

Depreciation, Repairs and Fixed Assets

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APRIL 23, 2016 BY ED ZOLLARS, CPA

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For the Week of May 2, 2016




May 2, 2016 - IRS and the High Seas

APRIL 30, 2016 BY ED ZOLLARS, CPA

For this week of May 2, 2016 in Current Federal Tax Developments we look at:

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	May 2, 2016 Current Developments - IRS and the High Seas Edward K Zollars, CPA	Download
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- [2016-05-02 Current Federal Tax Developments](#)

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- Links to material related to this course
- Includes
 - September 2016 IRS Audit Technique Guide on Capitalization
 - IRS Tables for Depreciation

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Depreciation, Repairs and Fixed Assets

GENERAL RULES FOR EXPENSING VS. CAPITALIZING

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Repair vs. Capitalize

- Always a matter of dispute between taxpayers and the IRS
- Supreme Court found the default treatment is **capitalization**

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Indopco v. Commissioner, 503 US 79

In exploring the relationship between deductions and capital expenditures, this Court has noted the "familiar rule" that "an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer." *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593 (1943); *Deputy v. Du Pont*, 308 U.S. 488, 493 (1940); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934). The notion that deductions are exceptions to the norm of capitalization finds support in various aspects of the Code. Deductions are specifically enumerated and thus are subject to disallowance in favor of capitalization. See sections 161 and 261. Nondeductible capital expenditures, by contrast, are not exhaustively enumerated in the Code; rather than providing a "complete list of nondeductible expenditures," *Lincoln Savings*, 403 U.S., at 358, section 263 serves as a general means of distinguishing capital expenditures from current expenses. See *Commissioner v. Idaho Power Co.*, 418 U.S., at 16. For these reasons, deductions are strictly construed and allowed only "as there is a clear provision therefor." *New Colonial Ice Co. v. Helvering*, 292 U.S., at 440; *Deputy v. Du Pont*, 308 U.S., at 493. ⁴

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Section 263 & 162

- Despite default, IRS found courts were looking at the repair regulation first
- Thus we got results under the old regulations that weren't always to the IRS' s liking, though they sometimes were

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No “Capitalization Policy” Policy

- Prior law provided no option for using a capitalization policy – see *Alacare Home Services*, TC Memo 2001-149

Petitioner contends that we have sanctioned the use of a minimum expensing rule, citing *Galazin v. Commissioner*, T.C. Memo. 1979-206, in which we allowed the taxpayer to deduct the cost of a calculator due to the small amount of the expenditure (\$52.45) and the relatively short (2-year) useful life of the asset. Here, respondent disallowed deductions of \$467,944 and \$351,543 for the disputed items. These amounts are not comparable to the amount at issue in *Galazin*. Cf. *Sharon v. Commissioner*, 66 T.C. 515, 527 (1976) (taxpayer must capitalize \$801 bar examination fees and expenses to practice law in California because amount was too large to disregard its capital nature), *affd.* 591 F.2d 1273 (9th Cir. 1978).

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IRS Repair Losses Under Old Regulations

- Roof cases – amount of expense not the key, rather it is an issue of proper thing to measure improvement against
 - *Oberman Manufacturing Co. v. Commissioner*, 47 T.C. 471 (1967)
 - *Thomas J. Northen v. Commissioner*, TC Summary Opinion 2003-113 (among others)
- Aircraft engine rebuild also a repair – *FedEx Corporation v. U.S.*, CA6, 2005-1 USTC ¶150,186

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Depreciation, Repairs and Fixed Assets

RECENT CHANGES

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Executive Summary

- Expected practical impact will be
 - Change how repair vs. capitalize is determined
 - New elections that need to be tracked
 - Force fewer repairs for buildings
- What now?
 - Use new rules
 - Consider annual elections (3)

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Accounting Methods

- Accounting method
 - Affects timing of recognition
 - Does not change ultimate amount recognized
- CCA 201345025 example of difference
 - Deducted commissions twice, once when accrued and once when paid
 - Not accounting method

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Form 3115/Tangible Property Relief

- Revenue Procedure 2015-20, 2/13/15
 - Small business taxpayers get relief for trade or business with either
 - Total assets of less than \$10 million *or*
 - Average annual gross receipts of \$10 million or less
 - Optional method of adopting new rules
 - Only take into accounts amounts in years beginning on or after 1/1/14
 - No Form 3115 or attachment needed

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Form 3115/Tangible Property Relief

- Revenue Procedure 2015-20, 2/13/15
 - Elections are not impacted – still must make these elections if wish to use
 - De minimis
 - Small taxpayer small building safe harbor
 - Capitalize repair and maintenance costs
 - Covers most changes (DCNs 184, 185, 186, 187, 188, 189, 190, 191, 192, 193, 200, 205 and 206)

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Form 3115/Tangible Property Relief

- Revenue Procedure 2015-20, 2/13/15
 - Trade-offs if elect to use
 - Must still file Form 3115 for other changes if need/wish to make
 - No audit protection for prior years
 - Can't take into account dispositions occurring in years beginning before 1/1/14
 - Have two sets of regulations that will apply to depreciation schedules going forward

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Change to De Minimis

- Notice 2015-82, 11/24/15
 - Raised de minimis invoice cost to \$2,500 from \$500
 - Effective for tax years beginning after January 1, 2016
 - IRS will not challenge earlier use *if meet all other requirements*

CAPITALIZATION RULES GENERALLY

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Overview

- Latest attempt by IRS to provide guidance on the deductibility (or required capitalization) of amounts paid (or incurred) to acquire, produce, or improve **tangible** property
 - Changes to fifteen regulation sections
 - Nine relate to Code Secs. **162 – 168**
 - Four relate to Code Sec. **263(a)**
 - One relates to Code Sec. **263A**
 - One relates to Code Sec. **1016**
 - **Numerous examples**
- Released as final **9/19/13 (except general asset disposition, issued 8/18/14)**, all effective 1/1/2014 (elective 1/1/12)

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Overview (continued)

- IRS acknowledges difficulty of applying the rules in practice, but offers these general distinctions
 - Repair – deduct
 - Renovation – capitalize
 - Betterment – capitalize
 - Adapt - capitalize

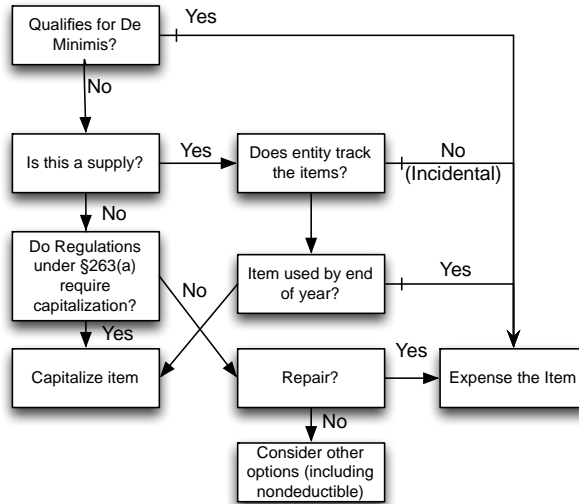
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Overview (continued)

- The overriding purpose of these regulations is to change the approach to deductibility, from:
 - Looking 1st to Sec. 162 . . . Is it deductible ?
To . . .
 - Looking 1st to Sec. 263 . . . Is it capitalizable ?
- Some of the rules changed by these regulations were last addressed in 1956 and 1960

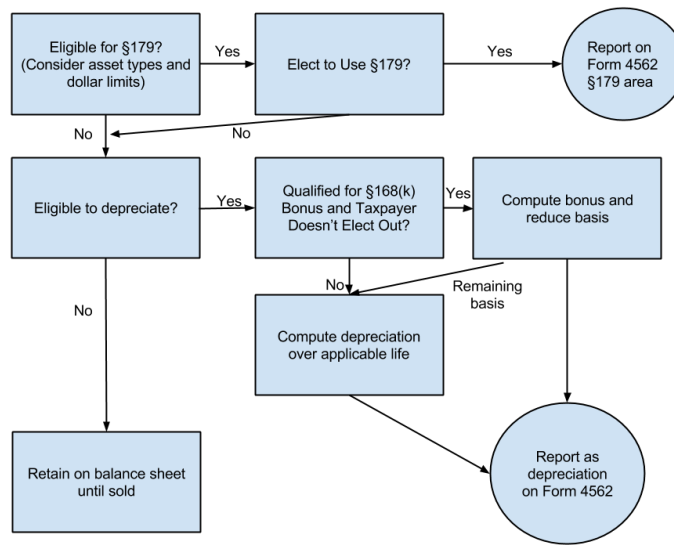
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Rough Summary



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If Capitalized



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De Minimis Rule

An Annual Election

1.263(a)-1 De Minimis Safe Harbor Election

- Rules found here to cover
 - Materials and supplies [Reg. § 1.162-3]
 - Acquisition [Reg. § 1.263(a)-2]
 - Improvement/Betterment [Reg. § 1.263(a)-3]
- Not applicable for
 - Property used as inventory
 - Amounts paid for land
 - Rotable, temporary and emergency spare parts
taxpayer either elects to depreciate or use optional method

1.263(a)-1 De Minimis Safe Harbor Election

- Taxpayer with applicable financial statement
 - Written policy in place as of first day of tax year regarding capitalization
 - Policy followed on applicable financial statement
 - Invoice cost \$5,000 or less

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1.263(a)-1 De Minimis Safe Harbor Election

- Taxpayer without applicable financial statement
 - Procedures in place as of first day of year (no mention of written but...)
 - Policy followed on books
 - Invoice cost of ~~\$500~~ \$2,500 or less

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Applicable Financial Statement

- First one of the following the taxpayer has for tax year is its AFS:
 - Financial statement required to be filed with SEC,
 - Certified audited statement used for
 - Credit purposes
 - Reporting to owners
 - Other substantial non-tax purpose, or
 - Financial statement (other than tax return) required to be provided to federal or state government or agency (other than SEC or IRS) [Apparently, not required to be certified]
- If do not have any of these, does not have an AFS

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Invoice Costs

- Cost to include/not include
 - Ignore costs not included in invoice
 - Include any additional costs on the invoice
 - Must reasonably allocate such expenses if relate to multiple pieces of property
 - If use method for § 263(a) must also use for materials and supplies

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Invoice Cost Example

	Quantity	Unit Price	Total
Servers	5	5,000.00	\$ 25,000.00
Sales Tax			<u>2,075.00</u>
Total Cost			<u>\$ 27,075.00</u>
Invoice Price for De Minimis Test			<u>\$ 5,415.00</u>

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Invoice Cost Example

Buy from Out of State

	Quantity	Unit Price	Total
Servers	5	5,000.00	\$ 25,000.00
Sales Tax			<u>-</u>
Total Cost			<u>\$ 25,000.00</u>
Use tax paid directly to state			<u>\$ 2,075.00</u>
Invoice Price for De Minimis Test			<u>\$ 5,000.00</u>

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Final Regulation De Minimis

- Reg. § 1.263(a)-1(f) – Relocated and Changes Made
- Taxpayer with applicable financial statement
 - Got rid of % of sales/depreciation limits
 - Allowed 12 month economic life policy
 - Cap of \$5,000 per invoice rather than aggregate limit
 - Allowed modified method for taxpayers without AFS

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Final Regulation De Minimis

- Administrative modification with examining agents
 - Preamble allows for agreed upon higher limit
 - Important to point out on exam that can still argue “clear reflection of income”
 - Note “clear reflection of income” always applies under § 446, so taxpayer can maintain “unallowed” method if it still clearly reflects income

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Final Regulation De Minimis

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

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Final Regulation De Minimis

- So essentially
 - No policy (or procedures if no AFS) - \$200 limit
 - With AFS and policy – protection up to \$5,000 for items expensed per policy
 - Without AFS but with procedures – protection up to ~~\$500~~ **\$2,500** for items expensed per policy

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1.263(a)-1 De Minimis Safe Harbor Election

- Groups that report on same applicable financial statement can use single accounting procedures
- Making election
 - Required statement [Reg. § 1.263(a)-1(f)(5)]
 - Titled “Section 1.263(a)-1(f) de minimis safe harbor election”
 - Include name, EIN and statement making election under Reg. § 1.263(a)-1(f)
 - Partnership/S corporation must elect at entity, not equity holder, level

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Example

Section 1.263(a)-1(f) de minimis safe harbor election

Taxpayer Information

ABC Widgets
4000 East 1st Street
Anywhere, USA 00000
EIN: 99-9999999

Statement Required

The taxpayer is making the de minimis safe harbor election under §1.263(a)-1(f)

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1.263(a)-1 De Minimis Safe Harbor Election

- Anti-abuse rule
 - Example of attempting to “componentize” via invoices
 - Other methods that appear to attempt to use option in unintended fashion
- Eleven examples

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1.263(a)-1 De Minimis Safe Harbor Election

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

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1.263(a)-1 De Minimis Safe Harbor Election

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

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1.263(a)-1 De Minimis Safe Harbor Election

Example 3. De minimis safe harbor; taxpayer with AFS. C is a member of a consolidated group for Federal income tax purposes. C's financial results are reported on the consolidated applicable financial statements for the affiliated group. C's affiliated group has a written accounting policy at the beginning of Year 1, which is followed by C, to expense amounts paid for property costing \$5,000 or less. In Year 1, C pays \$6,250,000 to purchase 1,250 computers at \$5,000 each. C receives an invoice from its supplier indicating the total amount due (\$6,250,000) and the price per item (\$5,000).

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1.263(a)-1 De Minimis Safe Harbor Election

Assume that each computer is a unit of property under § 1.263(a)-3(e). The amounts paid for the computers meet the requirements for the de minimis safe harbor under paragraph (f)(1)(i) of this section. If C elects to apply the de minimis safe harbor under this paragraph (f) for Year 1, C may not capitalize the amounts paid for the 1,250 computers or any other amounts meeting the criteria for the de minimis safe harbor under paragraph (f)(1) of this section. Instead, in accordance with paragraph (f)(3)(iv) of this section, C may deduct these amounts under § 1.162-1 in the taxable year the amounts are paid provided the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on a trade or business.

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1.263(a)-1 De Minimis Safe Harbor Election

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

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1.263(a)-1 De Minimis Safe Harbor Election

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

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1.263(a)-1 De Minimis Safe Harbor Election

Example 5. De minimis safe harbor; additional invoice costs. E is a member of a consolidated group for Federal income tax purposes. E's financial results are reported on the consolidated applicable financial statements for the affiliated group. E's affiliated group has a written accounting policy at the beginning of Year 1, which is followed by E, to expense amounts paid for property costing less than \$5,000. In Year 1, E pays \$45,000 for the purchase and installation of wireless routers in each of its 10 office locations. Assume that each wireless router is a unit of property under § 1.263(a)-3(e). E receives an invoice from its supplier indicating the total amount due (\$45,000), including the material price per item (\$2,500), and total delivery and installation (\$20,000).

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1.263(a)-1 De Minimis Safe Harbor Election

E allocates the additional invoice costs to the materials on a pro rata basis, bringing the cost of each router to \$4,500 (\$2,500 materials + \$2,000 labor and overhead). The amounts paid for each router, including the allocable additional invoice costs, meet the requirements for the de minimis safe harbor under paragraph (f)(1)(i) of this section. If E elects to apply the de minimis safe harbor under this paragraph (f) for Year 1, E may not capitalize the amounts paid for the 10 routers (including the additional invoice costs) or any other amounts meeting the criteria for the de minimis safe harbor under paragraph (f)(1) of this section. Instead, in accordance with paragraph (f)(3)(iv) of this section, E may deduct these amounts under § 1.162-1 in the taxable year the amounts are paid provided the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on a trade or business.

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1.263(a)-1 De Minimis Safe Harbor Election

Example 6. De minimis safe harbor; non-invoice additional costs. F is a corporation that provides consulting services to its customer. F does not have an AFS, but F has accounting procedures in place at the beginning of Year 1 to expense amounts paid for property costing less than \$500. In Year 1, F pays \$600 to an interior designer to shop for, evaluate, and make recommendations regarding purchasing new furniture for F's conference room. As a result of the interior designer's recommendations, F acquires a conference table for \$500 and 10 chairs for \$300 each. In Year 1, F receives an invoice from the interior designer for \$600 for his services, and F receives a separate invoice from the furniture supplier indicating a total amount due of \$500 for the table and \$300 for each chair. For Year 1, F treats the amount paid for the table and each chair as an expense on its books and records, and F elects to use the de minimis safe harbor for amounts paid for tangible property that qualify under the safe harbor.

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1.263(a)-1 De Minimis Safe Harbor Election

The amount paid to the interior designer is a cost of facilitating the acquisition of the table and chairs under § 1.263(a)-2(f). Under paragraph (f)(3)(i) of this section, F is not required to include in the cost of tangible property the additional costs of acquiring such property if these costs are not included in the same invoice as the tangible property. Thus, F is not required to include a pro rata allocation of the amount paid to the interior designer to determine the application of the de minimis safe harbor to the table and the chairs. Accordingly, the amounts paid by F for the table and each chair meet the requirements for the de minimis safe harbor under paragraph (f)(1)(ii) of this section, and F may not capitalize the amounts paid for the table or each chair under paragraph (f)(1) of this section. In addition, F is not required to capitalize the amounts paid to the interior designer as a cost that facilitates the acquisition of tangible property under § 1.263(a)-2(f)(3)(i). Instead, F may deduct the amounts paid for the table, chairs, and interior designer under § 1.162-1 in the taxable year the amounts are paid provided the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on a trade or business.

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1.263(a)-1 De Minimis Safe Harbor Election

Example 7. De minimis safe harbor; 12-month economic useful life. G operates a restaurant. In Year 1, G purchases 10 hand-held point-of-service devices at \$300 each for a total cost of \$3,000 as indicated by invoice. G also purchases 3 tablet computers at \$500 each for a total cost of \$1,500 as indicated by invoice. Assume each point-of-service device and each tablet computer has an economic useful life of 12 months or less, beginning when they are used in G's business. Assume that each device and each tablet is a unit of property under § 1.263(a)-3(e). G does not have an AFS, but G has accounting procedures in place at the beginning of Year 1 to expense amounts paid for property costing \$300 or less and to expense amounts paid for property with an economic useful life of 12 months or less. Thus, G expenses the amounts paid for the hand-held devices on its books and records because each device costs \$300. G also expenses the amounts paid for the tablet computers on its books and records because the computers have an economic useful life of 12 months or less, beginning when they are used.

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1.263(a)-1 De Minimis Safe Harbor Election

The amounts paid for the hand-held devices and the tablet computers meet the requirements for the de minimis safe harbor under paragraph (f)(1)(ii) of this section. If G elects to apply the de minimis safe harbor under this paragraph (f) in Year 1, G may not capitalize the amounts paid for the hand-held devices, the tablet computers, or any other amounts meeting the criteria for the de minimis safe harbor under paragraph (f)(1) of this section. Instead, in accordance with paragraph (f)(3)(iv) of this section, G may deduct the amounts paid for the hand-held devices and tablet computers under § 1.162-1 in the taxable year the amounts are paid provided the amounts otherwise constitute deductible ordinary and necessary business expenses incurred in carrying on a trade or business.

