

Reg. Section 1.263(a)-3T(d)

Amounts paid to improve tangible property (temporary).

(a) Overview. This section provides rules for applying section 263(a) to amounts paid to improve tangible property. Paragraph (b) of this section provides definitions. Paragraph (c) of this section provides rules for coordinating this section with other provisions of the Internal Revenue Code. Paragraph (d) of this section provides the requirement to capitalize amounts paid to improve tangible property and provides the general rules for determining whether a unit of property is improved. Paragraph (e) of this section provides the rules for determining the appropriate unit of property. Paragraph (f) of this section provides special rules for determining improvement costs in particular contexts. Paragraph (g) provides a safe harbor for routine maintenance costs. Paragraph (h) of this section provides rules for determining whether amounts paid result in betterments to the unit of property. Paragraph (i) of this section provides rules for determining whether amounts paid restore the unit of property. Paragraph (j) of this section provides rules for amounts paid to adapt the unit of property to a new or different use. Paragraph (k) of this section provides an optional regulatory accounting method. Paragraph (l) of this section provides for a repair allowance or other methods of accounting identified in published guidance. Paragraphs (m) through (o) of this section provide additional rules related to these provisions. Paragraphs (p) and (q) of this section provides the effective/applicability and expiration dates for the rules in this section.

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

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

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

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

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

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


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

(3) Exception for amounts subject to de minimis rule. A taxpayer is not required to capitalize amounts paid to acquire or produce units of property used in improvements under paragraph (d) of this section (including materials and supplies used in improvements) if these amounts are properly deducted under the de minimis rule of section § 1.263(a)-2(g).

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

Example. Railroad rolling stock.

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



(d) Requirement to capitalize amounts paid for improvements. Except as provided in the optional regulatory accounting method in paragraph (k) of this section or under any other accounting method published in accordance with paragraph (l) of this section, a taxpayer generally must capitalize the aggregate of related amounts (as defined in paragraph (f)(4) of this section) paid to improve a unit of property owned by the taxpayer. However, see paragraph (f)(1) of this section for the treatment of amounts paid to improve leased property. See section 263A for the costs required to be capitalized to property produced by the taxpayer or to property acquired for resale; section 1016 for adding capitalized amounts to the basis of the unit of property; and section 168 for the treatment of additions or improvements for depreciation purposes. For purposes of this section, a unit of property is improved if the amounts paid for activities performed after the property is placed in service by the taxpayer--

- (1) Result in a betterment to the unit of property (see paragraph (h) of this section);
- (2) Restore the unit of property (see paragraph (i) of this section); or
- (3) Adapt the unit of property to a new or different use (see paragraph (j) of this section).

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

(2) Building --(i) In general. Except as otherwise provided in paragraphs (e)(4), (e)(5)(ii), and (f)(1)(ii)(B) of this section, in the case of a building (as defined in § 1.48-1(e)(1)), each building and its structural components (as defined in § 1.48-1(e)(2)) is a single unit of property ("building").

(ii) Application of improvement rules to a building. An amount is paid for an improvement to a building under paragraphs (d) and (f)(1)(iii) of this section if the amount paid results in an improvement under paragraph (h), (i), or (j) of this section to any of the following:

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

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

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

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

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

(4) All escalators;

(5) All elevators;

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

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

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

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

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

(B) Application of improvement rules to a condominium. An amount is paid for an improvement to a condominium under paragraph (d) of this section if the amount paid results in an improvement under paragraph (h), (i), or (j) of this section to the building structure (as defined in paragraph (e)(2)(ii)(A) of this section) that is part of the condominium or to the portion of any building system (as defined in paragraph (e)(2)(ii)(B) of this section) that is part of the condominium. In the case of the condominium management association, the association

must apply the improvement rules to the building structure or to any building system as determined under paragraphs (e)(2)(ii)(A) and (e)(2)(ii)(B) of this section.

