2008, X replaces the existing engine, cab, and petroleum tank of a truck with a new engine, cab, and tank. Assume the tractor of the truck (which includes the cab and the engine) is a separate unit of property from the rest of the truck. Also assume that the trailer (which contains the petroleum tank) is a separate unit of property from the truck. The engine and the cab are major components of the truck tractor, and the petroleum tank is a major component of the trailer. Therefore, under paragraphs (f)(1) and (f)(3)(ii) of this section, X must capitalize as an improvement to the tractor amounts paid to replace the engine and cab, and must capitalize as an improvement to the trailer amounts paid to replace the petroleum tank.

Example 10. Restoration of major component to like-new condition. (i) X is a towboat operator that owns and leases a fleet of towboats. In 2008, X replaces an existing towboat engine with a rebuilt engine. A towboat engine is rebuilt through a series of steps designed to put the engine in like-new operating condition to the maximum extent possible. Engines in a towboat nearing the end of its useful life or engines that have been removed from towboats due to a catastrophic malfunction are likely candidates for the rebuilding process. The goal of the rebuilding process is to bring each of an engine's component parts to the manufacturer's original dimensional specifications for new parts.

(ii) Replacement of the existing towboat engine with a rebuilt engine involves dry-docking the towboat. The rebuilding and replacement process takes approximately 3 to 5 months. The process requires the removal of the engine from the towboat and the removal of all of the moving and nonmoving components from the engine as well. The engine's crankcase and oil pan are separated, and every part of the engine is cleaned, inspected using intense illumination, machined, and treated with special materials to restore the engine to like-new operating condition. The engine crankcase and oil pan are extensively machined and welded, and numerous dimensional tests and checks are performed to ensure that the engine is returned to a like-new condition through the rebuilding process. In addition, a reconditioned crankshaft and camshaft normally are installed in the engine during the rebuilding process. The power packs are completely rebuilt with a large number of new parts during the rebuilding process. The oil pumps, water pumps, engine turbochargers, and governors are normally removed and exchanged for rebuilt parts during the rebuilding process. The accessory drive gears, all of the piping on the front and aft ends of the engine, the governor drive gear, and the turbocharger drive gears are removed and normally exchanged for rebuilt parts during the rebuilding process. The goal of the rebuilding process is to bring each of an engine's component parts to the engine manufacturer's original dimensional specifications for new parts. Assume the towboat (which includes the engine) is the appropriate unit of property. The work done on the towboat engine constitutes a remanufacture or rebuild of the engine, which is a major component of the towboat. Therefore, under paragraphs (f)(1) and (f)(3)(iii) of this section, X must capitalize as an improvement to the towboat amounts paid to rebuild the towboat engine.

Example 11. Repairs performed during an improvement; coordination with section 263A. Assume the same facts as in *Example 10*, except that while the towboat is in dry-dock to have the engine rebuilt, X also makes repairs to the hull and rudders that are not by themselves an improvement under this section. The amounts paid to repair the hull and rudders do not directly benefit nor are incurred by reason of the engine rebuild. Under section 263A, all indirect costs, including otherwise deductible repair costs that directly benefit or are incurred by reason of the improvement must be capitalized as part of the improvement. Therefore, all amounts paid that are incurred by reason of the engine being rebuilt must be capitalized to the improvement, including, for example, amounts paid for activities such as cleaning and inspecting the engine, which usually would be deductible maintenance costs. Amounts paid to repair the hull and rudders, however, are not incurred by reason of the engine being rebuilt, nor do the amounts paid directly benefit the engine rebuild, despite being incurred at the same time. Thus, in accordance with paragraph (d)(5)(i) of this section, X is not required to capitalize to the towboat amounts paid to repair the hull and rudders to the improvement.

Example 12. Restoration to like-new condition; coordination with section 263A. Assume the same facts as *Example 10*, except that while the towboat is in dry-dock, X also makes substantial improvements to the propulsion systems and the mechanical systems, including rebuilding large sections of the hull, and rebuilding, replacing, or upgrading the steering systems, shafting systems, and electrical systems, such that almost the entire towboat is restored to like-new condition. This process constitutes a remanufacture or rebuild of the towboat. Under section 263A, all indirect costs, including otherwise deductible repair costs that directly benefit or are incurred by reason of the improvement must be capitalized as part of the improvement. Therefore, under paragraph (d)(5)(i) of this section, X must capitalize to the improvement of the towboat (the rebuild) amounts paid that otherwise would be deductible repair costs that directly benefit or are incurred by reason of the improvement.