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1.263(a)-1 De Minimis Safe Harbor Election

The amounts paid for the hand-held devices and the tablet computers meet the requirements for the de minimis safe harbor under paragraph (f)(1)(ii) of this section. If G elects to apply the de minimis safe harbor under this paragraph (f) in Year 1, G may not capitalize the amounts paid for the hand-held devices, the tablet computers, or any other amounts meeting the criteria for the de minimis safe harbor under paragraph (f)(1) of this section. Instead, in accordance with paragraph (f)(3)(iv) of this section, G may deduct the amounts paid for the hand-held devices and tablet computers under § 1.162-1 in the taxable year the amounts are paid provided the amounts otherwise constitute deductible ordinary and necessary business expenses incurred in carrying on a trade or business.

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1.263(a)-1 De Minimis Safe Harbor Election

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

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1.263(a)-1 De Minimis Safe Harbor Election

Example 9. De minimis safe harbor; materials and supplies. H is a corporation that provides consulting services to its customers. H has an AFS and a written accounting policy at the beginning of the taxable year to expense amounts paid for property costing \$5,000 or less. In Year 1, H purchases 1,000 computers at \$500 each for a total cost of \$500,000. Assume that each computer is a unit of property under § 1.263(a)-3(e) and is not a material or supply under § 1.162-3. In addition, H purchases 200 office chairs at \$100 each for a total cost of \$20,000 and 250 customized briefcases at \$80 each for a total cost of \$20,000. Assume that each office chair and each briefcase is a material or supply under § 1.162-3(c)(1). H treats the amounts paid for the computers, office chairs, and briefcases as expenses on its AFS.

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1.263(a)-1 De Minimis Safe Harbor Election

The amounts paid for computers, office chairs, and briefcases meet the requirements for the de minimis safe harbor under paragraph (f)(1)(i) of this section. If H elects to apply the de minimis safe harbor under this paragraph (f) in Year 1, H may not capitalize the amounts paid for the 1,000 computers, the 200 office chairs, and the 250 briefcases under paragraph (f)(1) of this section. H may deduct the amounts paid for the computers, the office chairs, and the briefcases under § 1.162-1 in the taxable year the amounts are paid provided the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on a trade or business.

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1.263(a)-1 De Minimis Safe Harbor Election

Example 10. De minimis safe harbor; coordination with section 263A. J is a member of a consolidated group for Federal income tax purposes. J's financial results are reported on the consolidated AFS for the affiliated group. J's affiliated group has a written accounting policy at the beginning of Year 1, which is followed by J, to expense amounts paid for property costing less than \$1,000 or that has an economic useful life of 12 months or less. In Year 1, J acquires jigs, dies, molds, and patterns for use in the manufacture of J's products. Assume each jig, die, mold, and pattern is a unit of property under § 1.263(a)-3(e) and costs less than \$1,000.

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1.263(a)-1 De Minimis Safe Harbor Election

In Year 1, J begins using the jigs, dies, molds and patterns to manufacture its products. Assume these items are materials and supplies under § 1.162-3(c)(1)(iii), and J elects to apply the de minimis safe harbor under paragraph (f)(1)(i) of this section to amounts qualifying under the safe harbor in Year 1. Under paragraph (f)(3)(v) of this section, the amounts paid for the jigs, dies, molds, and patterns may be subject to capitalization under section 263A if the amounts paid for these tangible properties comprise the direct or allocable indirect costs of other property produced by the taxpayer or property acquired for resale.

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1.263(a)-1 De Minimis Safe Harbor Election

Example 11. De minimis safe harbor; anti-abuse rule. K is a corporation that provides hauling services to its customers. In Year 1, K decides to purchase a truck to use in its business. K does not have an AFS. K has accounting procedures in place at the beginning of Year 1 to expense amounts paid for property costing less than \$500. K arranges to purchase a used truck for a total of \$1,500. Prior to the acquisition, K requests the seller to provide multiple invoices for different parts of the truck. Accordingly, the seller provides K with four invoices during Year 1--one invoice of \$500 for the cab, one invoice of \$500 for the engine, one invoice of \$300 for the trailer, and a fourth invoice of \$200 for the tires. K treats the amounts paid under each invoice as an expense on its books and records. K elects to apply the de minimis safe harbor under paragraph (f) of this section in Year 1 and does not capitalize the amounts paid for each invoice pursuant to the safe harbor.

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1.263(a)-1 De Minimis Safe Harbor Election

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

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De Minimis Rule Example

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

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De Minimis Rule Example

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

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Election to Capitalize and Depreciate

- Taxpayer may “elect” (by simply doing so) to capitalize and depreciate any “material and supply” except:
 - Parts to be used in unit of property that will not be capitalized and appreciated, or
 - Cost of a rotatable or temporary spare part for which taxpayer has elected the optional method of accounting

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Election Example

Example 13. Election to capitalize and depreciate. M is in the mining business. M acquires certain temporary spare parts, which it keeps on hand to avoid operational time loss in the event it must make temporary repairs to a unit of property that is subject to depreciation. These parts are not used to improve property under § 1.263(a)-3(d). These temporary spare parts are used until a new or repaired part can be installed and then are removed and stored for later temporary installation. M does not use the optional method of accounting for rotatable and temporary spare parts in paragraph (e) of this section for any of its rotatable or temporary spare parts. The temporary spare parts are materials and supplies under paragraph (c)(1)(i) of this section. Under paragraphs (a)(1) and (a)(3) of this section, the amounts paid for the temporary spare parts are deductible in the taxable year in which they are disposed of by M.

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Election Example

However, because it is unlikely that the temporary spare parts will be disposed of in the near future, M would prefer to treat the amounts paid for the spare parts as capital expenditures subject to depreciation. M may elect under paragraph (d) of this section to treat the cost of each temporary spare part as a capital expenditure and as an asset subject to an allowance for depreciation. M makes this election by capitalizing the amounts paid for each spare part in the taxable year that M acquires the spare parts and by beginning to recover the costs of each part on its timely filed Federal tax return for the taxable year in which the part is placed in service for purposes of determining depreciation under the applicable provisions of the Internal Revenue Code and the Treasury Regulations. See § 1.263(a)-2(g) for the treatment of capital expenditures

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Other Definitions, Elections, and Examples

- Elect to apply de minimis rule **making election**
- Disposition of materials and supplies is ordinary income transaction, not 1221 or 1231
- 14 examples illustrate the new rules governing materials, supplies, and rotatable spare parts

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Depreciation, Fixed Assets and Repairs

CAPITAL EXPENDITURES IN GENERAL

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1.263(a)-1 Capital Expenditures; In General

- General rule . . . Except as provided in chapter 1 of the IRC (elsewhere in the Code) no deduction is allowed for
 - Any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property
 - Any amount paid to restore property or make good the exhaustion thereof for which an allowance is or has been made

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1.263(a)-1 (continued)

- Coordination with 263A . . .
 - 263(a) **requires capitalization of costs** to acquire produce or improve real or tangible property
 - 263A **prescribes direct and indirect costs that must be capitalized** to property produced or acquired for resale by the taxpayer
 - Examples of capital expenditures:
 - Amount paid to acquire or produce a unit of property - 1.263(a)-2
 - Amount paid to improve a unit of property – 1.263(a)-3
 - Amount paid to acquire or create intangibles – 1.263(a)-4
 - Amount paid or incurred to facilitate acquisition of a trade or business or changing capital structure of the same – 1.263(a)-5
 - Amount paid to acquire or create interests in land; easements, life estates, mineral interests, zoning variances, etc.

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1.263(a)-1 Amounts Paid to Sell Property

- In general . . . Commissions and other transaction costs to facilitate sale of property must be capitalized
 - Dealers in property treat such amounts as 162 expenses
- Capitalized amounts are treated as reduction in amount realized and taken into account in year sale is abandoned if loss is permissible
- Amount paid . . . For accrual basis taxpayer means a liability incurred as defined in 1.446-1(c)(1)(ii)
- Taxpayer changing to a method of accounting allowed by these rules must follow admin. process

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1.263(a)-1 Amounts Paid to Sell Property

- Six examples
 - All commissions, legal fees, etc. to sell property must be capitalized
 - Dealer deducts as ordinary and necessary
 - Other than dealers, appraisals must be capitalized (examples 4, 5, & 6)

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1.263(a)-1 Amounts Paid to Sell Property

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.

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1.263(a)-1 Amounts Paid to Sell Property

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.

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1.263(a)-1 Amounts Paid to Sell Property

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

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1.263(a)-1 Amounts Paid to Sell Property

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

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1.263(a)-1 Amounts Paid to Sell Property

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, Year 1, X pays for an appraisal to determine a reasonable asking price. On February 15, Year 2, X sells the truck to Y. X is required to capitalize in Year 1 the amount paid to appraise the truck and, in Year 2, is required to offset the amount paid against the amount realized from the sale of the truck.

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1.263(a)-1 Amounts Paid to Sell Property

Example 6. Costs of abandoned sale of personal property not used in a trade or business. Assume the same facts as in Example 5, except that, instead of selling the truck on February 15, Year 2, X decides on that date not to sell the truck and takes the truck off the market. X is required to capitalize in Year 1 the amount paid to appraise the truck. Although the sale is abandoned in Year 2, X may not treat the amount paid to appraise the truck as a loss under section 165 because the truck was not used in X's trade or business or in a transaction entered into for profit.

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PAYMENTS TO ACQUIRE ASSETS

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Sec. 1.263(a)-2 Payments to Acquire or Produce Tangible Property

- Overview . . . 2 provides rules for applying 263(a) to amounts paid to acquire or produce a unit of real or personal property
 - (b) . . . definitions
 - (c) . . . rules for coordinating with other provisions of the code
 - (d) . . . general requirement to capitalize amounts paid to acquire or produce a unit of property
 - (e) . . . requirement to capitalize amounts paid to defend or perfect title to property

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1.263(a)-2 Overview (continued)

- (f) . . . rules for capitalizing transaction costs related to acquisition of property
- (g) & (h) . . . treatment and recovery of capital expenditures
- (i) . . . changes in methods of accounting to comply with new rules
- (j) . . . effective for tax years beginning on or after 1/1/14 (though can elect application as of 1/1/12)
- Note – removed old “(g)” which was de minimis rules and moved it to § 1.263(a)-1 discussed earlier

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1.263(a)-2 Definitions

- Amount paid . . . Amount paid or liability incurred by taxpayer using the accrual method of accounting
- Personal property . . . Tangible personal property as defined in 1.48-1(c)
- Real property . . . Land and improvements thereto
 - Buildings or other inherently permanent structures (including structural components of the buildings or structures)
 - Not personal property
 - Tangible property under 1.48-1(d)
 - Local law does not determine real property
- Produce . . . Construct, build, install, manufacture, develop, create, raise, or grow [See 1.263A-2(a)(1)(i)]

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1.263(a)-2 Coordination with Other Provisions of Code

- In general . . . Except as provided in de minimis rule which follows, nothing in 1.263(a)-2 changes the treatment of any amount specifically dealt with in the Code other than in 162(a) and 212 and their regulations
- Materials and supplies . . . Except as provided in de minimis rule, nothing in 1.263(a)-2 changes the treatment of amounts paid to acquire or produce property properly treated as materials and supplies under 1.162-3

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1.263(a)-2 When to Capitalize Acquisition or Production Cost

- Requirement to capitalize . . . Except as provided in de minimis rule, and in 1.162-3 (relating to materials and supplies) a taxpayer must capitalize amounts paid to acquire or produce a unit of real or personal property (as determined under 1.263(a)-3(e), including:
 - Leasehold improvements
 - Land and land improvements
 - Buildings
 - Machinery and equipment
- “amounts paid” include invoice price, transaction costs, and costs incurred prior to property being placed in service

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1.263(a)-2 When to Capitalize Acquisition or Production Cost

- Eleven examples – capitalize . . . ?
 - New Cash Registers - yes
 - Stock of aircraft parts to be used for maintenance & repair – no?
 - Small items held for rent and held for replacement – maybe !
 - Jigs, dies, molds and patterns - yes
 - Acquisition of building (costs to facilitate) - yes
 - Acquisition of property for resale - yes
 - Production of building (See 263A for cost to capitalize) - yes
 - Section 1060 acquisition (capitalize FMV of tangible assets)
 - Work prior to placed in service - yes
 - Testing prior to placed in service – yes . . . After - no

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1.263(a)-2 When to Capitalize Acquisition or Production Cost

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

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1.263(a)-2 When to Capitalize Acquisition or Production Cost

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

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1.263(a)-2 When to Capitalize Acquisition or Production Cost

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

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1.263(a)-2 When to Capitalize Acquisition or Production Cost

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

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1.263(a)-2 When to Capitalize Acquisition or Production Cost

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

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1.263(a)-2 When to Capitalize Acquisition or Production Cost

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

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1.263(a)-2 When to Capitalize Acquisition or Production Cost

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

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1.263(a)-2 When to Capitalize Acquisition or Production Cost

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

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1.263(a)-2 When to Capitalize Acquisition or Production Cost

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

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1.263(a)-2 When to Capitalize Acquisition or Production Cost

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

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1.263(a)-2 When to Capitalize Acquisition or Production Cost

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

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1.263(a)-2 When to Capitalize Payments for Defense of Title

- In general . . . Amounts paid to defend or perfect title to real or personal property are considered paid to acquire or produce the property and must be capitalized
- Examples
 - Attorney fees paid to contest condemnation - capitalize
 - Attorney fees paid to invalidate ordinance – deduct
 - Attorney fees paid to challenge building line - capitalize

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1.263(a)-2 When to Capitalize Payments for Defense of Title

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

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1.263(a)-2 When to Capitalize Payments for Defense of Title

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

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1.263(a)-2 When to Capitalize Payments for Defense of Title

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

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1.263(a)-2 Transaction Costs to Facilitate Acquisition or Production

- In general . . . Costs to facilitate acquisition or production of real or personal property must be capitalized
 - See 263A for rules relating to property produced by taxpayer
 - See 1.263(a)-5 for rules relating to amounts paid to facilitate acquisition of assets constituting a trade or business
 - See 1.167(a)-5 for allocation of facilitative costs between depreciable and non-depreciable property
- Paid to facilitate an acquisition . . . Paid in process of investigating or otherwise pursuing an acquisition

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1.263(a)-2 Transaction Costs to Facilitate Acquisition or Production

- Employee compensation and overhead
 - Generally do not capitalize [Reg. § 1.263(a)-2(f)(2)(iv)(A)]
 - Can elect to do so [Reg. § 1.263(a)-2(f)(2)(iv)(B)]
 - Cannot undo election once made
 - Partnerships/S corporations must make at the entity level

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1.263(a)-2 Transaction Costs to Facilitate Acquisition or Production

- Inherently facilitative costs include . . .
 - Transporting property
 - Appraisals and value determinations
 - Negotiating terms and obtaining tax advice on acquisition
 - Application fees, bidding costs, etc.
 - Preparing and reviewing sales contract, etc.
 - Examining and evaluating title to property
 - Obtaining regulatory approval, costs of permits and fees
 - Conveyance costs; transfer taxes and title registration
 - Finders fee or brokers commission including contingencies
 - Various inspection services performed before closing
 - Services provided by Q I to facilitate 1031 exchange

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1.263(a)-2 Transaction Costs to Facilitate Acquisition or Production

- Special rules for acquisition of real property
 - Cost is **not** facilitative if related to determining whether to acquire real property and which real property to acquire
 - Use reasonable allocation method for costs incurred to acquire real and personal property in a single transaction
 - Except as required by 263A, employee compensation and overhead are not required to be capitalized
 - Taxpayer may elect to capitalize amounts otherwise deductible
 - All facilitative costs are required to be capitalized

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1.263(a)-2 Transaction Costs to Facilitate Acquisition or Production

- Added definition of “contingency fee”
 - Contingent on successful closing of the property
 - Must be allocated only to property acquired— cannot treat part as allocable to property not acquired

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1.263(a)-2 Transaction Costs to Facilitate Acquisition or Production

- Ten examples . . .
 - Broker’s fees to facilitate acquisition – capitalize
 - Inspection and survey costs – capitalize
 - Moving costs to facilitate acquisition – capitalize
 - Geological and geophysical costs; oil and gas production – capitalize as a separate asset from real property
 - Fee to interior designer – capitalize
 - Fees to evaluate alternative sites – capitalize
 - Fees for building plan – capitalize as building cost, not land
 - Fees to development consultant – not capitalized
 - Costs of purchasing function – not capitalized
 - Compensation – not capitalized unless elect to do so

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1.263(a)-2 Transaction Costs to Facilitate Acquisition or Production

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

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1.263(a)-2 Transaction Costs to Facilitate Acquisition or Production

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

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1.263(a)-2 Transaction Costs to Facilitate Acquisition or Production

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

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1.263(a)-2 Transaction Costs to Facilitate Acquisition or Production

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

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1.263(a)-2 Transaction Costs to Facilitate Acquisition or Production

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

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1.263(a)-2 Transaction Costs to Facilitate Acquisition or Production

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

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1.263(a)-2 Transaction Costs to Facilitate Acquisition or Production

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

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1.263(a)-2 Transaction Costs to Facilitate Acquisition or Production

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

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1.263(a)-2 Transaction Costs to Facilitate Acquisition or Production

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

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1.263(a)-2 Transaction Costs to Facilitate Acquisition or Production

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

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1.263(a)-2 Transaction Costs to Facilitate Acquisition or Production

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

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1.263(a)-2 Recovery of Capital Expenditures

- Amounts required to be capitalized by this section are capital expenditures, to be recovered by a charge to the basis of capital assets or inclusion in inventory costs
- Such amounts are recovered through depreciation, cost of goods sold or an adjustment to basis when property is placed in service, sold, used, or otherwise disposed of
- 2 examples
 - New refrigerator in apartment – capitalize and depreciate
 - Tractor/loader to move materials in manufacturing plant – capitalize. Depreciation will be a cost of goods manufactured to be recovered through cost of goods sold.