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

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

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

(B) Application of improvement rules to a leased building. An amount is paid for an improvement to a leased building or a leased portion of a building under paragraphs (d) and (f)(1)(ii) of this section if the amount paid results in an improvement under paragraph (h), (i), or (j) of this section to any of the following:

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

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

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

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

(B) Unit of property for plant property. In the case of plant property, the unit of property determined under the general rule of paragraph (e)(3)(i) of this section is further divided into

smaller units comprised of each component (or group of components) that performs a discrete and major function or operation within the functionally interdependent machinery or equipment.

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

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

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

(4) Improvements to property. An improvement to a unit of property, other than a lessee improvement as determined under paragraph (f)(1)(ii) of this section, is not a unit of property separate from the unit of property improved. For the unit of property for lessee improvements, see paragraph (f)(1)(ii)(B) of this section.

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

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

(6) Examples. The rules of this paragraph (e) are illustrated by the following examples, in which it is assumed that the taxpayer has not made a general asset account election with regard to property or accounted for property in a multiple asset account. In addition, unless the facts

specifically indicate otherwise, assume that the additional rules in paragraph (e)(5) of this section do not apply:

Example 1. Building systems.

X 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. X pays an amount for labor and materials for work performed on the roof-mounted units. Under paragraph (e)(2)(i) of this section, X 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 for an improvement to a building if it results in 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 X for work on the roof-mounted units results in an improvement (for example, a betterment) to the HVAC system, X must treat this amount as an improvement to the building.

Example 2. Building systems.

X 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. X pays an amount for labor and materials for work performed on the elevators. Under paragraph (e)(2)(i) of this section, X 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 for an improvement to a building if it results in an improvement to the building structure or any designated building system. Under paragraph (e)(2)(ii)(B)(5) of this section, all of the elevators, including all their components, comprise a building system. Therefore, under paragraph (e)(2)(ii) of this section, if an amount paid by X for work on the elevators results in an improvement (for example, a betterment) to the entire elevator system, X must treat these amounts as an improvement to the building.

Example 3. Building structure and systems; condominium.

X owns a condominium unit in a condominium office building. X 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 bathroom fixtures. X pays an amount for labor and materials to perform work on the pipes, sinks, toilets, and plumbing fixtures that are part of the condominium unit. Under paragraph (e)(2)(iii) of this section, X 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 for an improvement to the condominium if it results in an improvement to the building structure that is part of the unit or to a portion of any designated building system that is part of the unit. Under paragraph (e)(2)(ii)(B)(2) of this section, the pipes, sinks, toilets, and plumbing fixtures that are part of X's unit comprise the plumbing system for the condominium unit. Therefore, under paragraph (e)(2)(iii) of this section, if an amount paid by X for work on pipes, sinks, toilets, and plumbing fixtures results in an improvement (for example, a betterment) to the portion of the plumbing system that is part of X's condominium unit, X must treat this amount as an improvement to the condominium.

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

X, a manufacturer, owns a building adjacent to its manufacturing facility that contains office space and related facilities for X's employees that manage and administer X's manufacturing operations. The office building contains equipment, such as desks, chairs, computers, telephones, and bookshelves that are not building structure or building systems. X pays an amount to add an extension to the office building. Under paragraph (e)(2)(i) of this section, X 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 for an improvement to a building if it results in an improvement to the building structure or any designated building system. Therefore, under paragraph (e)(2)(ii) of this section, if an amount paid by X for the addition of an extension to the office building results in an improvement (for example, a betterment) to the building structure, X 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 the general rule in paragraph (e)(3)(i) of this section and are comprised of the groups of components that are functionally interdependent.

Example 5. Plant property; discrete and major function.

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

Example 6. Plant property; discrete and major function.

X is engaged in a uniform and linen rental business. X 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. X utilizes two laundering lines in its plant, each of which can operate independently. One line is used for uniforms and another line is used for linens. Both lines incorporate several sorters, boilers, washers, dryers, ironers, folders, and waste water treatment systems. Because the laundering equipment contained within the plant is property other than a building, the unit of property for the laundering equipment is initially determined under the general rule in paragraph (e)(3)(i) of this section and is comprised of all the components that are functionally interdependent. Under this rule, the initial units of property are each laundering line because each line is functionally independent and is comprised of components that are functionally interdependent. However, because each line is comprised of plant property under paragraph (e)(3)(ii) of this section, X 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, X must treat each sorter, boiler, washer, dryer, ironer, folder, and waste water treatment system in each line as a separate unit of property because each of these components performs a discrete and major function within the line.