Example 13. Restoration to like-new condition. X is a Class I railroad that owns a fleet of freight cars. Approximately every 10 years, X rebuilds its freight cars. The rebuild includes a complete disassembly, inspection, and reconditioning and/or replacement of components of the suspension and draft systems, trailer hitches, and other special equipment. Modifications are made to the car to upgrade various components to the latest engineering standards. The freight car essentially is stripped to the frame, with all of its substantial components either reconditioned or replaced. The frame itself is the longest-lasting part of the car and is reconditioned. The walls of the freight-train car are replaced or are sandblasted and repainted. New wheels typically 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 cars have been restored to like-new condition. Assume the freight car is the appropriate unit of property. The work done to the freight car constitutes a remanufacture or rebuild of the freight car. Therefore, under paragraphs (f)(1) and (f)(3)(iii) of this section, X must capitalize as an improvement to the freight car amounts paid to rebuild the freight car.

Example 14. Restoration of major component to like-new condition. X owned a factory that it acquired in 1997. In 2008, the factory roof began to leak. These leaks on occasion resulted in damage to X's products and prevented the use of certain portions of the factory. X decided to reroof the entire factory and hired a contractor to perform the reroofing. The structure of the roof, including substantial portions of the rafters and joists, was restored to a like-new condition. Assume the factory building and its structural components are the appropriate unit of property. The roofing process constitutes a remanufacture or rebuild of the roof, which is a substantial structural part of the factory. Therefore, under paragraphs (f)(1) and (f)(3)(iii) of this section, X must capitalize as an improvement to the factory amounts paid to reroof the factory.

Example 15. Minor part replacement; coordination with section 263A. X is in the business of smelting aluminum. X's aluminum smelting facility includes a plant where molten aluminum is poured into molds and allowed to solidify. Because of the potential of fire from a molten metal explosion, the plant's roof must be made of fire-resistant material. The roof must also be without leaks because rain water hitting the molten aluminum could cause an explosion. The roof of the plant was made of roofing material and corrugated sheet metal decking, which supports the roofing material. During 2008, X removed and replaced a minor portion of the plant's roof decking and roofing material. At the time of the replacement, the pattern of the original metal support decking was not available. Therefore, X used comparable fire resistant wood decking to replace the corrugated metal decking. For purposes of this *Example 15*, assume the plant building and its structural components are the appropriate unit of property and that the amount paid does not prolong the economic useful life of the plant under paragraph (f)(3)(i) of this section. The portion of the roof structure being replaced is not a substantial structural part of the plant, nor does the work performed return to like-new condition a major component or substantial structural part of the plant. Further, because X could not practicably replace the roof material with the same type of material, the replacement of the original roof material with an improved, but comparable, material does not, by itself, result in an improvement. Therefore, the amount paid to remove and replace a minor part of the plant's roof decking and roofing materials does not substantially prolong the economic useful life of the plant. However, under section 263A, all indirect costs, including otherwise deductible costs, that directly benefit or are incurred by reason of the taxpayer's manufacturing activities must be capitalized to the property produced for sale. Therefore, because the amounts paid for the roof decking and materials are incurred by reason of X's manufacturing operations, the amounts paid must be capitalized under section 263A to the property produced for sale by X.

Example 16. Minor part replacement. (i) X is a commercial airline engaged in the business of transporting passengers and freight throughout the United States and abroad. To conduct its business, X owns or leases various types of aircraft. As a condition of maintaining its airworthiness certification for these aircraft, X is required by the Federal Aviation Administration (FAA) to establish and adhere to a continuous maintenance program for each aircraft within its fleet. These programs, which are designed by X and the aircraft's manufacturer and approved by the FAA are incorporated into each aircraft's maintenance manual. The maintenance manuals require a variety of periodic maintenance visits at various intervals during the operating lives of each aircraft. One type of maintenance visit is an engine shop visit (ESV), which is performed on X's aircraft engines approximately every 4 years.