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1.263(a)-2 Recovery of Capital Expenditures

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

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1.263(a)-2 Recovery of Capital Expenditures

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

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Depreciation, Repairs and Fixed Assets

DEPRECIATION & § 179

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Depreciation Issues

- Property owned and eligible for depreciation
- Date placed in service
- Available methods and lives

Depreciation, Repairs & Fixed Assets

ELIGIBLE PROPERTY

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Qualifying for Depreciation

- Must be property owned by the taxpayer
- Used in the taxpayer's business or income producing activity
- Has a useful life of more than one year

134

Property Owned by the Taxpayer

- Legal title is not determinative
 - *Lyon v. United States*, 1978, US Supreme Court, 435 U.S. 561
 - Property leased from a lender
 - Tenant was deemed true owner, entitled to depreciation
 - *Arevalo v. Commissioner*, CA5, 2006, 469 F.3d 436
 - Taxpayer “bought” payphones in ADA tax shelter
 - No actual ownership – no depreciation allowed

135

Property Owned by the Taxpayer

- Owner is the one that bears the burdens and benefits of ownership, regardless of legal title
- All facts and circumstances are considered
- Tax Court, citing prior cases, listed some of the factors to be considered in the *Davis Equipment Corporation* case (77 TC 1221, 1981)

136

Davis Factors

- Whether legal title passes (*Commissioner v. Segall*, 114 F.2d 706, 709 (6th Cir. 1940), cert. denied 313 U.S. 562 (1941); *Oesterreich v. Commissioner*, 226 F.2d 798, 802 (9th Cir. 1955))
- How the parties treat the transaction (*Oesterreich v. Commissioner*, supra at 803);
- Whether an equity was acquired in the property (*Haggard v. Commissioner*, 241 F.2d 288, 289 (9th Cir. 1956); *Oesterreich v. Commissioner*, supra at 803; see *Mathews v. Commissioner*, 61 T.C. 12, 21-23 (1973), revd. 520 F.2d 323 (5th Cir. 1975), cert. denied 424 U.S. 967 (1976))
- Whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments (*Wiseman v. Scruggs*, 281 F.2d 900, 902 (10th Cir. 1960));

137

Davis Factors

- Whether the right of possession is vested in the purchaser (*Wiseman v. Scruggs*, supra at 902; *Commissioner v. Segall*, supra at 709);
- Which party pays the property taxes (*Harmston v. Commissioner*, 61 T.C. 216, 229 (1973), affd. 528 F.2d 55 (9th Cir. 1976))
- Which party bears the risk of loss or damage to the property (*Harmston v. Commissioner*, supra at 230)
- Which party receives the profits from the operation and sale of the property (*Harmston v. Commissioner*, supra at 230).

138

Lessor/Lessee

- Is the agreement
 - A Lease *or*
 - A conditional sales agreement
- IRS position found at Revenue Ruling 55-540
- Note the test is different from that found under GAAP at ASC 840-30 for capital vs. operating leases

139

Revenue Ruling 55-540

- Presumed conditional sale if one or more of the following factors exist:
 - Portions of the periodic payments are made specifically applicable to an equity to be acquired by the lessee
 - The lessee will acquire title upon the payment of a stated amount of “rentals” which under the contract he is required to make

140

Revenue Ruling 55-540

- Presumed conditional sale if one or more of the following factors exist:
 - The total amount which the lessee is required to pay for a relatively short period of use constitutes an inordinately large proportion of the total sum required to be paid to secure the transfer of the title.
 - The agreed “rental” payments materially exceed the current fair rental value.

141

Revenue Ruling 55-540

- Presumed conditional sale if one or more of the following factors exist:
 - The property may be acquired under a purchase option at a price which is nominal in relation to the value of the property determined at time of entering into agreement
 - Option to purchase at a relatively small amount compared to the total lease payments

142

Revenue Ruling 55-540

- Presumed conditional sale if one or more of the following factors exist:
 - Some portion of the payment is “recognizable” as the equivalent of interest
- Factors that indicate a rental include
 - Payments at an hourly, daily or weekly rate
 - Payments related to production, use, or mileage
 - An option to purchase approximating fair market value at option date

143

Revenue Ruling 55-540

- Conditional sales contract assumed if
 - Total payments plus option price approximate purchase contract (with appropriate interest rate)
or
 - Lease for a relatively short term in relation to life of property and payments cover the purchase price plus interest with title transfer
- Need persuasive reason to override presumptions

144

Used in Business or Income Producing Activity

- Proprietorship
- Rental property
- Employee
- Investment related use (§ 212 expense)
- Last two will be miscellaneous itemized deductions
 - 2% of adjusted gross income haircut
 - Not deductible for AMT purposes

145

Conversion to Business Activity

- Special limitation – depreciation is computed on the *lesser* of
 - Adjusted basis of the property *or*
 - Fair market value of the property
- Tested at date of conversion
[Reg. § 1.167(g)-1]

146

Useful Life Greater Than One Year

- Period property expected to useful to taxpayer in current activity [Reg. § 1.167-1(b)]
- Remember the *de minimis* rule
 - If have an “applicable financial statement” and have a policy (\$5,000 invoice)
 - If don’t have AFS, put have procedures (\$2,500 invoice)
[Reg. § 1.263(a)-1]
 - Otherwise, can only use \$200 “supplies” rule of Reg. § 1.162-3

147

Depreciation, Repairs and Fixed Assets

DATE PLACED IN SERVICE

148

Starting Depreciation

- Start depreciation when
 - First placed in service
 - By the taxpayer
- Placed in service defined at Reg. § 1.167(a)-11(e)(1)

149

Importance of Placed in Service Date

- Depreciation not allowed unless can show asset was placed in service
- Expiring bonus provisions tied to date asset placed in service
- Impacts IRC § 179 as well [Reg. § 1.179-1(c)]
- Is not an election (can't ignore fact property placed in service in prior year)

150

Regulation Definition

- Placed in state of
 - Readiness and availability for a particular function
 - In a trade or business, production of income, tax-exempt activity or personal activity (though not all will give rise to depreciation)
[Reg. § 1.167(a)-11(e)(1)(i)]

151

Key Issues

- Not necessarily the date the property is acquired
- Generally will be date actually used in the taxpayer's business, unless taxpayer took all steps necessary to place it in service

152

Examples

- *85 Gorgonio Wind Generating Co. v Commissioner*, TC Memo 1994-544
 - Wind turbines lacked controllers and had wrong sized blades
 - Could produce electricity
 - Not efficient to do so
 - Did not actually do so
 - Never intended to run this way
 - Not in service prior to installation of controllers

153

Examples

- *Noell v. Commissioner*, 66 TC 718
 - Actual use may not be enough
 - Unpaved runway actually used in 1967
 - Pilots risked damaging planes by landing on it
 - Ruined by weather on a regular basis
 - Not placed in service until finally paved in 1968
- *Brown v. Commissioner*, TC Memo 2013-275
 - “Plane useless” so didn’t matter if flown for business
 - Cited *Noell* case

154

Examples

- *Sears Oil v. Commissioner*, 359 F.2d 191 (2d Cir. 1966)
 - Actual use may not be needed if
 - Engaged in business for which equipment was purchased and
 - Taxpayers did all they could to put in service
 - In *Sears* had a barge that was in a frozen canal from time acquired until year end
 - Was “available for use” should the canal thaw

155

Examples

- *Stine LLC v. United States*, 115 AFTR 2d ¶2015-381, DC LA, 1/27/15
 - Building not yet leased to tenant
 - Substantially complete
 - Available for use
 - Treated as in service¶

156

Examples

- *Schraeder v. Commissioner*, TC Memo 1975-364
 - Taxpayer installed air conditioners four months before year end
 - Due to weather, never ran during that year
 - Were available if needed and the reason it was not used was outside of the taxpayer's control

157

Depreciation, Repairs and Fixed Assets

METHODS AND LIVES

158

MACRS

- Property placed in service prior to 1981 had lives based on estimated useful lives
- 1981 – the Accelerated Cost Recovery System (ACRS) introduced with statutory lives
- 1986 – the Modified Accelerated Cost Recovery System (MACRS) enacted, revising ACRS

159

Covered Assets

- IRC § 168 (MACRS) overrides treatment provided in general depreciation section (IRC § 167)
- Covers most tangible personal property placed in service after 1986

160

Excluded Property

- Public utility property (unless a normalization method is used) [IRC § 168(f)(2)]
- Films and video tapes [IRC § 168(f)(3)]
- Sound recordings [IRC § 168(f)(4)]

161

Election Out

- Taxpayer may elect out for a piece of property if
 - Properly depreciates the property under a method not expressed in a term of years (units of production method, for example)
 - Attaches a proper election [IRC § 168(f)(1)]
- Election provided for in Rev. Proc. 87-57 and Reg. § 301.9100-7T

162

MACRS Methods

- 200% Declining Balance
- 150% Declining Balance
- Straight Line

163

200% Declining Balance

- Applies to
 - 3, 5 and 7 year property
 - Does not apply to farming property [§ 168(b)(1)]
- Switches to straight line in “optimal” year

164

150% Declining Balance

- Applies to
 - Farming property
 - 15 and 20 year property except for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property [§ 168(b)(2)]
- AMT method for certain property unless elected straight line
- Can elect to use this method [IRC § 168(b)(5)]

165

Straight Line Method

- Required for
 - Nonresidential real property
 - Residential rental property
 - Any railroad grading or tunnel bore
 - Qualified leasehold improvement, restaurant and retail improvement property placed in service before 2012;
 - trees or vines bearing fruit or nuts
 - water utility property

166

MACRS Recovery Periods

- 3 year property
- 5 year property
- 7 year property
- 10 year property
- 15 year property
- 20 year property
- Water utility property (25 years)
- Residential rental property (27.5 years)
- Nonresidential real property (39 years)
- Railroad grading or tunnel bore (50 years)

167

General Rule [§ 168(e)(1)]

Property treated as	ADR Class life (per Rev Proc 87-56)
3 year property	4 years or less
5 year property	4 or more but less than 10
7 year property	10 or more but less than 16
10 year property	16 or more but less than 20
15 year property	20 or more but less than 25
20 year property	25 or more

Unless otherwise provided

168

ADR Class Lives

- Revenue Procedure 87-56 tables reproduced in Appendix B of IRS Publication 946
- Provided for your use – also important in certain areas of improvement rules (routine maintenance exception)

169

Using the Tables

- Check Tables
 - Check for asset in table B-1
 - If asset in B-1, see if activity described in B-2
 - If it is and asset not excluded, use B-2 class life
 - Otherwise use
 - If not in B-1, generally tangible personal property will have a 7 year recovery period
 - Real property uses one of two lives

170

Real Property

- Residential real property
 - 80% of gross rental income (including imputed rental income from owner if owner uses part of property) from dwelling units
 - Dwelling unit – “a house or apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, or other establishment more than one-half of the units in which are used on a transient basis”

171

Real Property

- Nonresidential Real Property
 - Not residential real property
 - Not property with a class life of less than 27.5 years

172

Conventions

- Mid-month convention [IRC § 168(d)(2)]
 - Real property and railroad grading or tunnel bore
 - Placed in service and disposed at mid-point of month
- Mid-quarter convention [§ 168(d)(3)(A)]
 - Used for other assets
 - 40% of depreciable bases of property acquired in last three months of tax year
 - Excludes mid-month property and property disposed of during year

173

Conventions

- Half-year convention
 - Used if neither other convention applies
 - Assumed placed in service and disposed at mid-point of year

174

SECTION 179

175

General Rules

- Allows limited expensing of certain property placed in service by a “small” business (as defined by the law)
 - \$500,000 for tax beginning in 2016
 - Inflation adjusted for later years (IRS just announced for 2017 will be \$510,000)

176

General Rules

- Phases out dollar for dollar for acquisitions in excess of
 - \$2,010,000 for tax years **beginning in 2016**
 - Inflation adjusted for later years (\$2,030,000 for 2017)

177

General Rules

- Limited by trade or business taxable income
- Must elect to use § 179 on any particular asset
- Eligible taxpayers – individuals, corporations (S or C), partnerships
- Not eligible taxpayers – estates and trusts [IRC § 179(d)(4)]

178

Qualifications for § 179

- Eligible Property [IRC § 179(d)(1)]
- Acquired for Business Use [IRC § 179(d)(1)(C)]
- Acquired by Purchase [IRC § 179(d)(1)(C)]

179

Eligible Property

- Generally will include
 - Tangible personal property
 - Certain other tangible property (except for buildings) used in transportation, communications, electricity, gas, water, or sewage disposal services
 - Single purpose agricultural/horticultural facilities
 - Non-building petroleum storage facilities used in distribution
 - Off the shelf computer software

180

Eligible Property

- Land and land improvements are generally not considered § 179 property
- Certain property is blocked from obtaining § 179 treatment

181

Excluded – Noncorporate Lessor

- General rule is that a noncorporate lessor cannot take § 179 on property leased to a corporation [IRC § 179(d)(5)]
- Subject to two tests where deduction will be allowed

182

Excluded – Noncorporate Lessor

- Exception One: Noncorporate lessor manufactured or produced the property in question [IRC § 179(d)(5)(A)]

183

Excluded – Noncorporate Lessor

- Exception Two: Mechanical operating lease test
 - Term is for less than 50% of the ADR class life of the property and
 - For first 12 months of lease, expenses allowed under § 162 (that is, no interest or depreciation) exceed 15% of the lease income

184

Excluded: Property Used for Lodging

- Generally no deduction allowed [IRC § 179(d)(1) via reference to § 50(b)]
- Hotel exception
 - Not considered used in lodging
 - Predominant use rental by transients
 - Must be more than 50%
 - Average rental less than 30 days

185

Excluded: Property Used for Lodging

- Other activities available to both tenants and nontenants exempted
- Exemption for coin operated laundry
- Exemption for qualified rehabilitation expenditures of certified historic structure

186

Excluded: HVAC

- Air conditioning and heating units specifically excluded
- Found at IRC § 179(d)(1)

187

Excluded: Foreign Property

- Property used outside the United States is generally excluded
- Specific exceptions are property listed at IRC § 168(g)(4):
 - Vehicles operated to and from the US;
 - Containers used in transportation of property to and from the US;

188

Excluded: Foreign Property

- Specific exceptions are property listed at IRC § 168(g)(4):
 - Aircraft operated to and from the US or under contract with the US;
 - Vessels documented under the laws of the US

189

Excluded: Foreign Property

- Specific exceptions are property listed at IRC § 168(g)(4):
 - Property used in US possessions
 - Number of other specific items such as railroad corporation rolling stock, certain exploration property, satellites and certain energy property
 - Restrictions and special rules exist for each type

190

Excluded: Tax Exempt Organization Use

- Property used by tax exempt organizations
- Can be used if activity is subject to UBIT and otherwise qualifies

191

Excluded: Used By a Government

- Property used by any government (domestic or foreign)
- If property used for less than six months, then limitation does not apply

192

Business Use

- Active conduct of a trade or business, thus generally excluding
 - Investment activity property
 - Rental property
 - Property that produces royalties
- 50% of use must be for the trade or business

193

Business Use: Recapture

- Must recapture § 179 deductions if business use drops below 50% during property's regular recovery period [IRC § 179(d)(10)]
- Recalculate what would have been allowed had § 179 not been elected and MACRS used in prior years, pick up as income

194

Business Use: Recapture

- Must recognize ordinary income even if no tax benefit received from § 179 deduction
- However recapture is reduced for:
 - Amounts carried forward due to taxable income limitation
 - Amounts not allowed as a deduction because total expenses exceeded annual limitations

195

Acquisition by Purchase

- Defined by telling us what it is not [IRC § 179(d)(2)]
 - Basis cannot be determined by reference to adjusted basis of property in hands of prior owner
 - Cannot be acquired from a decedent with a basis adjustment under IRC § 1014(a)
 - Cannot be acquired from another member of a controlled group
 - Cannot be acquired from a related party
- If acquired in any other manner, it is a “purchase”

196

Related Party

- Related under either § 707(b) (partnership rules) or § 267 (though this one is modified)
- Related for these purposes includes:
 - A person and that person's spouse, ancestors and lineal descendants
 - Corporation and individual that owns > 50% of its stock
 - Corporations that are members of the same controlled group

197

Related Party

- Related for these purposes includes:
 - Trust fiduciary and corporation where > 50 stock owned by trust or grantor of trust
 - Fiduciary of a trust and
 - The trust's grantor or
 - A beneficiary of the trust
 - Fiduciaries of different trusts that share the same grantor (will also be the beneficiaries of the trusts related to all such fiduciaries)

198

Related Party

- Related for these purposes includes:
 - Tax exempt entity and any individual (or member of that individual's family) that controls the organization
 - Two S corporations or an S and C corporation if same person owns more than 50% of each
 - Corporation and partnership where same person owns more than 50% of each

199

Related Party

- Related for these purposes includes:
 - Executor and beneficiary of an estate
 - Partnership and person holding more than 50% of capital or profits
 - Two partnerships where same person holdings more than 50% of capital or profits interest in each
 - Related person and person who is engaged in trades or businesses under common control

200

Making the Election

- Regular rule – must be made on
 - Taxpayer's original return
 - Amended return filed by due date of original return (including extensions)
- Election can be made, revoked or changed without IRS consent
- Made permanent by the PATH Act

201

Taxable Income Limit

- Limited to income from active conduct of trades or businesses for the year
 - Does not need to be business in which asset is used
 - Can include W-2 wages for individuals
- Passthroughs test this at entity level and then must be tested at individual level

202

Taxable Income Limit

- Ignore following deductions in computing limitation
 - Section 179 deduction itself
 - Self-employment tax deduction
 - NOL carrybacks/forward
 - Unreimbursed employee business expenses
- Amounts disallowed carried forward

203

Depreciation, Repairs and Fixed Assets

BONUS DEPRECIATION

204

Additional First Year Depreciation

- Provided for under IRC § 168(k)
- First entered the law in 2002, retroactive to 2001
- Is an additional amount allowed as depreciation in the first year
- Basis is then reduced and regular depreciation is calculated on remaining basis

205

Additional First Year Depreciation

- Percentages
 - Has varied over the years
 - For items placed in service in 2011 was set at 100%
 - For items placed in service in 2012 through 2017 set at 50%
- Will drop to 40% in 2018, 30% in 2019 and phased out in 2020 (PATH Act)

206

Additional First Year Depreciation

- Other PATH Act Changes
 - Bonus depreciation for certain trees, vines and plants in year of planting or grafting (rather than when productive)
 - Bonus allowed for “qualified improvement property” regardless of whether it is subject to a lease and removes three year test

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Property That Qualifies

- Must be one of the following
 - Has a recovery period of 20 years or less
 - Is computer software
 - Water utility property
 - Qualified leasehold improvement property
- Also has to meet three additional tests

Additional Tests

- Original use must begin with taxpayer
- Acquisition test
 - Acquired before 1/1/20 (not taxpayer's tax year does not impact)
 - Acquired pursuant to a written contract entered into prior to 1/1/20
- Placed in service
 - Before 1/1/20 for most property
 - Before 1/1/21 for
 - Aircraft property
 - Long production period property

209

Excluded Property

- Property for which the ADR applies (except for those for which it is electively available)
- Qualified New York Liberty Zone property
- Property where the taxpayer elects not to claim bonus depreciation

210

Original Use

- First use to which the property is put
[Reg. § 1.168(k)-1(b)(3)(i)]
- Uses old “new section 38” property test
- Reconditioned property
 - If taxpayer reconditions property he/she owns, those items may qualify
 - However if acquire reconditioned property, won’t qualify

211

Election Out

- If taxpayer does not elect out, must take bonus depreciation
- Election made for a class of property and applies to all property in that class acquired during the tax year
- Thus unlike § 179, cannot “pick and choose” individual assets

212

Tax Free Exchange

- Taxpayer can take additional first depreciation on property acquired via like kind exchange if it otherwise qualifies [Reg. § 1.168(k)-1(f)(5)]
- Excess basis and carryover basis both qualify for additional first year depreciation

213

Luxury Autos

- Luxury auto limits increased by \$8,000
- Note that the limit applies to total depreciation claimed

214

LISTED PROPERTY

215

Listed Property

- Any passenger automobile
- Other property used for transportation
- Property generally used for purposes of entertainment, recreation or amusement
- Computer or peripheral equipment
- Any other property of a type specified by the IRS

216

Computer Equipment

- Applies to computers
 - Used by an employee or proprietor and
 - Owned by or leased to employer or proprietor
- Does not include computers **exclusively located** at a regular business establishment
 - Desktops will be fine
 - Laptops are going to be a problem

217

Depreciation Limits

- If business use below 50%, must depreciation under ADS, not MACRS
- If initially above 50% but drops below 50%, must recapture excess depreciation
 - Recalculate as of start of the year and pick up as ordinary income
 - Cannot use bonus depreciation since not allowed under ADS

218

Substantiation Rules

- Subject to the “anti-Cohan” provisions of IRC § 274(d)
- No documentation, no deduction for listed property
- On exam, agent will treat as swapping to 0% business use, thus dropping in recapture

219

Depreciation, Repairs and Fixed Assets

INTERACTION WITH FINANCIAL REPORTING

220

GAAP vs. Tax Depreciation

- Tax Depreciation
 - Life specified by statute
 - No residual value
 - Section 179 expensing in first year
- GAAP Depreciation
 - Life should be economic life of asset
 - Residual value to be respected

221

GAAP vs. Tax

- Generally the two are not acceptable equivalent
 - ASC 360-10-35-9 labeled “Unacceptable Depreciation Methods”
 - “If the number of years specified by the Accelerated Cost Recovery System of the Internal Revenue Service (IRS) for recovery deductions for an asset does not fall within a reasonable range of the asset's useful life, the recovery deductions shall not be used as depreciation expense for financial reporting.”