Example 7. Plant property; industrial process.

X operates a restaurant that prepares and serves food to retail customers. Within its restaurant, X has a large piece of equipment that uses an assembly line-like process to prepare and cook tortillas that X serves to its customers. Because the tortilla-making equipment is 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 X's retail restaurant operations. Thus, X is not required to further divide the equipment into separate units of property based on the components that perform discrete and major functions.

Example 8. Personal property.

X owns locomotives that it uses in its railroad business. Each locomotive consists of various components, such as an engine, generators, batteries and trucks. X acquired a locomotive with all its components and treated all the components of the locomotive as being within the same class of property under section 168(e) and depreciated all the components using the same depreciation method. Because X's locomotive is property other than a building, the initial unit of property is determined under the general rule in paragraph (e)(3)(i) of this section and is comprised of the components that are functionally interdependent. Under paragraph (e)(3)(i) of this section, the locomotive is a single unit of property because it consists entirely of components that are functionally interdependent.

Example 9. Personal property.

X provides legal services to its clients. X purchased a laptop computer and a printer for its employees to use in providing legal services. When X placed the computer and printer into service, X treated the computer and printer and all their components as being within the same class of property under section 168(e) and depreciated all the components using the same depreciation method. Because the computer and printer are property other than a building, the initial units of property are determined under the general rule in paragraph (e)(3)(i) of this section and are comprised of the components that are functionally interdependent. Under paragraph (e)(3)(i) of this section, the computer and the printer are separate units of property because the computer and the printer are not components that are functionally interdependent (that is, the placing in service of the computer is not dependent on the placing in service of the printer).

Example 10. Building structure and systems; leased building.

X is a retailer of consumer products. X conducts its retail sales in a building that it leases from Y. The leased building consists of the building structure (including the floor, walls, and a roof) and various building systems, including a plumbing system, an electrical system, a HVAC system, a security system, and a fire protection and prevention system. X 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 X leases the entire building, X 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 for an improvement to a leased building if it results in 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 X for work on the HVAC system results in an improvement to the heating and air conditioning system in the leased building, X must treat this amount as an improvement to the entire leased building.

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

Assume the same facts as in Example 10, except that X receives a construction allowance from Y and X uses the construction allowance to build a driveway adjacent to the leased building. Assume that under the terms of the lease, X, 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 that are functionally interdependent are a single unit of property under paragraphs (e)(3)(i) and (e)(3)(iv) of this section.

Example 12. Leasehold improvements; construction allowance used for lessor-owned improvements.

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

Example 13. Buildings and structural components; leased office space.

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

Example 14. Leased property; personal property.

X is engaged in the business of transporting passengers on private jet aircraft. To conduct its business, X leases several aircraft from Y. Assume that each aircraft is not plant property or a network asset. Under paragraph (e)(3)(iv) of this section (referencing paragraph (e)(3)(i) of this section), X must treat all of the components of each leased aircraft that are functionally interdependent as a single unit of property. Thus, X must treat each leased aircraft as a single unit of property.

Example 15. Improvement property.

(i) X is a retailer of consumer products. In Year 1, X purchases a building from Y, which X intends to use as a retail sales facility. Under paragraph (e)(2)(i) of this section, X 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 for an improvement to a building if it results in an improvement to the building structure or any designated building system.

(ii) In Year 2, X 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 results in a betterment to the building structure under paragraph (h) 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, X 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), X must determine whether the expenditure constitutes an improvement to the building structure, including the building extension, or any of the designated building systems.

Example 16. Personal property; additional rules.

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

Example 17. Additional rules; change in subsequent year.

X is engaged in the business of leasing nonresidential real property to retailers. In Year 1, X acquired and placed in service a building for use in its retail leasing operation. In Year 5, in order to accommodate the needs of a new lessee, X incurred costs to improve the building structure. X 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, X determined that the structural improvement made in Year 5 qualified under section 168(e)(8) as qualified retail improvement property and, therefore, is 15-year property under section 168(e). In Year 5, X changed its method of accounting to use a 15-year recovery period for the improvement. Under the additional rule of paragraph (e)(5)(ii) of this section, in Year 7, X must treat the improvement as a unit of property separate from the building.