(ii) In 2004, X purchased a new aircraft and engine. In 2008, X performs its first ESV on the aircraft engine. The ESV includes some or all of the following activities: Disassembly, cleaning, inspection, repair, replacement, reassembly, and testing. During the ESV, the engine is removed from the aircraft and shipped to an outside vendor who performs the ESV. When the engine arrives at the vendor, the engine is cleaned and externally inspected. Regardless of condition, it is thoroughly inspected visually and, as appropriate, further inspected using a number of non-destructive testing procedures. The engine is then disassembled into major parts and, if necessary, into smaller parts. If inspection or testing discloses a discrepancy in a part's conformity to the specifications in X's maintenance program, the part is repaired, or if necessary, replaced with a new or used serviceable part conforming to the specifications. If a part can be repaired, but not in time to be returned to the engine with which the part had arrived, the vendor first attempts to replace the part with a similar part from customer stock (used parts from X's aircraft that were replaced or exchanged and repaired during an earlier ESV and then stored for future use on X's aircraft). If a part is not available from customer stock, the part is exchanged with a used, serviceable part in the vendor's inventory. A part is replaced (generally with a used serviceable part) only if the part removed from X's engine cannot be repaired timely. Although many minor parts may be replaced during the ESV, the ESV does not return the engine to a like-new condition.

(iii) For purposes of this *Example 16*, assume the aircraft engine is the appropriate unit of property. The ESV does not result in the replacement of the engine nor does it restore the engine to a like-new condition. Therefore, the amount paid for the ESV does not substantially prolong the economic useful life of the engine.

Example 17. Repairs performed during an improvement; coordination with section 263A. (i) Assume the same facts as in *Example 16*, except that X purchased the aircraft in 1986 and, in addition to the continuous maintenance program for engines, X adheres to a continuous maintenance program for its aircraft airframes. One type of maintenance visit is a heavy maintenance visit (HMV), which is performed on X's aircraft airframes approximately every 8 years. In 2008, X decided to make substantial modifications to the airframe, which resulted in the restoration of the airframe to like-new condition. The modifications included removing all the belly skin panels on the aircraft's fuselage and replacing them with new skin panels; replacing the metal supports under the lavatories and galleys; removing the wiring in the leading edges of both wings and replacing it with new wiring; removing the fuel tank bladders, harnesses, wiring systems, and connectors and replacing them with new components; opening every lap joint on the airframe and replacing the epoxy and rivets used to seal the lap joints with a non-corrosive sealant and larger rivets; reconfiguring and upgrading the avionics and the equipment in the cockpit; replacing all the seats, overhead bins, sidewall panels, partitions, carpeting, windows, galleys, lavatories, and ceiling panels with new items; installing a cabin smoke and fire detection system, and a ground proximity warning system; and painting the exterior of the aircraft. In addition, X performed much of the same work that would be performed during an HMV.

(ii) For purposes of this *Example 17*, assume the aircraft airframe is the appropriate unit of property. The amounts paid to modify the airframe are required to be capitalized as an improvement to the airframe under paragraph (f) of this section because the modifications restored the airframe to a like-new condition. Assume the amounts paid for the HMV are not required to be capitalized as a separate improvement to the airframe. Under section 263A, all indirect costs, including otherwise deductible repair costs that directly benefit or are incurred by reason of the improvement must be capitalized as part of the improvement. Therefore, X must capitalize to the improvement of the airframe (the restoration) amounts paid that usually would be ordinary and necessary repair costs, including any amounts paid for the HMV that directly benefit or are incurred by reason of the improvement to the airframe. X is not required, however, to capitalize to the improvement of the airframe any amounts paid for the HMV that do not directly benefit or are not incurred by reason of the improvement to the airframe.

Example 18. Restoration of major component to like-new condition; coordination with section 263A. (i) X is a Class I railroad that owns a fleet of locomotives. In 1994, X purchased a new locomotive (Locomotive A) with an economic useful life (as defined in paragraph (f)(2) of this section) of 20 years (from 1994–2014). X performed cyclical maintenance on Locomotive A in 2000, and again in 2008. In 2000, X replaced the power cylinders on Locomotive A's engine, and performed work on other components of Locomotive A. In 2008, X removed the engine and replaced it with one it had previously remanufactured to the manufacturer's original specifications, and again performed work on other components of Locomotive A. The engine that X removed from Locomotive A in 2008 was remanufactured to the manufacturer's original specifications and installed on Locomotive B later in 2008.