222

CPA's Responsibility

- Assumption statements comply with GAAP
 - Outside accountant – report must indicate and describe any departures from GAAP
 - Inside accountant – need to communicate departures
- Note that attorneys are known to reference GAAP numbers in buy/sell agreements for closely held entities, creating exposure to CPAs

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Depreciation, Repairs and Fixed Assets

PAYMENTS TO IMPROVE PROPERTY

1.263(a)-3 Payments to Improve Property

- Overview . . . 3 provides rules for applying 263(a) to amounts paid to improve tangible property
 - (b) . . . definitions
 - (c) . . . rules for coordinating with other code provisions
 - (d) . . . requirement to capitalize amounts paid to improve property and tests to determine whether property is improved
 - (e) . . . rules to determine appropriate unit of property
 - (f) . . . Rules for determining improvement costs in particular contexts

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1.263(a)-3 Overview (continued)

- (g) . . . Rules for determining improvement costs
- (h) . . . Safe harbor for small taxpayers
- (i) . . . Safe harbor for routine maintenance
- (j) . . . Capitalization of betterments
- (k) . . . Rules to determine restoration
- (l) . . . Rules to determine adaptation - new or different use
- (m) . . . Optional regulatory accounting method

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1.263(a)-3 Overview (continued)

- (n) . . . Election to capitalize repairs and maintenance
- (o) . . . Treatment of capital expenditures
- (p) . . . Recovery of capitalized amounts
- (q) . . . Accounting method changes
- (r) . . . Effective dates

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1.263(a)-3 Definitions

- Amount paid . . . Includes a liability incurred by an accrual basis taxpayer
- Personal property . . . Tangible personal property as defined in 1.48-1(c)
- Real property . . . Land and improvements, buildings and other inherently permanent structures (including their structural components). Also includes other tangible property under 1.48-1(d). Local law does not control.
- Owner . . . Taxpayer that has benefits and burdens of ownership for federal income tax purposes

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1.263(a)-3 Coordination With Other Code Provisions

- In general . . . Nothing in this section changes treatment of any amount specifically provided for under any other provision of the Code or regulations other than 162(a) and 212 and of their regulations
 - Materials and supplies . . . A material or supply [as defined in [1.162-3\(c\)](#)], used to improve a unit of tangible property is subject to capitalization and not treated as a material or supply
 - De minimis exception . . . Taxpayer is not required to capitalize amounts properly deducted under the de minimis rule of [1.263\(a\)-1\(f\)](#)
 - [Small taxpayer building safe harbor](#) . . . Taxpayer is not required to capitalize amounts properly deducted under the small taxpayer building property safe harbor of [1.263\(a\)-3\(h\)](#)

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1.263(a)-3 Coordination With Other Code Provisions

- In general . . . Nothing in this section changes treatment of any amount specifically provided for under any other provision of the Code or regulations other than 162(a) and 212 and of their regulations
 - [Elective capitalization of repairs and maintenance](#) . . . Taxpayer may capitalize otherwise deductible repairs and maintenance under the elective capitalization rules of [1.263\(a\)-3\(n\)](#)
- Example . . . This section does not change deduction for rehabilitation of railroad rolling stock specifically allowed by [263A\(d\)](#)

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1.263(a)-3 Amounts Paid to Improve Property

- Taxpayer must generally capitalize aggregate of amounts paid to improve a unit of property. Unit of property is improved if amounts paid for work done after property is placed in service:
 - Result in a betterment of the unit of property
 - Restore the unit of property
 - Adapt the unit of property to a new or different use
- Note that amounts paid for repairs and “routine maintenance” continue to be deductible. It is the distinction between repair, betterment, restoration, and adaptation that will continue to be troublesome

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1.263(a)-3 Appropriate Unit of Property

- Unit of Property Rule [Reg. § 1.263(a)-3(e)]
- Default classification – look for functional interdependence [Reg. § 1.263(a)-3(e)(3)(i)]
- However have special rules that override functional interdependence test for
 - Buildings
 - Plant property
 - Network assets
 - Leased Property

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1.263(a)-3 Appropriate Unit of Property

Reg. § 1.263(a)-3(e)(3) – Functional Interdependence

(i) In general.

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

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1.263(a)-3 Appropriate Unit of Property

- Special cases outside of “functional interdependence” test for unit of property
 - Building structure . . . a building and its structural components (*watch the definition*) are a single unit of property. An amount is paid for an improvement to a building if it improves
 - Building structure and/or its structural components [1.48-1(e)(2)]

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1.263(a)-3 Appropriate Unit of Property

(2) The term "structural components" includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building.

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1.263(a)-3 Appropriate Unit of Property

However, the term "structural components" does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs. Machinery may meet the "sole justification" test provided by the preceding sentence even though it incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas where such temperature or humidity requirements are not essential. For example, an air conditioning and humidification system installed in a textile plant in order to maintain the temperature or humidity within a narrow optimum range which is critical in processing particular types of yarn or cloth is not included within the term "structural components". For special rules with respect to an elevator or escalator, the construction, reconstruction, or erection of which is completed by the taxpayer after June 30, 1963, or which is acquired after June 30, 1963, and the original use of which commences with the taxpayer and commences after such date, see section 48(a)(1)(C) and paragraph (m) of this section.

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1.263(a)-3 Appropriate Unit of Property

- Special cases outside of “functional interdependence” test for unit of property
 - Building systems . . . These structural components are identified as separate from the building structure for the purpose of determining unit of property as required by these rules
 - HVAC systems
 - Plumbing systems
 - Electrical systems
 - Escalators
 - Elevators
 - Fire protection and alarm systems
 - Security systems

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1.263(a)-3 Appropriate Unit of Property (continued)

- Gas distribution system
- Other structural components identified in published guidance may be excepted from the building structure and are specifically designated as building systems
- Condominium . . . Unit of property is individual unit owned by the taxpayer and its structural components [1.48-1(e)(2)]
 - Amount paid for improvement to a condominium is not deductible if it results in a betterment, restoration, or adaptation
 - Condominium Association must apply the improvement rules to the building structure or any building system

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1.263(a)-3 Appropriate Unit of Property (continued)

- Cooperative . . . Unit of property is that portion of the building in which taxpayer has possessory rights and structural components that are part of that portion
 - Amount paid for improvement to a cooperative unit is not deductible if it results in a betterment, restoration, or adaptation
 - Cooperative housing corporation must apply the improvement rules to the building structure or any building system
- Leased building . . . Unit of property is that portion of a building subject to the lease and structural components associated with the leased portion
 - Amount paid for improvement to leased premises is not deductible if it results in a betterment, restoration, or adaptation to entire building or the leased portion

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1.263(a)-3 Appropriate Unit of Property (continued)

- Property other than building . . . All the components that are functionally interdependent make up a single unit of property.
 - Plant property . . . Functionally interdependent machinery or equipment, other than network assets, performing industrial process -- manufacturing, generation, warehousing, distribution, automated materials handling, etc.
 - unit of property for plant property . . . Determined under the general rule but further divided into smaller units of each component (or group of components) that perform separate and major function or operation
 - Network assets . . . Railroad track, oil and gas pipelines, water and sewage pipelines, power transmission and distribution lines, and telephone and cable lines. Unit of property determined by each taxpayer's facts and circumstances

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1.263(a)-3 Appropriate Unit of Property (continued)

- Leased property other than buildings . . . Unit of property determined under general rules of this section but may not be larger than unit of leased property
- Improvements to property . . . Improvement, except for lessee improvement, cannot be unit of property separate from property improved
- Additional rules . . .
 - Year placed in service . . . Component may be treated as separate unit of property if properly in a different class
 - Change in subsequent taxable year . . . If taxpayer or IRS changes the treatment of property in a subsequent year, then reclassified portion must be treated as a separate asset

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1.263(a)-3 Appropriate Unit of Property (continued)

- Nineteen examples . . .
 - Replacement of roof mounted HVAC units – capitalize
 - Work on elevators – capitalize if “improvement”
 - Work on plumbing system – capitalize if “improvement”
 - Expanding office building – capitalize
 - Power plant boiler, generator, and turbine are separate systems
 - Laundry sorter, boiler, washer, dryer, etc. are separate systems
 - Tortilla machine in restaurant is discrete system
 - Locomotive is single unit of property because its systems are functionally interdependent
 - Computer and printer are not functionally interdependent

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1.263(a)-3 Appropriate Unit of Property (continued)

- Lease of entire building requires separate consideration of building structure and building systems, such as HVAC
- Driveway constructed by lessee, using construction allowance from lessor, is a separate unit of property
- Same driveway, constructed by lessor, is also a separate unit of property
- Lessee is responsible for maintenance of building systems and must capitalize any improvements
- Leased aircraft are separate units of property
- Expanding size of warehouse is capitalizable
- Semi-truck tractor, including its tires, is single unit of property
- Leasehold improvement is separate unit of property from building in which it was constructed

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1.263(a)-3 Appropriate Unit of Property (continued)

- Change in classification based on cost segregation study requires parking lot to be treated as separate asset from associated building
- Change in classification of previously segregated cost to structural component of building requires change in depreciation method

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1.263(a)-3 Appropriate Unit of Property (continued)

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

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1.263(a)-3 Appropriate Unit of Property (continued)

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

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1.263(a)-3 Appropriate Unit of Property (continued)

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

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1.263(a)-3 Appropriate Unit of Property (continued)

Example 3. Building structure and systems; condominium (continued).

Under paragraph (e)(2)(ii)(B)(2) of this section, the pipes, sinks, toilets, and plumbing fixtures that are part of C's condominium comprise the plumbing system for the condominium. Therefore, under paragraph (e)(2)(iii) of this section, if an amount paid by C for work on pipes, sinks, toilets, and plumbing fixtures is an improvement (for example, a betterment) to the portion of the plumbing system that is part of C's condominium, C must treat this amount as an improvement to the condominium.

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1.263(a)-3 Appropriate Unit of Property (continued)

Example 4. Building structure and systems; property other than buildings. D, a manufacturer, owns a building adjacent to its manufacturing facility that contains office space and related facilities for D's employees that manage and administer D's manufacturing operations. The office building contains equipment, such as desks, chairs, computers, telephones, and bookshelves that are not building structure or building systems. D pays an amount to add an extension to the office building. Under paragraph (e)(2)(i) of this section, D must treat the building and its structural components as a single unit of property. As provided under paragraph (e)(2)(ii) of this section, an amount is paid to improve a building if it is for an improvement to the building structure or any designated building system.

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1.263(a)-3 Appropriate Unit of Property (continued)

Example 4. Building structure and systems; property other than buildings (continued).

Therefore, under paragraph (e)(2)(ii) of this section, if an amount paid by D for the addition of an extension to the office building is an improvement (for example, a betterment) to the building structure or any of the building systems, D must treat this amount as an improvement to the building. In addition, because the equipment contained within the office building constitutes property other than the building, the units of property for the office equipment are initially determined under paragraph (e)(3)(i) of this section and are comprised of all the components that are functionally interdependent (for example, each desk, each chair, and each book shelf).

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1.263(a)-3 Appropriate Unit of Property (continued)

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

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1.263(a)-3 Appropriate Unit of Property (continued)

Example 5. Plant property; discrete and major function (continued).

Under this rule, the initial unit of property is the entire plant because the components of the plant are functionally interdependent. However, because the power plant is plant property under paragraph (e)(3)(ii) of this section, the initial unit of property is further divided into smaller units of property by determining the components (or groups of components) that perform discrete and major functions within the plant. Under this paragraph, E must treat the structure, the boiler, the turbine, the generator, and the pulverizer each as a separate unit of property because each of these components performs a discrete and major function within the power plant. E may not treat components, such as the turbine blades, as separate units of property because each of these components does not perform a discrete and major function within the plant.

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1.263(a)-3 Appropriate Unit of Property (continued)

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

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1.263(a)-3 Appropriate Unit of Property (continued)

Example 6. Plant property; discrete and major function (continued).

Under this rule, the initial units of property are each laundering line because each line is functionally independent and is comprised of components that are functionally interdependent. However, because each line is comprised of plant property under paragraph (e)(3)(ii) of this section, F must further divide these initial units of property into smaller units of property by determining the components (or groups of components) that perform discrete and major functions within the line. Under paragraph (e)(3)(ii) of this section, F must treat each sorter, boiler, washer, dryer, ironer, folder, and waste water treatment system in each line as a separate unit of property because each of these components performs a discrete and major function within the line.

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1.263(a)-3 Appropriate Unit of Property (continued)

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

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1.263(a)-3 Appropriate Unit of Property (continued)

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

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1.263(a)-3 Appropriate Unit of Property (continued)

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

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1.263(a)-3 Appropriate Unit of Property (continued)

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

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1.263(a)-3 Appropriate Unit of Property (continued)

Example 11. Production of real property related to leased property.

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

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1.263(a)-3 Appropriate Unit of Property (continued)

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

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1.263(a)-3 Appropriate Unit of Property (continued)

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

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1.263(a)-3 Appropriate Unit of Property (continued)

Example 13. Buildings and structural components; leased office space (continued).

Under paragraphs (e)(2)(v)(B)(1) and (e)(2)(ii)(B)(1) of this section, M must treat the HVAC system associated with each leased office space as a building system of that leased building property. Thus, M must treat the HVAC system associated with the first leased office space as a building system of the first leased office space and the HVAC system associated with the second leased office space as a building system of the second leased office space. Under paragraph (e)(2)(v)(B) of this section, if the amount paid by M for work on the HVAC system in one leased office space is for an improvement (for example, a betterment) to the HVAC system that is part of that leased space, then M must treat the amount as an improvement to that individual leased property.

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1.263(a)-3 Appropriate Unit of Property (continued)

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

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1.263(a)-3 Appropriate Unit of Property (continued)

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

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1.263(a)-3 Appropriate Unit of Property (continued)

Example 15. Improvement property (continued).

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

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1.263(a)-3 Appropriate Unit of Property (continued)

Example 16. Additional rules; year placed in service. R is engaged in the business of transporting freight throughout the United States. To conduct its business, R owns a fleet of truck tractors and trailers. Each tractor and trailer is comprised of various components, including tires. R purchased a truck tractor with all of its components, including tires. The tractor tires have an average useful life to R of more than one year. At the time R placed the tractor in service, it treated the tractor tires as a separate asset for depreciation purposes under section 168. R properly treated the tractor (excluding the cost of the tires) as 3-year property and the tractor tires as 5-year property under section 168(e).

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1.263(a)-3 Appropriate Unit of Property (continued)

Example 16. Additional rules; year placed in service (continued).

Because R's tractor is property other than a building, the initial units of property for the tractor are determined under the general rule in paragraph (e)(3)(i) of this section and are comprised of all the components that are functionally interdependent. Under this rule, R must treat the tractor, including its tires, as a single unit of property because the tractor and the tires are functionally interdependent (that is, the placing in service of the tires is dependent upon the placing in service of the tractor). However, under paragraph (e)(5)(i) of this section, R must treat the tractor and tires as separate units of property because R properly treated the tires as being within a different class of property under section 168(e).

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1.263(a)-3 Appropriate Unit of Property (continued)

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

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1.263(a)-3 Appropriate Unit of Property (continued)

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

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1.263(a)-3 Appropriate Unit of Property (continued)

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

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1.263(a)-3 Leased Property

- Improvements to leased property generally follow same rules as improvements to property owned by taxpayer. Capitalize improvements, betterments, and adaptations, while deducting repairs and routine maintenance.
 - Amount capitalized by lessee is separate unit of property
 - Amount capitalized by lessor is **not** separate unit of property
 - Landlord must capitalize construction allowance . . . !

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1.263(a)-3 Leased Property

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

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1.263(a)-3 Leased Property

Example 1. Lessee improvements; additions to building (continued).

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

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1.263(a)-3 Leased Property

Example 1. Lessee improvements; additions to building (continued).

(iii) In Year 5, T pays an amount to add a large overhead door to the building extension that it constructed in Year 2 to accommodate the loading of larger products into the warehouse space. Under paragraph (f)(2)(ii) of this section, to determine whether the amount paid by T is for a leasehold improvement, the unit of property and the improvement rules are applied in accordance with paragraph (e)(2)(v) of this section and include T's previous improvements to the leased property. Therefore, under paragraph (e)(2)(v)(A) of this section, the unit of property is the entire leased building, including the extension built in Year 2. In addition, under paragraph (e)(2)(v)(B) of this section, the leased building property is improved if the amount is paid for an improvement to the building structure or any building system.

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1.263(a)-3 Leased Property

Example 1. Lessee improvements; additions to building (continued).