(ii) Assume the locomotive (which includes the engine) is the appropriate unit of property. The replacement of the power cylinders and the other work performed on Locomotive A in 2000 did not prolong the economic useful life of Locomotive A under paragraph (f)(3) of this section. However, the amounts paid in 2008 to remove the engine and replace it with a previously manufactured engine must be capitalized under paragraph (f)(3)(ii) of this section. Assume the amounts paid in 2008 to perform work on other components of Locomotive A are not required to be capitalized as a separate improvement to Locomotive A. Under section 263A, all indirect costs, including otherwise deductible repair costs that directly benefit or are incurred by reason of the improvement must be capitalized as part of the improvement. Therefore, X must capitalize to the improvement of Locomotive A (the installation of the remanufactured engine) amounts paid that usually would be ordinary and necessary repair costs, including any amounts paid for work on other components that directly benefit or are incurred by reason of the improvement to Locomotive A. X is not required, however, to capitalize to the improvement of Locomotive A any amounts paid for work performed on other components that do not directly benefit or are not incurred by reason of the improvement to Locomotive A. Further, X must capitalize to the improvement of Locomotive B (the installation of remanufactured engine) the amounts paid to remanufacture the engine removed from Locomotive A and amounts paid to install the remanufactured engine on Locomotive B.

(g) *Repair allowance method*—(1) *In general.* This paragraph (g) provides an optional simplified method (the repair allowance method) for determining whether amounts paid to repair, maintain, or improve certain tangible property are to be treated as deductible expenses or capital expenditures. A taxpayer that elects to use the repair allowance method described in paragraph (g)(3) of this section may use that method 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, except for the rules in paragraph (d)(2) of this section for determining the appropriate unit of property, the capitalization rules in § 1.263(a)–3(d) do not apply to property for which the taxpayer uses the repair allowance method under this paragraph (g). See section 263A for the scope of costs required to be capitalized to property produced by the taxpayer or to property acquired for resale.

(2) *Election of repair allowance method.* In the case of repair allowance property (as defined in paragraph (g)(6) of this section), a taxpayer may elect to use the repair allowance method described in paragraph (g)(3) of this section. See paragraph (g)(9) of this section for the manner of electing the repair allowance. A taxpayer that elects to use the repair allowance method must use that method for all of its repair allowance property in all MACRS classes (including property classified into a MACRS class for purposes of the repair allowance method under paragraph (g)(6)(ii) of this section). A taxpayer electing the repair allowance method must use that method consistently for all future years unless the taxpayer revokes the election in accordance with paragraph (g)(10) of this section.

(3) *Application of repair allowance method.* Under the repair allowance method, a taxpayer must treat all amounts paid (other than amounts paid for excluded additions, as defined in paragraph (g)(7) of this section) for materials and labor to repair, maintain, or improve all the repair allowance property in a particular MACRS class as deductible expenses under section 162 for the taxable year, up to the repair allowance amount (as determined in paragraph (g)(4) of this section) for that MACRS class, and treat the excess of all amounts paid to repair, maintain, or improve all the repair allowance property in that MACRS class (the capitalized amount) in accordance with paragraph (g)(5) of this section.

(4) *Repair allowance amount*—(i) *In general.* Except as provided in paragraph (g)(4)(iv) of this section (with regard to buildings), under the repair allowance method for a particular taxable year, the repair allowance amount for a particular MACRS class consisting of repair allowance property is an amount equal to the average unadjusted basis (as defined in paragraph (g)(4)(ii) of this section) of repair allowance property in the MACRS class multiplied by the repair allowance percentage in effect for the MACRS class for the taxable year.

(ii) *Average unadjusted basis.* For purposes of this section, average unadjusted basis is the average of the unadjusted basis (as defined in paragraph (g)(4)(iii) of this section) of all repair allowance property in the MACRS class at the beginning of the taxable year and the unadjusted basis of all repair allowance property in the MACRS class at the end of the taxable year.

(iii) *Unadjusted basis.* For purposes of this section, unadjusted basis is the basis as determined under section 1012, or other applicable sections of subchapter O, and subchapters 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 section 179, 179B, or 179C), but with regard to basis reductions which are required because of credits taken on the property (for example, under section 44, 45G, 45H, or 50(c)). Unadjusted basis also must reflect the reduction in basis for the percentage of the taxpayer's use of property for the taxable year other than for use in the taxpayer's trade or business (or for the production of income).

(iv) *Buildings.* In the case of buildings and structural components that are repair allowance property, the repair allowance method is applied separately with respect to each unit of property.