Assume that the amount paid to add the overhead door is for a betterment, under paragraph (j) of this section, to the building structure, which includes the extension. Accordingly, T must capitalize the amounts paid to add the overhead door as a leasehold improvement to the leased building property. In addition, paragraph (f)(2)(i) of this section requires T to treat the amount paid for the improvement as the acquisition or production of a unit of property (leasehold improvement property) under § 1.263(a)-2(d)(1). However, to determine whether a future amount paid by T is for a leasehold improvement to the leased building, the unit of property and the improvement rules are again applied in accordance with paragraph (e)(2)(v) of this section and include the new overhead door.

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1.263(a)-3 Leased Property

Example 2. Lessee improvements; additions to certain structural components of buildings.

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

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1.263(a)-3 Leased Property

Example 2. Lessee improvements; additions to certain structural components of buildings (continued).

(ii) In Year 5, T pays an amount to add an additional chiller to the portion of the HVAC system that it constructed in Year 2 to accommodate the climate control requirements for new product offerings. Under paragraph (f)(2)(ii) of this section, to determine whether the amount paid by T is for a leasehold improvement, the unit of property and the improvement rules are applied in accordance with paragraph (e)(2)(v) of this section and include T's previous improvements to the leased building property. Therefore, under paragraph (e)(2)(v)(B) of this section, the leased building property is improved if the amount is paid for an improvement to the building structure or any building system.

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1.263(a)-3 Leased Property

Example 2. Lessee improvements; additions to certain structural components of buildings (continued).

Assume that the amount paid to add the chiller is for a betterment, under paragraph (j) of this section, to the HVAC system, which includes the extension of the system in Year 2. Accordingly, T must capitalize the amounts paid to add the chiller as a leasehold improvement to the leased building property. In addition, paragraph (f)(2)(i) of this section requires T to treat the amount paid for the chiller as the acquisition or production of a unit of property (leasehold improvement property) under § 1.263(a)-2(d)(1). However, to determine whether a future amount paid by T is for a leasehold improvement to the leased building, the unit of property and the improvement rules are again applied in accordance with paragraph (e)(2)(v) of this section and include the new chiller.

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1.263(a)-3 Leased Property

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

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1.263(a)-3 Leased Property

Example 3. Lessor Improvements; additions to building (continued).

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

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1.263(a)-3 Leased Property

Example 4. Lessee property; personal property added to leased building.

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

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1.263(a)-3 Leased Property

Example 5. Lessor property; buildings on leased property. L is the owner of a parcel of unimproved real property that L leases to T. Pursuant to the lease, L provides a construction allowance to T of \$500,000, which T agrees to use to construct a building costing not more than \$500,000 on the leased real property and to lease the building from L after it is constructed. Assume that for Federal income tax purposes, L is treated as the owner of the building that T will construct. T uses the \$500,000 to construct the building as required under the lease. The building consists of the building structure and the following building systems: (1) a plumbing system; (2) an electrical system; and (3) an HVAC system.

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1.263(a)-3 Leased Property

Example 5. Lessor property; buildings on leased property (continued).

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

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1.263(a)-3 Leased Property

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

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1.263(a)-3(g) Improvement Costs

- Capitalize
 - Direct costs
 - Indirect costs that directly benefit or incurred as result of improvement
- Residence exception – limited to significant renovation (so ignore all of those minor receipts).

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1.263(a)-3(g) Improvement Costs

- Removal costs
 - Generally removal costs apply to old asset
 - However, if not a disposition for tax purposes, then costs are capitalized
 - Method originally allowed per Revenue Ruling 2000-7

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1.263(a)-3 Improvement Costs

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

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1.263(a)-3 Improvement Costs

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

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1.263(a)-3 Improvement Costs

Example 3. Component removed during repair or maintenance; no disposition. Y owns a building in which it conducts its retail business. The roof over Y's building is covered with shingles. Over time, the shingles begin to wear and Y begins to experience leaks into its retail premises. However, the building still functions in Y's business. To eliminate the problems, a contractor recommends that Y remove the original shingles and replace them with new shingles. Accordingly, Y pays the contractor to replace the old shingles with new but comparable shingles. The new shingles are comparable to original shingles but correct the leakage problems. Assume that Y disposes of the original shingles, and the disposal of these shingles is not a disposition under Prop. Reg. § 1.168(i)-1(e), or Prop. Reg. § 1.168(i)-8.

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1.263(a)-3 Improvement Costs

Example 3. Component removed during repair or maintenance; no disposition (continued).

Assume that replacement of old shingles with new shingles to correct the leakage is not a betterment or a restoration of the building structure or systems under paragraph (j) or (k) of this section and does not adapt the building structure or systems to a new or different use under paragraph (l) of this section. Thus, the amounts paid by Y to replace the shingles are not improvements to the building unit of property under paragraph (d) of this section. Under paragraph (g)(2)(i) of this section, the amounts paid to remove the shingles are not required to be capitalized because they directly benefit and are incurred by reason of repair or maintenance to the building structure.

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1.263(a)-3 Improvement Costs

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

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1.263(a)-3 Improvement Costs

- If amounts paid over multiple years, must aggregate to determine if there is an improvement overall
- Regulatory requirement to make certain repairs or maintenance is not relevant in determination of an improvement

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1.263(a)-3(h) Small Taxpayer Building Safe Harbor

- New in the final regulations
- Taxpayer with average annual gross receipts of < \$10 million over past three years can elect to use
- Applies if total amount paid for maintenance, improvement and similar activity is less than the lesser of
 - \$10,000
 - 2% of the unadjusted basis of the building

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1.263(a)-3(h) Small Taxpayer Building Safe Harbor

- Must count items that would otherwise be excludable under
 - De minimis rule
 - Routine maintenance safe harbor
- Applies only to buildings with unadjusted basis of \$1,000,000 or less (or total rent expected to be paid if leased)

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1.263(a)-3(h) Small Taxpayer Building Safe Harbor

- Is a “pass/fail” test
 - If amounts < cap, can be treated as repairs
 - If amounts > cap, then cannot use safe harbor and must apply standard rules to all items
 - Now can use de minimis rule, routine maintenance
 - Test other expenditures under standard rules
- Meant to be “simplifying” option for taxpayers for whom keeping the detailed records would be a burden

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1.263(a)-3(h) Small Taxpayer Building Safe Harbor

- Election
 - Found at Reg. § 1.263(a)-3(h)(6)
 - Attach statement to tax return for year in question (due with return)
 - Titled “Section 1.263(a)-3(h) Safe Harbor Election for Small Taxpayers”
 - Include taxpayer's name, address, taxpayer identification number, and a description of each eligible building property to which the taxpayer is applying the election
 - Partnership/S Corporation election at entity level

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1.263(a)-3(h) Small Taxpayer Building Safe Harbor

Example 1. Safe harbor for small taxpayers applicable. A is a qualifying taxpayer under paragraph (h)(3) of this section. A owns an office building in which A provides consulting services. In Year 1, A's building has an unadjusted basis of \$750,000 as determined under paragraph (h)(5)(i) of this section. In Year 1, A pays \$5,500 for repairs, maintenance, improvements and similar activities to the office building. Because A's building unit of property has an unadjusted basis of \$1,000,000 or less, A's building constitutes eligible building property under paragraph (h)(4) of this section.

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1.263(a)-3(h) Small Taxpayer Building Safe Harbor

Example 1. Safe harbor for small taxpayers applicable (continued).

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

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1.263(a)-3(h) Small Taxpayer Building Safe Harbor

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

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1.263(a)-3(h) Small Taxpayer Building Safe Harbor

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

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1.263(a)-3(h) Small Taxpayer Building Safe Harbor

Example 3. Safe harbor applied building-by-building (continued).

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

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1.263(a)-3(h) Small Taxpayer Building Safe Harbor

Example 3. Safe harbor applied building-by-building (continued).

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

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1.263(a)-3(h) Small Taxpayer Building Safe Harbor

Example 4. Safe harbor applied to leased building property. C is a qualifying taxpayer under paragraph (h)(3) of this section. C is the lessee of a building in which C operates a retail store. The lease is a triple-net lease, and the lease term is 20 years, including reasonably expected renewals. C pays \$4,000 per month in rent. In Year 1, C pays \$7,000 for repairs, maintenance, improvements, and similar activities performed on the building. Under paragraph (h)(5)(ii) of this section, the unadjusted basis of C's leased unit of property is \$960,000 (\$4,000 monthly rent x 12 months x 20 years). Because C's leased building has an unadjusted basis of \$1,000,000 or less, the building is eligible building property for Year 1 under paragraph (h)(4) of this section.

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1.263(a)-3(h) Small Taxpayer Building Safe Harbor

Example 4. Safe harbor applied to leased building property (continued).

The total amount paid by C during Year 1 for repairs, maintenance, improvements, and similar activities on the leased building (\$7,000) does not exceed the lesser of \$19,200 (2 percent of the building's unadjusted basis of \$960,000) or \$10,000. Therefore, under paragraph (h)(1) of this section, for Year 1, C may elect to not apply the capitalization rule under paragraph (d) of this section to the amounts it paid for repairs, maintenance, improvements, and similar activities on the leased building. If C properly makes the election under paragraph (h)(6) of this section for the leased building and the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on C's trade or business, C may deduct these amounts under § 1.162-1.


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1.263(a)-3(i) Routine Maintenance Costs

- In general . . . An amount paid for routine maintenance on a unit of property other than a building or structural component of the building is deemed not to improve that unit of property. Routine maintenance includes:
 - Inspection, cleaning, and testing
 - Replacement of parts with comparable, commercially available, and reasonable replacements
 - Activities reasonably expected to be required more than once during the class life (See Rev. Proc. 87-56) of the unit of property
 - Consider recurring nature of activity, industry practice, maker’s recommendations, taxpayer’s experience, ~~and taxpayers treatment of the activity in its “applicable financial statement”~~

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1.263(a)-3(i) Routine Maintenance Costs



Asset class	Description of assets included	Recovery Periods (in years)		
		Class Life (in years)	General Depreciation System	Alternative Depreciation System
SPECIFIC DEPRECIABLE ASSETS USED IN ALL BUSINESS ACTIVITIES, EXCEPT AS NOTED:				
00.11	OFFICE FURNITURE, FIXTURES AND EQUIPMENT:			
	Includes furniture and fixtures that are not a structural component of a building. Includes such assets as desks, files, safes, and communications equipment. Does not include communications equipment that is included in other classes	10	7	10

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1.263(a)-3(i) Routine Maintenance Costs

- Final regulations add a building routine maintenance provision [Reg. § 1.263(a)-3(i)(1)(i)]
 - Keep each building system and structure in ordinary efficient operating condition
 - Use “10 years” rather than ADR class life for testing
 - Thus only building maintenance expected to be performed twice within 10 years can meet this test

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1.263(a)-3(i) Routine Maintenance Costs

- Ten (now fifteen) examples . . .
 - Routine maintenance of aircraft engine during its class life** is deductible (engine is not separate unit of property)
 - Same maintenance after engine’ s class life is also deductible because it does not improve the aircraft
 - Spare aircraft engines are rotatable spare parts subject to same repair requirements - - routine maintenance is deductible
 - Routine maintenance relating to prior owners use – capitalize
 - Routine maintenance – new owners use – deduct
 - Routine maintenance – scheduled replacement of substantial structural part – deduct

** Class Life . . . See Rev. Proc. 87-56 or IRS Pub. 946, Appendix B

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1.263(a)-3(i) Routine Maintenance Costs

- Reconditioning of railcar once during class life would be capitalizable, but for 263A(d)
- Scheduled preventive maintenance on towboat engines – not required to be capitalized (Ingram Industries, T.C. Memo. 2000-323; 10/18/2000)
- Scheduled preventive maintenance on towboat engines with upgrade to increase their horse power and propulsion permitting them to tow heavier loads must be capitalized
- Routine maintenance not performed on schedule, allowing asset to fall into state of disrepair, not deductible
 - This example has caused great controversy. Why should routine maintenance be capitalized simply because it is deferred due to financial considerations ? It's still the same maintenance !

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1.263(a)-3(i) Routine Maintenance Costs

Example 1. Routine maintenance on component. (i) A is a commercial airline engaged in the business of transporting passengers and freight throughout the United States and abroad. To conduct its business, A owns or leases various types of aircraft. As a condition of maintaining its airworthiness certification for these aircraft, A is required by the Federal Aviation Administration (FAA) to establish and adhere to a continuous maintenance program for each aircraft within its fleet. These programs, which are designed by A and the aircraft's manufacturer and approved by the FAA, are incorporated into each aircraft's maintenance manual. The maintenance manuals require a variety of periodic maintenance visits at various intervals. One type of maintenance visit is an engine shop visit (ESV), which A expects to perform on its aircraft engines approximately every 4 years to keep its aircraft in its ordinarily efficient operating condition.

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1.263(a)-3(i) Routine Maintenance Costs

Example 1. Routine maintenance on component (continued).

In Year 1, A purchased a new aircraft, which included four new engines attached to the airframe. The four aircraft engines acquired with the aircraft are not materials or supplies under § 1.162-3(c)(1)(i) because they are acquired as part of a single unit of property, the aircraft. In Year 5, A performs its first ESV on the aircraft engines. The ESV includes disassembly, cleaning, inspection, repair, replacement, reassembly, and testing of the engine and its component parts. During the ESV, the engine is removed from the aircraft and shipped to an outside vendor who performs the ESV. If inspection or testing discloses a discrepancy in a part's conformity to the specifications in A's maintenance program, the part is repaired, or if necessary, replaced with a comparable and commercially available replacement part. After the ESVs, the engines are returned to A to be reinstalled on another aircraft or stored for later installation. Assume that the class life for A's aircraft, including the engines, is 12 years. Assume that none of the exceptions set out in paragraph (i)(3) of this section apply to the costs of performing the ESVs.

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1.263(a)-3(i) Routine Maintenance Costs

Example 1. Routine maintenance on component (continued).

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

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1.263(a)-3(i) Routine Maintenance Costs

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

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1.263(a)-3(i) Routine Maintenance Costs

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

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1.263(a)-3(i) Routine Maintenance Costs

Example 3. Routine maintenance on rotatable spare parts (continued).

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

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1.263(a)-3(i) Routine Maintenance Costs

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

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1.263(a)-3(i) Routine Maintenance Costs

Example 4. Routine maintenance resulting from prior owner's use (continued).

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

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1.263(a)-3(i) Routine Maintenance Costs

Example 5. Routine maintenance resulting from new owner's use.

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

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Example 6. Routine maintenance; replacement of substantial structural part; coordination with section 263A. C is in the business of producing commercial products for sale. As part of the production process, C places raw materials into lined containers in which a chemical reaction is used to convert raw materials into the finished product. The lining, which comprises 60 percent of the total physical structure of the container, is a substantial structural part of the container. Assume that each container, including its lining, is the unit of property and that a container has a class life of 12 years. At the time that C placed the container into service, C was aware that approximately every three years, the container lining would need to be replaced with comparable and commercially available replacement materials. At the end of three years, the container will continue to function, but will become less efficient and the replacement of the lining will be necessary to keep the container in an ordinarily efficient operating condition. This maintenance comprises the direct or allocable indirect costs of the property produced by C. See § 1.263A-1(e)(3)(ii)(O).

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Example 6. Routine maintenance; replacement of substantial structural part; coordination with section 263A (continued).

In Year 1, C acquired 10 new containers and placed them into service. In Year 4, Year 7, Year 9, and Year 12, C pays amounts to replace the containers' linings with comparable and commercially available replacement parts. Assume that none of the exceptions set out in paragraph (i)(3) of this section apply to the amounts paid for the replacement linings. Because the replacement of the linings involves recurring activities that C expects to perform as a result of its use of the containers to keep the containers in their ordinarily efficient operating condition and consists of maintenance activities that C expects to perform more than once during the 12-year class life of the containers, C's lining replacement costs are within the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section.

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1.263(a)-3(i) Routine Maintenance Costs

Example 6. Routine maintenance; replacement of substantial structural part; coordination with section 263A (continued).

Accordingly, the amounts that C paid for the replacement of the container linings are deemed not to improve the containers and are not required to be capitalized under paragraph (d) of this section. However, the amounts paid to replace the lining may be subject to capitalization under section 263A if the amounts paid for this maintenance comprise the direct or allocable indirect costs of the property produced by C. See § 1.263A-1(e)(3)(ii)(O).

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1.263(a)-3(i) Routine Maintenance Costs

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

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Example 8. Routine maintenance; reasonable expectation. Assume the same facts as Example 7, except in Year 1, D acquires and places in service several refrigerated freight cars, which also have a class life of 14 years. Because of the special requirements of these cars, at the time they are placed in service, D expects to perform a reconditioning of the refrigeration components of the freight car every 6 years to keep the freight car in an ordinarily efficient operating condition. During the reconditioning, D pays amounts to disassemble, inspect, and recondition or replace the refrigeration components of the freight car with comparable and commercially available replacement parts. Assume that none of the exceptions set out in paragraph (i)(3) of this section apply to the amounts paid for the reconditioning of these freight cars.

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Example 8. Routine maintenance; reasonable expectation (continued).

In Year 6, D pays amounts to perform a reconditioning on the refrigeration components on one of the freight cars. However, because of changes in the frequency that D utilizes this freight car, D does not perform the second reconditioning on the same freight car until Year 15, after the end of the 14-year class life of the car. Under paragraph (i)(1)(ii) of this section, D's reasonable expectation that it would perform the reconditioning every 6 years will not be deemed unreasonable merely because D did not actually perform the reconditioning a second time during the 14-year class life, provided that D can substantiate that its expectation was reasonable at the time the property was placed in service. If D can demonstrate that its expectation was reasonable in Year 1 using the factors provided in paragraph (i)(1)(ii) of this section, then the amounts paid by D to recondition the refrigerated freight car components in Year 6 and in Year 15 are within the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section.

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1.263(a)-3(i) Routine Maintenance Costs

Example 9. Routine maintenance on non-rotable part. E is a towboat operator that owns and leases a fleet of towboats. Each towboat is equipped with two diesel-powered engines. Assume that each towboat, including its engines, is the unit of property and that a towboat has a class life of 18 years. At the time that E places its towboats into service, E is aware that approximately every three to four years E will need to perform scheduled maintenance on the two towboat engines to keep the engines in their ordinarily efficient operating condition. This maintenance is completed while the engines are attached to the towboat and involves the cleaning and inspecting of the engines to determine which parts are within acceptable operating tolerances and can continue to be used, which parts must be reconditioned to be brought back to acceptable tolerances, and which parts must be replaced. Engine parts replaced during these procedures are replaced with comparable and commercially available replacement parts.

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1.263(a)-3(i) Routine Maintenance Costs

Example 9. Routine maintenance on non-rotable part (continued).

Assume the towboat engines are not rotatable spare parts under § 1.162-3(c)(2). In Year 1, E acquired a new towboat, including its two engines, and placed the towboat into service. In Year 5, E pays amounts to perform scheduled maintenance on both engines in the towboat. Assume that none of the exceptions set out in paragraph (i)(3) of this section apply to the scheduled maintenance costs. Because the scheduled maintenance involves recurring activities that E expects to perform more than once during the 18-year class life of the towboat, the maintenance results from E's use of the towboat, and the maintenance is performed to keep the towboat in an ordinarily efficient operating condition, the scheduled maintenance on E's towboat is within the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section. Accordingly, the amounts paid for the scheduled maintenance to its towboat engines in Year 5 are deemed not to improve the towboat and are not required to be capitalized under paragraph (d) of this section.