(5) *Capitalized amount*—(i) *In general.* Under the repair allowance method for a particular taxable year, the capitalized amount is the excess of all amounts paid to repair, maintain, or improve all the repair allowance property in a MACRS class over the repair allowance amount for that MACRS class. In addition, the capitalized amount includes all of the indirect costs of producing the repair allowance property in the MACRS class, which must be capitalized in accordance with the taxpayer's method of accounting for section 263A costs. Except as provided in paragraphs (g)(5)(iv), (g)(5)(v), and (g)(5)(vi) of this section, a taxpayer may choose to treat the capitalized amount as a single asset under paragraph (g)(5)(ii) of this section or, alternatively, may choose to allocate the capitalized amount to specific repair allowance property in the MACRS class in accordance with paragraph (g)(5)(iii) of this section.

(ii) *Single asset treatment of capitalized amount.* In general, the capitalized amount for a particular MACRS class may be treated by the taxpayer as a separate single asset and depreciated in accordance with that MACRS class. The single asset is treated as a section 168(i)(6) improvement and is treated as placed in service by the taxpayer on the last day of the first half of the taxable year in which the amount is paid, before application of the convention under section 168(d). Except for a sale of assets constituting a trade or business, no gain or loss is recognized on capitalized amounts treated as a single asset under this paragraph (g)(5)(ii) upon disposition of any repair allowance property to which the capitalized amounts are related. A disposition includes the sale, exchange, retirement, physical abandonment, or destruction of property. Taxpayers must continue to depreciate the single asset over the remainder of the MACRS applicable recovery period.

(iii) *Allocation treatment of capitalized amount.* Instead of treating the capitalized amount as a single asset under paragraph (g)(5)(ii) of this section, a taxpayer may allocate the capitalized amount for a particular MACRS class to all repair allowance property in the particular MACRS class in proportion to the unadjusted basis of the property in that MACRS class as of the beginning of the taxable year. The capitalized amount allocated to repair allowance property is treated as a section 168(i)(6) improvement to the underlying repair allowance property and is treated as placed in service by the taxpayer on the last day of the first half of the taxable year in which the amount is paid, before application of the convention under section 168(d).

(iv) *Section 168(g) repair allowance property.* If any repair allowance property in a particular MACRS class as of the beginning of the taxable year is depreciated under section 168(g) pursuant to section 168(g)(1)(A) through (D) or other provisions of the Internal Revenue Code, the portion of the capitalized amount for that MACRS class that is attributable to all section 168(g) repair allowance property in that MACRS class (section 168(g) total capitalized amount) is determined by multiplying the capitalized amount for that MACRS class (as determined under paragraph (g)(5)(i) of this section) by a percentage that is equal to the unadjusted basis of all section 168(g) repair allowance property in that MACRS class as of the beginning of the taxable year divided by the unadjusted basis of all repair allowance property in that MACRS class as of the beginning of the taxable year. The section 168(g) total capitalized amount for a particular MACRS class then is allocated to each section 168(g) repair allowance property in that MACRS class by multiplying the section 168(g) total capitalized amount for that MACRS class by a percentage that is equal to the unadjusted basis of the particular section 168(g) repair allowance property in that MACRS class as of the beginning of the taxable year divided by the unadjusted basis of all section 168(g) repair allowance property in that MACRS class as of the beginning of the taxable year. The capitalized amount allocated to each section 168(g) repair allowance property is depreciated in accordance with section 168(g), is treated as a section 168(i)(6) improvement to the underlying repair allowance property, and is treated as placed in service by the taxpayer on the last day of the first half of the taxable year in which the amount is paid, before application of the convention under section 168(d).

(v) *Section 168(g) election.* If a taxpayer makes an election under section 168(g)(7) for a particular MACRS class with respect to property placed in service in the current taxable year, the election applies to the capitalized amount for that MACRS class. If such an election is made, the taxpayer must allocate the capitalized amount for that MACRS class to all repair allowance property in the MACRS class in proportion to the unadjusted basis of the property in that MACRS class as of the beginning of the taxable year. The capitalized amount is treated as a section 168(i)(6) improvement to the underlying repair allowance property and is treated as placed in service by the taxpayer on the last day of the first half of the taxable year in which the amount is paid, before application of the convention under section 168(d). The depreciation of the capitalized amount allocated to repair allowance property must be determined under section 168(g) whether or not the repair allowance property in the MACRS class as of the beginning of the taxable year is depreciated under section 168(g).