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1.263(a)-3(i) Routine Maintenance Costs

Example 10. Routine maintenance with related betterments. Assume the same facts as Example 9, except that in Year 9 E's towboat engines are due for another scheduled maintenance visit. At this time, E decides to upgrade the engines to increase their horsepower and propulsion, which would permit the towboats to tow heavier loads. Accordingly, in Year 9, E pays amounts to perform many of the same activities that it would perform during the typical scheduled maintenance activities such as cleaning, inspecting, reconditioning, and replacing minor parts, but at the same time, E incurs costs to upgrade certain engine parts to increase the towing capacity of the boats in excess of the capacity of the boats when E placed them in service. In combination with the replacement of parts with new and upgraded parts, the scheduled maintenance must be completed to perform the horsepower and propulsion upgrade.

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1.263(a)-3(i) Routine Maintenance Costs

Example 10. Routine maintenance with related betterments (continued). Thus, the work done on the engines encompasses more than the recurring activities that E expected to perform as a result of its use of the towboats and did more than keep the towboat in its ordinarily efficient operating condition. Rather under paragraph (j) of this section, the amounts paid to increase the horsepower and propulsion of the engines are for a betterment to the towboat, and such amounts are excepted from the routine maintenance safe harbor under paragraph (i)(3)(i) of this section. In addition, under paragraph (g)(1)(i) of this section, the scheduled maintenance procedures directly benefit the upgrades. Therefore, the amounts that E paid in Year 9 for the maintenance and upgrade of the engines do not qualify for the routine maintenance safe harbor described under paragraph (i)(1)(ii) of this section. Rather, E must capitalize the amounts paid for maintenance and upgrades of the engines as an improvement to the towboats under paragraph (d) of this section.

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1.263(a)-3(i) Routine Maintenance Costs

Example 11. Routine maintenance with unrelated improvements.

Assume the same facts as Example 9, except in Year 5, in addition to paying amounts to perform the scheduled engine maintenance on both engines, E also incurs costs to upgrade the communications and navigation systems in the pilot house of the towboat with new state-of-the-art systems. Assume the amounts paid to upgrade the communications and navigation systems are for betterments under paragraph (j) of this section, and therefore result in an improvement to the towboat under paragraph (d) of this section. In contrast with Example 9, the amounts paid for the scheduled maintenance on E's towboat engines are not otherwise related to the upgrades to the navigation systems.

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1.263(a)-3(i) Routine Maintenance Costs

Example 11. Routine maintenance with unrelated improvements (continued).

Because the scheduled maintenance on the towboat engines does not directly benefit and is not incurred by reason of the upgrades to the communication and navigation systems, the amounts paid for the scheduled engine maintenance are not a direct or indirect cost of the improvement under paragraph (g)(1)(i) of this section. Accordingly, the amounts paid for the scheduled maintenance to its towboat engines in Year 5 are routine maintenance deemed not to improve the towboat and are not required to be capitalized under paragraph (d) of this section.

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1.263(a)-3(i) Routine Maintenance Costs

Example 12. Exceptions to routine maintenance. F owns and operates a farming and cattle ranch with an irrigation system that provides water for crops. Assume that each canal in the irrigation system is a single unit of property and has a class life of 20 years. At the time F placed the canals into service, F expected to have to perform major maintenance on the canals every three years to keep the canals in their ordinarily efficient operating condition. This maintenance includes draining the canals, and then cleaning, inspecting, repairing, and reconditioning or replacing parts of the canal with comparable and commercially available replacement parts. F placed the canals into service in Year 1 and did not perform any maintenance on the canals until Year 6. At that time, the canals had fallen into a state of disrepair and no longer functioned for irrigation. In Year 6, F pays amounts to drain the canals and do extensive cleaning, repairing, reconditioning, and replacing parts of the canals with comparable and commercially available replacement parts.

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1.263(a)-3(i) Routine Maintenance Costs

Example 12. Exceptions to routine maintenance (continued).

Although the work performed on F's canals was similar to the activities that F expected to perform, but did not perform, every three years, the costs of these activities do not fall within the routine maintenance safe harbor. Specifically, under paragraph (i)(3)(v) of this section, routine maintenance does not include activities that return a unit of property to its former ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use. Accordingly, amounts that F pays for work performed on the canals in Year 6 must be capitalized if they result in improvements under paragraph (d) of this section (for example, restorations under paragraph (k) of this section).

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1.263(a)-3(i) Routine Maintenance Costs

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

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1.263(a)-3(i) Routine Maintenance Costs

Example 13. Routine maintenance on a building; escalator system (continued).

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

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

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Example 15. Routine maintenance on building; reasonable expectation. In Year 1, H acquires a new office building, which it uses to provide services. The building contains an HVAC system, which is a building system under paragraph (e)(2)(ii)(B)(1) of this section. In Year 1, when H placed its building into service, H reasonably expected that every four years H would need to pay an outside contractor to perform detailed testing, monitoring, and preventative maintenance on its HVAC system to keep the HVAC system in its ordinarily efficient operating condition. This scheduled maintenance includes disassembly, cleaning, inspection, repair, replacement, reassembly, and testing of the HVAC system and many of its component parts. If inspection or testing discloses a problem with any component, the part is repaired, or if necessary, replaced with a comparable and commercially available replacement part.

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1.263(a)-3(i) Routine Maintenance Costs

Example 15. Routine maintenance on building; reasonable expectation (continued).

The scheduled maintenance at these intervals is recommended by the manufacturer of the HVAC system and is routinely performed on similar systems in similar buildings. Assume that none of the exceptions in paragraph (i)(3) of this section apply to the amounts paid for the maintenance on the HVAC system. In Year 4, H pays amounts to a contractor to perform the scheduled maintenance. However, H does not perform this scheduled maintenance on its building again until Year 11. Under paragraph (i)(1)(i) of this section, H's reasonable expectation that it would perform the maintenance every 4 years will not be deemed unreasonable merely because H did not actually perform the maintenance a second time during the 10-year period, provided that H can substantiate that its expectation was reasonable at the time the property was placed in service.

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1.263(a)-3(i) Routine Maintenance Costs

Example 15. Routine maintenance on building; reasonable expectation (continued).

If H can demonstrate that its expectation was reasonable in Year 1 using the other factors considered in paragraph (i)(1)(i), then the amounts H paid for the maintenance of the HVAC system in Year 4 and in Year 11 are within the routine maintenance safe harbor under paragraph (i)(1)(i) of this section.

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1.263(a)-3 Betterments

- In general . . . Taxpayer must capitalize amounts paid that it reasonably expects will be a betterment of a unit of property. A betterment:
 - Corrects a material condition or defect regardless of when discovered by the taxpayer,
 - Results in a material addition (physical enlargement, expansion, or extension) to a unit of property, or
 - Results in a material increase in capacity (additional space), productivity, efficiency, strength, or quality of the unit of property or its output
- A building is made better by improvements and/or expansion of square footage

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- Facts and circumstances . . . Consider all facts and circumstances including, but not limited to, purpose of the expenditure, physical nature of the work performed, effect of the expenditure on the unit of property, ~~and the taxpayer's treatment of the expenditure in its applicable financial statement~~
 - Replacement with improved, but comparable part is not necessarily a betterment
 - When particular event necessitates an expenditure determine whether a betterment is made by comparing condition of property immediately after expenditure with its condition immediately before the event necessitating the expenditure

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- Expenditure made to correct effects of normal wear and tear to the unit of property must be judged based on condition of the property after last correction of effects of normal wear and tear
- Condition of property requiring expenditure made as result of a particular event, is condition immediately before the event
- Twenty three examples

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1.263(a)-3 Betterments

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

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

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Example 2. Not amelioration of pre-existing condition or defect (continued).

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

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

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Example 3. Not amelioration of pre-existing material condition or defect (continued).

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

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Example 4. Not amelioration of pre-existing material condition or defect. D purchases a used ice resurfacing machine for use in the operation of its ice skating rink. To comply with local regulations, D is required to routinely monitor the air quality in the ice skating rink. One week after D places the machine into service, during a routine air quality check, D discovers that the operation of the machine is adversely affecting the air quality in the skating rink. As a result, D pays an amount to inspect and retune the machine, which includes replacing minor components of the engine that had worn out prior to D's acquisition of the machine. Assume the resurfacing machine, including the engine, is the unit of property. The routine maintenance safe harbor in paragraph (i) of this section does not apply to the amounts paid, because the activities performed do not relate solely to the taxpayer's use of the machine. The amount that D pays to inspect, retune, and replace minor components of the ice resurfacing machine ameliorates a condition or defect that existed prior to D's acquisition of the equipment.

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Example 4. Not amelioration of pre-existing material condition or defect (continued).

Nevertheless, considering the purpose and minor nature of the work performed, this amount does not ameliorate a material condition or defect in the machine under paragraph (j)(1)(i) of this section. In addition, the amount is not paid for a material addition to the machine or a material increase in the capacity of the machine under paragraph (j)(1)(ii) of this section. Also, the activities are not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the machine under paragraph (j)(1)(iii) of this section. Therefore, D is not required to capitalize the amount paid to inspect, retune, and replace minor components of the machine as a betterment under this paragraph (j).

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

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Example 5. Amelioration of material condition or defect (continued).

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

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Example 6. Not a betterment; building refresh. (i) F owns a nationwide chain of retail stores that sell a wide variety of items. To maintain the appearance and functionality of its store buildings after several years of wear, F periodically pays amounts to refresh the look and layout of its stores. The work that F performs during a refresh consists of cosmetic and layout changes to the store's interiors and general repairs and maintenance to the store building to modernize the store buildings and reorganize the merchandise displays. The work to each store consists of replacing and reconfiguring display tables and racks to provide better exposure of the merchandise, making corresponding lighting relocations and flooring repairs, moving one wall to accommodate the reconfiguration of tables and racks, patching holes in walls, repainting the interior structure with a new color scheme to coordinate with new signage, replacing damaged ceiling tiles, cleaning and repairing wood flooring throughout the store building, and power washing building exteriors.

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Example 6. Not a betterment; building refresh (continued).

The display tables and the racks all constitute section 1245 property. F pays amounts to refresh 50 stores during the taxable year. Assume that each section 1245 property within each store is a separate unit of property. Finally, assume that the work does not ameliorate any material conditions or defects that existed when F acquired the store buildings or result in any material additions to the store buildings.

(ii) Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. Considering the facts and circumstances including the purpose of the expenditure, the physical nature of the work performed, and the effect of the expenditure on the buildings' structure and systems, the amounts paid for the refresh of each building are not for any material additions to, or material increases in the capacity of, the buildings' structure or systems as compared with the condition of the structure or systems after the previous refresh.

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Example 6. Not a betterment; building refresh (continued).

Moreover, the amounts paid are not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of any building structure or system under as compared to the condition of the structures or systems after the previous refresh. Rather, the work performed keeps F's store buildings' structures and buildings' systems in their ordinarily efficient operating condition. Therefore, F is not required to treat the amounts paid for the refresh of its store buildings' structures and buildings' systems as betterments under paragraphs (j)(1)(ii), (j)(1)(iii), and (j)(2)(iv) of this section. However, F is required to capitalize the amounts paid to acquire and install each section 1245 property in accordance with § 1.263(a)-2(d)(1).

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

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Example 7. Building refresh; limited improvement (continued).

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

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Example 7. Building refresh; limited improvement (continued).

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

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Example 8. Betterment; building remodel. (i) G owns a large chain of retail stores that sell a variety of items. G determines that due to changes in the retail market, it can no longer compete in its current store class and decides to upgrade its stores to offer higher end products to a different type of customer. To offer these products and attract different types of customers, G must substantially remodel its stores. Thus, G pays amounts to remodel its stores by performing work on the buildings' structures and systems as defined under paragraphs (e)(2)(ii)(A) and (e)(2)(ii)(B) of this section. This work includes replacing large parts of the exterior walls with windows, replacing the escalators with a monumental staircase, adding a new glass enclosed elevator, rebuilding the interior and exterior facades, replacing vinyl floors with ceramic flooring, replacing ceiling tiles with acoustical tiles, and removing and rebuilding walls to move changing rooms and create specialty departments.

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Example 8. Betterment; building remodel (continued).

The work also includes upgrades to increase the capacity of the buildings' electrical system to accommodate the structural changes and the addition of new section 1245 property, such as new product information kiosks and point of sale systems. The work to the electrical system also involves the installation of new more efficient and mood enhancing lighting fixtures. In addition, the work includes remodeling all bathrooms by replacing contractor-grade plumbing fixtures with designer-grade fixtures that conserve water and energy. Finally, G also pays amounts to clean debris resulting from construction during the remodel, patch holes in walls that were made to upgrade the electrical system, repaint existing walls with a new color scheme to match the new interior construction, and to power wash building exteriors to enhance the new exterior facade.

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Example 8. Betterment; building remodel (continued).

(ii) Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. Considering the facts and circumstances, including the purpose of the expenditure, the physical nature of the work performed, and the effect of the work on the buildings' structures and buildings' systems, the amounts that G pays for the remodeling of its stores result in betterments to the buildings' structures and several of its systems under paragraph (j) of this section. Specifically, the amounts paid to replace large parts of the exterior walls with windows, replace the escalators with a monumental staircase, add a new elevator, rebuild the interior and exterior facades, replace vinyl floors with ceramic flooring, replace the ceiling tiles with acoustical tiles, and to remove and rebuild walls are for material additions, that is the addition of major components, to the building structure under paragraph (j)(1)(ii) of this section and are reasonably expected to increase the quality of the building structure under paragraph (j)(1)(iii) of this section.

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Example 8. Betterment; building remodel (continued).

Similarly, the amounts paid to upgrade the electrical system are to materially increase the capacity of the electrical system under paragraph (j)(1)(ii) of this section and are reasonably expected to increase the quality of this system under paragraph (j)(1)(iii) of this section. In addition, the amounts paid to remodel the bathrooms with higher grade and more resource-efficient materials are reasonably expected to increase the efficiency and quality of the plumbing system under paragraph (j)(1)(iii) of this section. Finally, the amounts paid to clean debris, patch and repaint existing walls with a new color scheme, and to power wash building exteriors, while not betterments by themselves, directly benefitted and were incurred by reason of the improvements to G's store buildings' structures and electrical systems under paragraph (g)(1) of this section.

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Example 8. Betterment; building remodel (continued).

Therefore, G must treat the amounts paid for betterments to the store buildings' structures and systems, including the costs of cleaning, patching, repairing, and power washing the building, as improvements to G's buildings and must capitalize these amounts under paragraphs (d)(1) and (j) of this section. Moreover, G is required to capitalize the amounts paid to acquire and install each section 1245 property in accordance with § 1.263(a)-2(d)(1). For the treatment of amounts paid to remove components of property, see paragraph (g)(2) of this section.

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

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

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

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Example 11. Betterment; regulatory requirement (continued).

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

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

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Example 12. Not a betterment; regulatory requirement (continued).

Moreover, the amount paid is not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the building structure under paragraphs (j)(1)(iii) and (j)(2)(iv) as compared to the condition of the structure prior to the seepage of the oil. Therefore, L is not required to treat the amount paid to correct the seepage as a betterment to the building under paragraph (d)(1) or (j) of this section. The federal inspectors' requirement that L correct the seepage to continue operating the plant is not relevant in determining whether the amount paid improves the plant.

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

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Example 13. Not a betterment; new roof membrane (continued).

Under these facts, the amount paid to add the new membrane to the roof is not for a material addition or a material increase in the capacity of the building structure under paragraph (j)(1)(ii) of this section as compared to the condition of the structure when it was placed in service. Moreover, the new membrane is not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the building structure under paragraph (j)(1)(iii) of this section as compared to the condition of the building structure when it was placed in service. Therefore, M is not required to treat the amount paid to add the new membrane as a betterment to the building under paragraph (d)(1) or (j) of this section.

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

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

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

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

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

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

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

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Example 20. Not material increase in efficiency; HVAC system (continued).

The replacement of the two roof mounted units is not a material addition to or a material increase in the capacity of the HVAC system under paragraphs (j)(1)(ii) and (j)(3)(ii) of this section as compared to the condition of the system prior to the climate control problems. In addition, given the 10 percent efficiency increase in two units of the entire HVAC system, the replacement is not expected to materially increase the productivity, efficiency, strength, quality, or output of the HVAC system under paragraphs (j)(1)(iii) and (j)(2)(iv) of this section as compared to the condition of the system prior to the climate control problems. Therefore, R is not required to capitalize the amounts paid for these replacements as betterments to the building unit of property under paragraphs (d)(1) and (j) of this section.

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

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

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Example 22. Material addition; building (continued).

Accordingly, T must capitalize as an improvement the amounts paid to add the partition, drive-through window, and overhang under paragraphs (d)(1) and (j) of this section. T is also required to capitalize the amounts paid to acquire and install each section 1245 property in accordance with § 1.263(a)-2(d)(1).

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

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Example 23. Costs incurred during betterment (continued).

Moreover, under paragraph (g)(1) of this section, U is required to capitalize the amounts paid to patch holes and repaint several walls in its building because these costs directly benefit and are incurred by reason of the improvement to U's building unit of property.

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1.263(a)-3 Restorations

- In general . . . Amounts paid to restore a unit of property, including making good the exhaustion for which an allowance is or has been made must be capitalized. An amount is paid to restore a unit of property only if it:
 - Replaces a component of a unit of property for which the taxpayer has properly claimed a deduction,
 - Replaces a component of a unit of property for which the taxpayer has taken the adjusted basis of the component into account in realizing gain or loss
 - Is for repair of damage to the unit of property for which taxpayer has properly taken a basis adjustment for a casualty loss under 165 (however, now special cap at basis level)

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1.263(a)-3 Restorations

- Returns a deteriorated unit of property, no longer functional for its intended use, to its ordinarily efficient operating condition
- Results in rebuilding the unit of property to like-new condition after the end of its class life
- Is for replacement of a part or combination of parts comprising a major component or substantial structural part of the unit of property
- An amount is paid to restore a building if it restores the building structure or any building system
- A unit of property is rebuilt to like new condition if it is brought to status of new, rebuilt, remanufactured or similar status under any federal guideline or manufacturer's original specifications

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- IRS claims to have clarified in final regulations “major component” or “substantial structural part”
 - Major component
 - A part or combination of parts that performs a discrete and critical function in the operation of the unit of property
 - An incidental component of the unit of property, even though such component performs a discrete and critical function in the operation of the unit of property, generally will not, by itself, constitute a major component.
 - Substantial structural part - A part or combination of parts that comprises a large portion of the physical structure of the unit of property.
 - Rejected comments that asked for a fixed percentage test
- Thirty one examples (up from 26 in temporary regulations)

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

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

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

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

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

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Example 5. Restoration after casualty loss; limitation (continued).

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

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

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Example 7. Rebuild of property to like-new condition before end of class life. E is a Class I railroad that owns a fleet of freight cars. Assume the freight cars have a recovery period of 7 years under section 168(c) and a class life of 14 years. Every 8 to 10 years, E rebuilds its freight cars. Ten years after E places the freight car in service, E performs a rebuild to the manufacturer's original specification, which includes a complete disassembly, inspection, and reconditioning or replacement of components of the suspension and draft systems, trailer hitches, and other special equipment. E also modifies the car to upgrade various components to the latest engineering standards. The freight car is stripped to the frame, with all of its substantial components either reconditioned or replaced. The frame itself is the longest-lasting part of the car and is reconditioned. The walls of the freight car are replaced or are sandblasted and repainted. New wheels are installed on the car. All the remaining components of the car are restored before they are reassembled. At the end of the rebuild, the freight car has been restored to like-new condition under the manufacturer's specifications.

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Example 7. Rebuild of property to like-new condition before end of class life (continued).

Assume the freight car is the unit of property. E is not required to treat as an improvement and capitalize the amounts paid to rebuild the freight car under paragraph (k)(1)(v) of this section because, although the amounts paid restore the freight car to like-new condition, the amounts were not paid after the end of the class life of the freight car. However, see paragraphs (k)(1)(vi) and (k)(6) of this section to determine whether any amounts must be capitalized because they are paid for the replacement of a major component or a substantial structural part of the unit of property.

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

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Example 9. Not a rebuild to a like-new condition. F is a commercial airline engaged in the business of transporting freight and passengers. To conduct its business, F owns several aircraft. As a condition of maintaining its airworthiness certificates, F is required by the FAA to establish and adhere to a continuous maintenance program for each aircraft in its fleet. F performs heavy maintenance on its airframes every 8 to 10 years. In Year 1, F purchased an aircraft for \$15 million. In Year 16, F paid \$2 million for the labor and materials necessary to perform the second heavy maintenance visit on the airframe of an aircraft. To perform the heavy maintenance visit, F extensively disassembles the airframe, removing items such as engines, landing gear, cabin and passenger compartment seats, side and ceiling panels, baggage stowage bins, galleys, lavatories, floor boards, cargo loading systems, and flight control surfaces. As specified by F's maintenance manual for the aircraft, F then performs certain tasks on the disassembled airframe for the purpose of preventing deterioration of the inherent safety and reliability levels of the airframe.

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Example 9. Not a rebuild to a like-new condition (continued).

These tasks include lubrication and service, operational and visual checks, inspection and functional checks, reconditioning of minor parts and components, and removal, discard, and replacement of certain life-limited single cell parts, such as cartridges, canisters, cylinders, and disks. Reconditioning of parts includes burnishing corrosion, repairing cracks, dents, gouges, punctures, tightening or replacing loose or missing fasteners, replacing damaged seals, gaskets, or valves, and similar activities. In addition to the tasks described above, to comply with certain FAA airworthiness directives, F inspects specific skin locations, applies doublers over small areas where cracks were found, adds structural reinforcements, and replaces skin panels on a small section of the fuselage. However, the heavy maintenance does not include the replacement of any major components or substantial structural parts of the aircraft with new components. In addition, the heavy maintenance visit does not bring the aircraft to the status of new, rebuilt, remanufactured, or a similar status under FAA guidelines or the manufacturer's original specifications. After the heavy maintenance, the aircraft was reassembled..

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Example 9. Not a rebuild to a like-new condition (continued).

Assume the aircraft, including the engines, is a unit of property and has a class life of 12 years under section 168(c). Although the heavy maintenance is performed after the end of the class life of the aircraft, F is not required to treat the heavy maintenance as a restoration and improvement of the unit of property under paragraph (k)(1)(v) of this section because, although extensive, the amounts paid do not restore the aircraft to like-new condition. See also paragraph (i)(1)(iii) of this section for the application of the safe harbor for routine maintenance.

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

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

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Example 11. Repair performed during restoration (continued).

The amounts paid to repair the broken taillight are not for the replacement of a major component, do not directly benefit, and are not incurred by reason of the replacement of the cab or the engine under paragraph (g)(1)(i) of this section, even though the repair was performed at the same time as these replacements. Thus, G is not required to capitalize the amounts paid to repair the broken taillight.

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

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Example 12. Related amounts to replace major component or substantial structural part; personal property (continued).

Installation of the new tanks includes placement of a liner in the excavated hole, placement of the new tanks, installation of a leak detection system, installation of an overfill system, connection of the tanks to the pipes leading to the pumps, backfilling of the hole, and replacement of the paving. H also is required to pay a permit fee to the county to undertake the installation of the new tanks.

(ii) H pays the permit fee to the county on October 15, Year 1. On December 15, Year 1, the contractor completes the removal of the old USTs and bills H for the costs of removal. On January 15, Year 2, the contractor completes the installation of the new USTs and bills H for the remainder of the work. Assume that H computes its taxes on a calendar year basis and H's gasoline pumping system is the unit of property.

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Example 12. Related amounts to replace major component or substantial structural part; personal property (continued).

Under paragraph (k)(1)(vi) of this section, H must capitalize the amounts paid to replace the USTs as a restoration to the gasoline pumping system because the USTs are parts or combinations of parts that comprise a major component and substantial structural part of the gasoline pumping system. Moreover, under paragraph (g)(2) of this section, H must capitalize the costs of removing the old USTs because H has not taken a loss on the disposition of the USTs, and the amounts to remove the USTs directly benefit and are incurred by reason of the restoration of, and improvement to, the gasoline pumping system. In addition, under paragraph (g)(1) of this section, H must capitalize the permit fees because they directly benefit and are incurred by reason of the improvement to the gasoline pumping system.

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Example 12. Related amounts to replace major component or substantial structural part; personal property (continued).

Finally, under paragraph (g)(3) of this section, H must capitalize the related amounts paid to improve the gasoline pumping system, including the permit fees, the amount paid to remove the old USTs, and the amount paid to install the new USTs, even though the amounts were separately invoiced, paid to different parties, and incurred in different tax years.

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

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

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

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Example 15. Not replacement of major component or substantial structural part; roof membrane (continued).

Although the replacement membrane may aid in the function of the building structure, it does not, by itself, comprise a significant portion of the roof major component under paragraph (k)(6)(ii)(A) of this section. In addition, the replacement membrane does not comprise a substantial structural part of L's building structure under paragraph (k)(6)(ii)(B) of this section. Therefore, L is not required to capitalize the amount paid to replace the membrane as a restoration of the building under paragraph (k)(1)(vi) of this section.

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

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Example 16. Not a replacement of major component or substantial structural part; HVAC system (continued).

However, the single furnace is not a significant portion of this major component of the HVAC system under paragraph (k)(6)(ii)(A) of this section, or a substantial structural part of the HVAC system under paragraph (k)(6)(ii)(B) of this section. Therefore, M is not required to treat the amount paid to replace the furnace as a restoration of the building under paragraph (k)(1)(vi) of this section.

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

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Example 17. Replacement of major component or substantial structural part; HVAC system (continued).

Because the chiller unit comprises a major component of a building system, N must treat the amount paid to replace the chiller unit as a restoration to the building under paragraphs (k)(1)(vi) and (k)(2) of this section and must capitalize the amount paid as an improvement to the building under paragraph (d)(2) of this section.

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Example 18. Not replacement of major component or substantial structural part; HVAC system. O owns an office building that it uses to provide services to customers. The building contains a HVAC system that incorporates ten roof-mounted units that provide heating and air conditioning for the building. The HVAC system also consists of controls for the entire system and duct work that distributes the heated or cooled air to the various spaces in the building's interior. O begins to experience climate control problems in various offices throughout the office building and consults with a contractor to determine the cause. The contractor recommends that O replace three of the roof-mounted heating and cooling units. O pays an amount to replace the three specified units. No work is performed on the other roof-mounted heating and cooling units, the duct work, or the controls. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount restores the building structure or any building system.

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Example 18. Not replacement of major component or substantial structural part; HVAC system (continued).

The HVAC system, including the 10 roof-mounted heating and cooling units, is a building system under paragraph (e)(2)(ii)(B)(1) of this section. As the components that generate the heat and the air conditioning in the HVAC system, the 10 roof-mounted units, together, perform a discrete and critical function in the operation of the HVAC system and, therefore, are a major component of the HVAC system under paragraph (k)(6)(ii)(A) of this section. The three roof-mounted heating and cooling units are not a significant portion of a major component of the HVAC system under (k)(6)(ii)(A) of this section, or a substantial structural part of the HVAC system, under paragraph (k)(6)(ii)(B) of this section. Accordingly, O is not required to treat the amount paid to replace the three roof-mounted heating and cooling units as a restoration of the building under paragraph (k)(1)(iv) of this section.

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

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

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

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

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Example 22. Replacement of major component or substantial structural part; plumbing system (continued).

Therefore, under paragraph (k)(6)(ii)(A) of this section, all the toilets comprise a major component of the plumbing system, and all the sinks comprise a major component of the plumbing system. Accordingly, S must treat the amount paid to replace all of the toilets and all of the sinks as a restoration of the building under paragraphs (k)(1)(vi) and (k)(2) of this section and must capitalize the amount paid as an improvement to the building under paragraph (d)(2) of this section.

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

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

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Example 24. Replacement of major component or substantial structural part; plumbing system (continued).

(ii) Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount restores the building structure or any building system. The plumbing system, including the bathtubs, toilets, and sinks, is a building system under paragraph (e)(2)(ii)(B)(2) of this section. All the bathtubs, together, all the toilets, together, and all the sinks together in the hotel building perform discrete and critical functions in the operation of the plumbing system under paragraph (k)(6)(ii)(A) of this section and comprise a large portion of the physical structure of the plumbing system under paragraph (k)(6)(ii)(B) of this section. Therefore, under paragraph (k)(6)(ii) of this section, these plumbing components comprise major components and substantial structural parts of the plumbing system, and T must treat the amount paid to replace these plumbing components as a restoration of, and improvement to, the building under paragraphs (k)(1)(vi) and (k)(2) of this section.

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Example 24. Replacement of major component or substantial structural part; plumbing system (continued).

In addition, under paragraph (g)(1)(i) of this section, T must treat the costs of repairing, repainting, and retiling the bathroom walls and floors as improvement costs because these costs directly benefit and are incurred by reason of the improvement to the building. Further, under paragraph (g)(3) of this section, T must treat the costs incurred in Years 1, 2, and 3 for the bathroom remodeling as improvement costs, even though they are incurred over a period of several taxable years, because they are related amounts paid to improve the building unit of property. Accordingly, under paragraph (d)(2) of this section, T must treat all the amounts it incurs to update its hotel restrooms as an improvement to the hotel building and capitalize these amounts. In addition, under § 1.263(a)-2 of the regulations, T must capitalize the amounts paid to acquire and install each section 1245 property.

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

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Example 25. Not replacement of major component or substantial structural part; windows (continued).

Therefore, under paragraph (k)(6) of this section, the replacement of the 100 windows does not constitute the replacement of a major component or substantial structural part of the building, and U is not required to treat the amount paid to replace the 100 windows as restoration of the building under paragraph (k)(1)(iv) of this section.

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

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

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

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Example 28. Not replacement of major component or substantial structural part; floors (continued).

Therefore, under paragraph (k)(6) of this section, the replacement of the lobby floors is not the replacement of a major component or substantial structural part of the building unit of property, and V is not required to treat the amount paid for the replacement of the lobby floors as a restoration to the building under paragraph (k)(1)(iv) of this section.

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

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Example 29. Replacement of major component or substantial structural part; floors (continued).

Accordingly, V must treat the amount paid to replace the public area floors as a restoration of the building unit of property under paragraphs (k)(1)(vi) and (k)(2) of this section and must capitalize the amounts as an improvement to the building under paragraph (d)(2) of this section.

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1.263(a)-3 Restorations

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

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1.263(a)-3 Restorations

Example 30. Replacement with no disposition (continued).

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

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1.263(a)-3 Restorations

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

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1.263(a)-3 Adaptation to New or Different Use

- In general . . . Capitalize amounts paid to adapt a unit of property to a new or different use
 - Adaptation is not consistent with the taxpayer's ordinary use of the unit of property at the time originally placed in service by the taxpayer.
 - Building . . . Adapts to a new or different use building structure or any building system
- Seven examples (up from four in temporary regulations)

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1.263(a)-3 Adaptation to New or Different Use

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

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1.263(a)-3 Adaptation to New or Different Use

Example 1. New or different use; change in building use (continued).

Therefore, A must capitalize the amount paid to convert the building into a showroom as an improvement to the building under paragraphs (d)(3) and (l) of this section.

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1.263(a)-3 Adaptation to New or Different Use

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

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1.263(a)-3 Adaptation to New or Different Use

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

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1.263(a)-3 Adaptation to New or Different Use

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

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1.263(a)-3 Adaptation to New or Different Use

Example 4. New or different use; land (continued).

However, the amount paid to regrade the land so that it can be used for residential purposes adapts the land to a new or different use that is inconsistent with D's intended ordinary use of the property at the time it was placed in service. Accordingly, the amounts paid to regrade the land must be capitalized as improvements to the land under paragraphs (d)(3) and (l) of this section.

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1.263(a)-3 Adaptation to New or Different Use

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

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1.263(a)-3 Adaptation to New or Different Use

Example 5. New or different use; part of building (continued).

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

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1.263(a)-3 Adaptation to New or Different Use

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

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1.263(a)-3 Adaptation to New or Different Use

Example 6. Not a new or different use; part of building (continued).

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

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1.263(a)-3 Adaptation to New or Different Use

Example 6. Not a new or different use; part of building (continued).

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

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1.263(a)-3 Adaptation to New or Different Use

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

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1.263(a)-3 Adaptation to New or Different Use

Example 7. Not a new or different use; part of building (continued).

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

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1.263(a)-3 Optional Regulatory Accounting Method

- In general . . . Taxpayer engaged in regulated industry may use the regulatory accounting method for repairs, maintenance, and improvements required by:
 - Federal Energy Regulatory Commission
 - Federal Communications Commission
 - Surface Transportation Board
 - Four examples restate above points
- Final regulations merely clarify must use standards of those agencies

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1.263(a)-3 Optional Regulatory Accounting Method

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

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1.263(a)-3 Optional Regulatory Accounting Method

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

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1.263(a)-3 Optional Regulatory Accounting Method

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

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1.263(a)-3 Optional Regulatory Accounting Method

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

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1.263(a)-3(n) Election to Capitalize Repairs and Maintenance

- Added in the final regulations
- Allows a taxpayer to elect to capitalize tangible property that otherwise would be treated as repairs and maintenance
 - Must treat the same way on books and records
 - Must file statement with return to elect
 - Title statement “Section 1.263(a)-3(n) Election”
 - Taxpayer's name, address, taxpayer identification number, and a statement that the taxpayer is making the election to capitalize repair and maintenance costs under § 1.263(a)-3(n)

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1.263(a)-3(n) Election to Capitalize Repairs and Maintenance

Example 1. Election to capitalize routine maintenance on non-rotable part.

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

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1.263(a)-3(n) Election to Capitalize Repairs and Maintenance

Example 1. Election to capitalize routine maintenance on non-rotatable part (continued).

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

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1.263(a)-3(n) Election to Capitalize Repairs and Maintenance

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

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1.263(a)-3(n) Election to Capitalize Repairs and Maintenance

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

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1.263(a)-3(n) Election to Capitalize Repairs and Maintenance

Example 3. Election to capitalize replacement of building component (continued).

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

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1.263(a)-3 Amounts Capitalized

- Reg. § 1.263(a)-3(o) simply states that anything treated as capitalized by this provision must be appropriately classified
- Reg. § 1.263(a)-3(p) goes on to state that costs can only be recovered by reference to another Code provision.

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1.263(a)-3 Effective Date/Accounting Method

- Effective date generally 1/1/14
- For years beginning after 1/1/12 and before 1/1/14
 - May use old rules
 - Can elect to use temporary regulations
 - Can elect to use final regulations (180 day relief option for missing elections)
- All modifications will be accounting method changes

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Depreciation, Repairs and Fixed Assets

PROVISIONS THAT OVERRIDE CAPITALIZATION RULES

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1.263(a)-6 Election to Deduct or Capitalize Certain Expenditures

- Lists 21 code sections permitting an election to treat capital expenditures as deductible or deferred expenses, or vice versa
 - Section 173 (circulation expenditures);
 - Section 174 (research and experiment expenditures);
 - Section 175 (soil and water conservation expenditures, and endangered species recovery expenditures);
 - Section 179 (election to expense depreciable business assets);
 - Section 179A (deduction for clean-fuel vehicles and certain refueling property)
 - Section 179B (deduction for costs incurred for EPA compliance)

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1.263(a)-6 (continued)

- 179C (election to expense certain refineries);
- 179D (energy efficient commercial buildings deduction);
- 179E (election to expense mine safety equipment);
- 180 (expenditures by farmers for fertilizer);
- 181 (certain qualified film and television productions);
- 190 (removal of architectural and transportation barriers to handicapped and elderly
- 191 (tertiary injectants);
- 194 (re-for a station expenditures);
- 195 (startup expenditures);
- 198 (expensing environmental remediation costs);

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1.263(a)-6 (continued)

- 198A (qualified disaster expenses);
- 248 (organization expenditures of Corporation);
- 266 (carrying charges);
- 616 (development expenditures); and
- 709 (organization and syndication fees of partnership).
- Applies to taxable years beginning on or after 1/1/2014 (again can elect to use effective 1/1/2012)

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Final Regulations TD 9636

- First available [9/13/13](#)
- Published in Federal Register [9/19/13](#)
- Indicates we will get new automatic election provisions – expect update to Rev. Proc. 2012-19 and 2012-20
- Made a few changes to proposed regulations
- Finalized § 168(i) disposition regulations in 2014 (TD 9689, 8/18/14)
- Can (but don't have to) use temporary regulations from 2012-2014 or use final regulations

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1.162-3

Materials and Supplies: Defined

- Tangible property that is used or consumed in the taxpayer's operations that is not inventory and is:
 - Required to maintain, repair, or improve a unit of tangible property [see [1.263\(a\)-3\(e\)](#)] owned or leased or serviced by taxpayer, not acquired as part of a unit of tangible property
 - Fuel, lubricants, water and similar items expected to be consumed within 12 months of first use
 - A unit of property with “economic useful life of 12 months or less” after first use in taxpayers operations
 - A “unit of property” costing less than ~~\$100~~ [\\$200](#)
 - Identified in other guidance as “materials and supplies” for which deductibility is permitted

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1.162-3

Materials and Supplies: Defined

- Tangible property that is used or consumed in the taxpayer's operations that is not inventory and is:
 - Standby emergency spare parts
 - Acquired when item acquired
 - Set aside to avoid substantial time loss
 - Located at or near equipment
 - Directly related to particular machinery
 - Normally expensive
 - Not subject to normal replacement
 - Not interchangeable in other machines
 - Not acquired in quantity
 - Not repaired and reused

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~~\$100~~ \$200 Rule Example

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

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~~\$100~~ \$200 Rule Example

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

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Materials and Supplies

- Non-incidentals materials and supplies:
 - Deductible in taxable year in which used or consumed in taxpayers operations
- Incidentals materials and supplies:
 - Carried on hand, but no record of consumption and no inventories maintained
 - Deductible in taxable year when amounts are paid or incurred subject to “clear reflection of income”
- Rotable and temporary spare parts (Later slides)
- Nothing in this section changes the treatment of any amount other than Sections 162(a) and 212

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Example of Application

Example 1. Non-rotatable components. X owns a fleet of aircraft that it operates in its business. In Year 1, X purchases a stock of spare parts, which it uses to maintain and repair its aircraft. X keeps a record of consumption of these spare parts. In Year 2, X uses the spare parts for the repair and maintenance of one of its aircraft. Assume each aircraft is a unit of property under § 1.263(a)-3T(e) and that spare parts are not rotatable or temporary spare parts under paragraph (c)(2) of this section. Assume these repair and maintenance activities do not improve the aircraft under § 1.263(a)-3T.