(vi) *Public utility property.* If any repair allowance property in a particular MACRS class is public utility property (as defined in section 168(i)(10) or former section 167(l)(3)(A)), the portion of the capitalized amount for that MACRS class that is attributable to all public utility property in that MACRS class (public utility property total capitalized amount) is determined by multiplying the capitalized amount for that MACRS class (as determined under paragraph (g)(5)(i) of this section) by a percentage that is equal to the unadjusted basis of all public utility property in that MACRS class as of the beginning of the taxable year divided by the unadjusted basis of all repair allowance property in that MACRS class as of the beginning of the taxable year. The public utility property total capitalized amount for a particular MACRS class then is subtracted from the unadjusted basis of all repair allowance property in that MACRS class as of beginning of the taxable year to determine the non-public utility property total capitalized amount. A taxpayer may choose to treat the public utility property total capitalized amount for a particular MACRS class as a single asset in accordance with paragraph (g)(5)(ii) of this section, and the non-public utility property total capitalized amount for that MACRS class as another single asset in accordance with paragraph (g)(5)(ii) of this section. Alternatively, the taxpayer may choose to allocate the public utility property total capitalized amount for a particular MACRS class in proportion to the unadjusted basis of the public utility property in that MACRS class as of the beginning of the taxable year in accordance with paragraph (g)(5)(iii) of this section, and allocate the non-public utility property total capitalized amount for a particular MACRS class in proportion to the unadjusted basis of the non-public utility property in that MACRS class as of the beginning of the taxable year in accordance with paragraph (g)(5)(iii) of this section. In either case, the public utility property total capitalized amount for a particular MACRS class is subject to the normalization requirements of section 168(i)(9).

(6) *Repair allowance property*—(i) *In general.* Except as provided in paragraph (g)(6)(iii) of this section, repair allowance property means real or personal property subject to section 168 of the Internal Revenue Code of 1986, or treated as subject to section 168 under paragraph (g)(6)(ii) of this section, that is used in the taxpayer's trade or business or for the production of income.

(ii) *Certain property not subject to section 168.* Repair allowance property includes tangible depreciable property not otherwise in a MACRS class if the taxpayer classifies the property, only for purposes of the repair allowance method in paragraph (g)(4) of this section, to determine the appropriate MACRS class and either the taxpayer placed the property in service before the effective date of section 168 of the Internal Revenue Code of 1986 or the taxpayer properly elected out of section 168 with regard to the property.

(iii) *Exclusions from repair allowance property.* Repair allowance property does not include any property for which the taxpayer has elected to use the asset guideline class repair allowance in § 1.167(a)–11(d)(2); the method of accounting provided in section 263(d) (with regard to certain railroad rolling stock); the method of accounting provided in Rev. Proc. 2001–46 (2001–2 C.B. 263) or Rev. Proc. 2002–65 (2002–2 C.B. 700) (with regard to railroad track) (see § 601.601(d)(2) of this chapter); or any other property or method of accounting that is designated in guidance published in the **Federal Register** or the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

(7) *Excluded additions*—(i) *In general. Excluded addition* means any amount paid—

(A) For the acquisition or production of a specific unit of property;

(B) For work that ameliorates a 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;

(C) For work performed prior to the date the unit of property is placed in service by the taxpayer (without regard to any applicable convention under section 168(d));

(D) That adapts the unit of property to a new or different use; or

(E) That increases the cubic or square space of a building.

(ii) *Treatment of excluded additions.* Any amount paid for an excluded addition is treated as a capital expenditure under sections 263(a) and 263A.

(8) *Repair allowance percentage.* Except as provided in any future guidance published in the **Federal Register** or the Internal Revenue Bulletin, the repair allowance percentage in effect for each MACRS class for a particular taxable year is as follows:

MACRS class	MACRS recovery period (years)	Repair allowance percentage
3-year property	3	16.5
5-year property	5	10
7-year property	7	7.14
10-year property	10	5
15-year property	15	3.33
20-year property	20	2.5
Water utility property	25	2
Residential rental property	27.5	1.82
Nonresidental rental property	39	1.28
Railroad grading or tunnel bore	50	1

(9) *Manner of election*. [Reserved]

(10) *Manner of revoking election*. A taxpayer may revoke an election made under the repair allowance method only by obtaining the Commissioner's consent to revoke the election. An election must be revoked prospectively and may not be revoked through the filing of an amended Federal income tax return. A taxpayer that revokes an election may not re-elect the repair allowance method for a period of at least five taxable years, beginning with the year of the revocation unless, based on a showing of unusual and compelling circumstances, consent is specifically granted by the Commissioner to re-elect the repair allowance at an earlier time.