These parts are materials and supplies under paragraph (c)(1)(i) of this section because they are components acquired and used to maintain and repair X's aircraft. Under paragraph (a)(1) of this section, the amounts that X paid for the spare parts in Year 1 are deductible in Year 2, the taxable year in which the spare parts are used to repair and maintain the aircraft.

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Rotable & Temporary Spare Parts

- Acquired for installation on a unit of property, removable, repaired and reinstalled or stored for later installation on another unit of property
- General rule: deductible in taxable year when taxpayer disposes of the part
- Two methods
 - Deductible in year disposed of (Disposal Method)
 - Optional method: Deduct when part is first installed
 - May not currently deduct maintenance and repair of part
 - Must include FMV in income when removed

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Regular (Disposal) Method

Example 2. Rotable spare parts. X operates a fleet of specialized vehicles that it uses in its service business. Assume that each vehicle is a unit of property under § 1.263(a)-3T(e). At the time that it acquires a new type of vehicle, X also acquires a substantial number of rotatable spare parts that it will keep on hand to quickly replace similar parts in X's vehicles as those parts break down or wear out. These rotatable parts are removable from the vehicles and are repaired so that they can be reinstalled on the same or similar vehicles. X does not use the optional method of accounting for rotatable and temporary spare parts provided in paragraph (e) of this section.

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Regular Method

In Year 1, X acquires several vehicles and a number of rotatable spare parts to be used as replacement parts in these vehicles. In Year 2, X repairs several vehicles by using these rotatable spare parts to replace worn or damaged parts. In Year 3, X removes these rotatable spare parts from its vehicles, repairs the parts, and reinstalls them on other similar vehicles. In Year 5, X can no longer use the rotatable parts it acquired in Year 1 and disposes of them as scrap.

Under paragraph (c)(1)(i) of this section, the rotatable spare parts acquired in Year 1 are materials and supplies. Under paragraph (a)(3) of this section, rotatable spare parts are generally used or consumed in the taxable year in which the taxpayer disposes of the parts. Therefore, under paragraph (a)(1) of this section, the amounts that X paid for the rotatable spare parts in Year 1 are deductible in Year 5, the taxable year in which X disposes of the parts.

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Optional Method

Example 3. Rotable spare parts; application of optional method of accounting. Assume the same facts as in Example 2, except X uses the optional method of accounting for all its rotatable and temporary spare parts under paragraph (e) of this section.

In Year 1, X acquires several vehicles and a number of rotatable spare parts (the "Year 1 rotatables") to be used as replacement parts in these vehicles. In Year 2, X repairs several vehicles and uses the Year 1 rotatables to replace worn or damaged parts. In Year 3, X pays amounts to remove these Year 1 rotatables from its vehicles. In Year 4, X pays amounts to maintain, repair, or improve the Year 1 rotatables. In Year 5, X pays amounts to reinstall the Year 1 rotatables on other similar vehicles. In Year 8, X removes the Year 1 rotatables from these vehicles and stores these parts for possible later use. In Year 9, X disposes of the Year 1 rotatables.

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Optional Method

Under paragraph (e) of this section, X must deduct the amounts paid to acquire and install the Year 1 rotatables in Year 2, the taxable year in which the rotatable spare parts are first installed by X in X's vehicles. In Year 3, when X removes the Year 1 rotatables from its vehicles, X must include in its gross income the fair market value of each part. Also, in Year 3, X must include in the basis of each Year 1 rotatable the fair market value of the rotatable and the amount paid to remove the rotatable from the vehicle. In Year 4, X must include in the basis of each Year 1 rotatable the amounts paid to maintain, repair, or improve each rotatable.

In Year 5, the year that X reinstalls the Year 1 rotatables (as repaired or improved) in other vehicles, X must deduct the reinstallation costs and the amounts previously included in the basis of each part. In Year 8, the year that X removes the Year 1 rotatables from the vehicles, X must include in income the fair market value of each rotatable part removed. In addition, in Year 8, X must include in the basis of each part the fair market value of that part and the amount paid to remove the each rotatable from the vehicle. In Year 9, the year that X disposes of the Year 1 rotatables, X may deduct the amounts remaining in the basis of each rotatable.

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Acquired With Property

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

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Economic Useful Life

- “. . . Not necessarily the useful life inherent in the property, but 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”
- Cross-referenced to 1.167(a)-1(b) , consider:
 - Wear & tear and decay from natural causes
 - Normal economic changes, inventions, and developments
 - Climate & other local conditions affecting taxpayers business
 - Taxpayers repair & replacement policy
- Conformity required if taxpayer has “applicable financial statement”

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REPAIRS

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1.162-4 Repairs

- Modifies “repair rules” in 1.162-4 to be consistent with “improvement rules” in 1.263(a)-3T
- **New rule . . .** amounts paid to repair and maintain tangible property are deductible provided they are not otherwise required to be capitalized by any other provision of Code or regulations. (Think 263A “UNICAP” rules or temporary 263(a) rules adopted concurrently with these temporary 162 rules)

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Old Reg. § 1.162-4

The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense, provided the cost of acquisition or production or the gain or loss basis of the taxpayer's plant, equipment, or other property, as the case may be, is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall either be capitalized and depreciated in accordance with section 167 or charged against the depreciation reserve if such an account is kept.

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New Reg. § 1.162-4(a)

(a) In general.

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

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1.162-4 Repairs

- Final regulations add option to capitalize what would otherwise be repairs to be consistent with taxpayer's books and records (See § 1.263(a)-3(n))
- Effective 1/1/2014 (can elect as of 1/1/2012). . .

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1.165-2 Obsolescence of Non-Depreciable Property

- See 1.167(a)-8, 1.168(i)-1, or 1.168(i)-8, for losses arising from permanent withdrawal of depreciable property from use in trade or business or production of income
- See 1.167-7 for casualty losses
- See 1.167(a)-9 for obsolescence of property depreciated under Sec. 167
 - But not 168, 1400I, 1400L(c), 168 prior to TRA 86, or any additional first-year depreciation deduction

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Reg. § 1.165-2(a)/(b) (Still in Force)

(a) Allowance of deduction.

A loss incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use therein, shall be allowed as a deduction under section 165(a) for the taxable year in which the loss is actually sustained. For this purpose, the taxable year in which the loss is sustained is not necessarily the taxable year in which the overt act of abandonment, or the loss of title to the property, occurs.

(b) Exceptions.

This section does not apply to losses sustained upon the sale or exchange of property, losses sustained upon the obsolescence or worthlessness of depreciable property, casualty losses, or losses reflected in inventories required to be taken under section 471. The limitations contained in sections 1211 and 1212 upon losses from the sale or exchange of capital assets do not apply to losses allowable under this section.

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1.168(i)-0

- Table of Contents for:
 - 1.168(i)-1
 - 12 new sections are added and some paragraph references are changed
- Final regulations issued 8/18/14 – minor revisions
- In course primary concern related to “slicing away” structural components of buildings when forced to capitalize

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Executive Summary

- IRS “borrowed” general asset account rules due to change in real estate capitalization
- Will be able to “slice off” portions of the building when incur certain capitalized improvements

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1.168(i)-1 Disposition of An Asset From a General Asset Account

- Under unit of property rules for § 1.263(a)-3, discussed later, a building exists in two views
 - The building as a whole is a unit of property
 - But the structural components of the building as treated as separate units in a special “group asset account”
- Thus can dispose of the structural component of building in some cases
- But, of course, you didn’t put the building on the depreciation schedule as a bunch of components when it was acquired
- Fine, regulations make an “assumed” general asset account election

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1.168(i)-1 Disposition of An Asset From a General Asset Account

- Elect to have a qualifying disposition [Reg. § 1.168(i)-1(e)(3)(iii)(B)] if dispose of structural component in
 - Direct result of casualty, fire, theft
 - Charitable contribution
 - Disposition of part of business
 - Certain nonrecognition transfers
- Claim loss on return

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1.168(i)-8 Disposition of MACRS Property


- Special partial disposition election on buildings at Reg. § 1.168(i)-8(d)(2) for replacement
 - “Nike” election (just do it)
 - Determine portion of asset retired using reasonable method [PPI Method most likely to be used – Reg. § 1.168(i)-8(f)(2)(A)]
 - Discount using Producer Price Index for Finished Goods or its successor, the Producer Price Index for Final Demand

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1.168(i)-8 Disposition of MACRS Property

- Finding Producer Price Index
 - Federal Reserve Bank of St Louis – ask for detailed Excel data
 - PPI Finished Goods
<http://research.stlouisfed.org/fred2/series/PPIFGS>
 - PPI Final Demand
<http://research.stlouisfed.org/fred2/series/PPIFIS>
 - Google Docs worksheet for PPI Finished Goods
<http://bit.ly/1KG597D>

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 Current Federal Tax Developments <small>Nichols Patrick CPE, Incorporated</small>	
PPI for Finished Goods Reg. §1.168(i)-1(j)(3)(A)	
Date Placed in Service	6/30/2005
Date Restored/Replaced	1/2/2011
Restoration/Replacement Cost	110,000.00
PPI for Date Placed in Service	153.9
PPI for Date Restored Replaced	185.3
Factor	0.8305450621
Calculated Cost at Acquisition	91,359.96
<i>Updated through 12/2014</i>	
<small>Uses PPI for Finished Goods - Data from Federal Reserve Bank of St. Louis</small>	

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1.168(i)-8 Disposition of MACRS Property

- IRS Exam Issue
 - Can make late disposition election if IRS requires capitalizing asset on exam
 - Do so by requesting a change in accounting method [Reg. § 1.168(i)-8(d)(2)(iii)]

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Calculating Loss on Disposition Using PPI Method

- Discount replacement cost as stand-in for portion of total basis
 - PPI for date property acquired
 - PPI for date of replacement
 - Divide replacement PPI into acquisition PPI
 - Multiply ratio times replacement cost = portion of unadjusted basis
 - Compute depreciation to date – remaining balance is loss on replacement

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Example of Partial Disposition Calculations

Example 9. (i) On July 1, 2011, E, a calendar-year taxpayer, purchased and placed in service an existing multi-story office building that costs \$20,000,000. The cost of each structural component of the building was not separately stated. E accounts for the building and its structural components in its tax and financial accounting records as a single asset with a cost of \$20,000,000. E depreciates the building as nonresidential real property and uses the optional depreciation table that corresponds with the general depreciation system, the straight-line method, a 39-year recovery period, and the mid-month convention. As of January 1, 2014, the depreciation reserve for the building is \$1,261,000.

Office building unadjusted basis	\$ 20,000,000
Accumulated depreciation as of January 1, 2014	<u>1,261,000</u>
Adjusted basis January 1, 2014	<u>\$ 18,739,000</u>

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Example of Partial Disposition Calculations

(ii) On June 30, 2014, E **replaces one of the two elevators** in the office building. E did not dispose of any other structural components of this building in 2014 and prior years. E **makes the partial disposition election provided under paragraph (d)(2)** of this section for this elevator. Although the office building, including its structural components, is the asset for disposition purposes, the result of E making the partial disposition election for the elevator is that the retirement of the replaced elevator is a disposition. Assume the replacement elevator is a restoration under § 1.263(a)-3(k), and not a betterment under § 1.263(a)-3(j) or an adaptation to a new or different use under § 1.263(a)-3(l).

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Example of Partial Disposition Calculations

Because E cannot identify the cost of the elevator from its records and the replacement elevator is a restoration under § 1.263(a)-3(k), E determines the cost of the disposed elevator by discounting the cost of the replacement elevator to its placed-in-service year cost using the Producer Price Index for Final Demand. Using this reasonable method, E determines the cost of the retired elevator by discounting the cost of the replacement elevator to its cost in 2011 (the placed-in-service year) using the Producer Price Index for Final Demand, resulting in \$150,000 of the \$20,000,000 purchase price for the building to be the cost of the retired elevator. Using the optional depreciation table that corresponds with the general depreciation system, the straight-line method, a 39-year recovery period, and the mid-month convention, the depreciation allowed or allowable for the retired elevator as of December 31, 2013, is \$9,458.

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Example of Partial Disposition Calculations

(iii) For E's 2014 Federal tax return, the loss for the retired elevator is determined as follows. The depreciation allowed or allowable for 2014 for the retired elevator is \$1,763 ((unadjusted depreciable basis of \$150,000 x depreciation rate of 2.564% for 2014) x 5.5/12 months). Thus, the adjusted depreciable basis of the retired elevator is \$138,779 (the adjusted depreciable basis of \$140,542 removed from the building cost less the depreciation allowed or allowable of \$1,763 for 2014). As a result, E recognizes a loss of \$138,779 for the retired elevator in 2014.

Elevator Basis	\$	150,000
Accumulated depreciation as of January 1, 2014		(9,458)
Depreciation for 2014		<u>(1,763)</u>
Basis upon disposition	\$	<u><u>138,779</u></u>

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Example of Partial Disposition Calculations

(iv) For E's 2014 Federal tax return, the depreciation allowance for the building is computed as follows. As of January 1, 2014, the unadjusted depreciable basis of the building is reduced from \$20,000,000 to \$19,850,000 (\$20,000,000 less the unadjusted depreciable basis of \$150,000 for the retired elevator), and the depreciation reserve of the building is reduced from \$1,261,000 to \$1,251,542 (\$1,261,000 less the depreciation allowed or allowable of \$9,458 for the retired elevator as of December 31, 2013). Consequently, the depreciation allowance for the building for 2014 is \$508,954 (\$19,850,000 x depreciation rate of 2.564% for 2014).

	<u>Full Building</u>	<u>Elevator</u>	<u>Building Minus Elevator</u>
Office building unadjusted basis	\$ 20,000,000	\$ 150,000	\$ 19,850,000
Accumulated depreciation as of January 1, 2014	1,261,000	9,458	1,251,542
Adjusted basis January 1, 2014	<u>\$ 18,739,000</u>	<u>\$ 140,542</u>	<u>\$ 18,598,458</u>

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Example of Partial Disposition Calculations

(v) E also must capitalize the amount paid for the replacement elevator pursuant to § 1.263(a)-3(k)(1). The replacement elevator is a separate asset for disposition purposes pursuant to paragraph (c)(4)(ii)(D) of this section and for depreciation purposes pursuant to section 168(i)(6).

Depreciation schedule will have (before 2014 depreciation):

Building Cost	\$ 19,850,000
Accumulated Depreciation - Building	1,251,542
 New Elevator - 39 year asset placed in service 6/30/14	 175,000
<i>*IRS didn't provide this number so we'll guess</i>	

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Accounting Methods

What Are They?

Accounting Methods

- Accounting method
 - Affects timing of recognition
 - Does not change ultimate amount recognized
- CCA 201345025 example of difference
 - Deducted commissions twice, once when accrued and once when paid
 - Not accounting method

Accounting Method

- Generally must use method used on taxpayer's books [IRC § 446(a)], but IRC may override
- Taxpayer is required to have books and records to support return [Reg. § 1.446-1(a)(4)]
- Books is not necessary a formal ledger [Reg. § 1.446-1(b)(7)]
- Generally need multiple years consistent treatment to establish a method

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Requesting a Change

- Governed by Section 6 of Revenue Procedure 2015-13
- Generally separate Form 3115 for each method change unless IRS allows for combination [Sec 6.02(1)]
- For automatic change, must provide change number [Sec 6.02(3)]
- Must be signed by taxpayer and preparer [Sec 6.02(8)]

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Automatic Changes

- Not filed within year of change [Sec 6.03(1)(a)]
 - Original attached to original tax return for year of change [Sec 6.03(1)(a)(i)(A)]
 - Copy to IRS Office in Ogden, Utah
 - Must be filed after year ends but
 - On or before date return is filed [Sec 6.03(1)(a)(i)(B)]
- No user fee [Sec 6.03(1)(c)]
- No IRS acknowledgment [Sec 6.03(1)(d)]

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Automatic Changes

- Automatic Extension [Section 6.03(4)]
 - Provided via mechanism of Reg. § 301.9100-2(b)
 - Within six months of unextended due date
 - File amended return and appropriate copies of Form 3115
 - See Revenue Procedure 2015-13 for details
- Other extensions
 - Only in “unusual and compelling circumstances”
 - Will require PLR and user fee

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§ 481(a) Adjustment

- Tax equivalent of cumulative effect of accounting change under GAAP
- Not impacted by “statute of limitations” issue
- Recover difference
 - Positive difference for voluntary change, $\frac{1}{4}$ in year of change, $\frac{1}{4}$ in each of next 3 years
 - Negative change taken into account in year of change

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Example Adjustment

Example 1. A taxpayer that is not required to use inventories uses the overall cash receipts and disbursements method of accounting and changes to an overall accrual method of accounting. The taxpayer has \$120,000 of income earned but not yet received (accounts receivable) and \$100,000 of expenses incurred but not yet paid (accounts payable) as of the end of the taxable year preceding the year of change in method of accounting. A positive net § 481(a) adjustment of \$20,000 (\$120,000 accounts receivable less \$100,000 accounts payable) is required as a result of the change in method of accounting.

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IRS Adjustment

- Change made under exam by taxpayer, adjustment period is two years for positive adjustments [Rev Proc 2015-13, 7.03(3)(b)]
- IRS change on exam– one year period [2.09]
- Incentive offered to taxpayer to make change voluntarily rather than playing “audit lottery” with the IRS
- Taxpayer who changes voluntarily generally gets audit protection on change

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Failure to Obtain Permission

- IRS can place taxpayer back on old method in years under exam
- So, for instance, could
 - Remove items from the depreciation schedule
 - Deny benefits of de minimis elections
 - Can do so even if old method not permissible
- Taxpayer would then need to seek permission in later year to change to new method

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THANK YOU !

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