(11) *Examples*. The following examples illustrate the rules of this paragraph (g) and assume that none of the rules in paragraph (g)(5)(iv) or (g)(5)(v) of this section applies:

Example 1. X elects the repair allowance method described in this paragraph (g). X's total unadjusted basis of all of its MACRS 10-year property as of January 1, 2008 is $10 million. X's total unadjusted basis of all MACRS 10-year property as of December 31, 2008 is $15 million (computed without regard to amounts capitalized under this repair allowance provision). During 2008, X pays $1,000,000 to repair, maintain, or improve MACRS 10-year property. Assume that none of X's property is an excluded addition as defined in paragraph (g)(7) of this section. The repair allowance percentage for MACRS 10-year property is 5 percent. X's repair allowance amount and capitalized amount are computed as follows:

(i) X determines its average unadjusted basis of MACRS 10-year property: ($10,000,000 + $15,000,000)/2 = $12,500,000.

(ii) X multiplies its average unadjusted basis of MACRS 10-year property by the prescribed repair allowance percentage for MACRS 10-year property to arrive at the repair allowance amount: $12,500,000 × 5% = $625,000.

(iii) Because X's amounts paid to repair, maintain, or improve MACRS 10-year property ($1,000,000) exceed the repair allowance amount for MACRS 10-year property ($625,000), X deducts under section 162(a) amounts paid to the extent of the repair allowance amount ($625,000) and capitalizes the amounts paid in excess of the repair allowance amount ($1,000,000 − $625,000 = $375,000).

(iv) The capitalized amount ($375,000) is treated as an improvement under section 168(i)(6). The improvement is depreciated as 10-year property under section 168 and is considered placed in service on the last day of the first half of 2008.

Example 2. X elects the repair allowance method described in this paragraph (g). X uses a car in providing a taxi service. X's unadjusted basis in the car is $25,000. Assume that the unit of property (as determined under paragraph (d)(2) of this section) is the car. In 2008, X incurs various costs to maintain, repair, and improve the car, including: $4,500 for gasoline; $550 for car washes and detailing, $2,200 for scheduled maintenance such as oil changes, tire rotation, new brakes, minor parts, and fluid replacements, etc.; $80 for new headlights; $250 for new tires; and $4,800 to rebuild the engine after the car overheated. Assume that none of X's expenditures are an excluded addition as defined in paragraph (g)(7) of this section. The car is classified as MACRS 5-year property. Assume that X has no other MACRS 5-year property. The repair allowance percentage for MACRS 5-year property is 10 percent. X's repair allowance amount and capitalized amount are computed as follows:

(i) X determines its average unadjusted basis of MACRS 5-year property is $25,000.

(ii) X multiplies its average unadjusted basis of MACRS 5-year property by the prescribed repair allowance percentage for MACRS 5-year property to arrive at the repair allowance amount: $25,000 × 10% = $2,500.

(iii) Because X's amounts to repair, maintain, or improve MACRS 5-year property ($2,200 + $80 + $250 + $4,800 = $7,330) exceed the repair allowance amount for MACRS 5-year property ($2,500), X treats $2,500 as an otherwise deductible ordinary and necessary expenditure under section 162(a) and capitalizes $4,830 as the amounts paid in excess of the repair allowance amount.

(iv) The capitalized amount ($4,830) is treated as an improvement under section 168(i)(6). The improvement is depreciated as 5-year property under section 168 and is considered placed in service on the last day of the first half of 2008.

(h) *Treatment of capital expenditures*. Amounts required to be capitalized under this section are capital expenditures and must be taken into account through a charge to capital account or basis, or in the case of property that is inventory in the hands of a taxpayer, through inclusion in inventory costs. See section 263A for the treatment of amounts referred to in this section as well as other amounts paid in connection with the production of real property and personal property, including films, sound recordings, video tapes, books, or similar properties.

(i) *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 Internal Revenue Code and regulation provisions relating to the use, sale, or disposition of property.

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

(k) *Accounting method changes*. [Reserved]

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

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