Example 18. Additional rules; change in subsequent year.

In Year 1, X acquired and placed in service a building and parking lot for use in its retail operations. Under § 1.263(a)-2T of the regulations, X 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, X completed a cost segregation study under which it properly determined that the parking lot qualifies as 15-year property under section 168(e). In Year 3, X changed its method of accounting to use a 15-year recovery period and the 150-percent declining balance method of depreciation for the parking lot. Under the additional rule of paragraph (e)(5)(ii) of this section, in Year 3, X must treat the parking lot as a unit of property separate from the building.

Example 19. Additional rules; change in subsequent year.

In Year 1, X acquired and placed in service a building for use in its manufacturing business. X 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). X 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, X 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, X changed its method of accounting to treat the wiring as nonresidential real property. Under the additional rule of paragraph (e)(5)(ii) of this section, in Year 3, X must change the unit of property for the wiring in a manner that is consistent with the change in treatment for depreciation purposes. Therefore, X must change the unit of property for the wiring to treat it as a structural component of the building, and as part of the building unit of property, in accordance with paragraph (e)(2)(i) of this section.

(f) Special rules for determining improvement costs --(1) Improvements to leased property --
(i) In general. This paragraph (f)(1) provides the exclusive rules for determining whether amounts paid by a taxpayer are for the improvement to a unit of leased property and must be capitalized. In the case of a leased building or a leased portion of a building, an amount results in an improvement to a unit of leased property if it results in an improvement to any of the properties designated under paragraph (e)(2)(ii) of this section (for lessor improvements) or under paragraph (e)(2)(v)(B) of this section (for lessee improvements except as provided in paragraph (f)(ii)(B) of this section). Section 1.263(a)-4 of the regulations does not apply to amounts paid for improvements to units of leased property or to amounts paid for the acquisition or production of leasehold improvement property.

(ii) Lessee improvements --(A) Requirement to capitalize. A taxpayer lessee must capitalize the aggregate of related amounts that it pays to improve (as defined under paragraph (d) of this section) a unit of leased property except to the extent that section 110 applies to a construction allowance received by the lessee for the purpose of such improvement or where the improvement constitutes a substitute for rent. See § 1.61-8(c) for the treatment of lessee expenditures that constitute a substitute for rent. A taxpayer lessee must also capitalize the aggregate of related

amounts that a lessor pays to improve (as defined under paragraph (d) of this section) a unit of leased property if the lessee is the owner of the improvement except to the extent that section 110 applies to a construction allowance received by the lessee for the purpose of such improvement. An amount paid for a lessee improvement under this paragraph (f)(1)(ii)(A) is treated as an amount paid to acquire or produce a unit of real or personal property under § 1.263(a)-2T(d)(1) of the regulations. See paragraph (e)(2)(v) of this section for the unit of property for a leased building and paragraph (e)(3)(iv) of this section for the unit of property for leased real or personal property other than a building.

(B) Unit of property for lessee improvements. An amount capitalized as a lessee improvement under paragraph (f)(1)(ii)(A) of this section comprises a unit of property separate from the leased property being improved. However, an amount that a lessee pays to improve (as defined under paragraph (d) of this section) a lessee improvement under paragraph (f)(1)(ii)(A) is not a unit of property separate from such lessee improvement.

(iii) Lessor improvements --(A) Requirement to capitalize. A taxpayer lessor must capitalize the aggregate of related amounts that it pays directly, or indirectly through a construction allowance to the lessee, to improve (as defined in paragraph (d) of this section) a unit of leased property where the lessor is the owner of the improvement or to the extent that section 110 applies to the construction allowance. A lessor must also capitalize the aggregate of related amounts that the lessee pays to improve a unit of property (as defined in paragraph (e) of this section) where the lessee's improvement constitutes a substitute for rent. See § 1.61-8(c) for treatment of expenditures by lessees that constitute a substitute for rent. Amounts capitalized by the lessor under this paragraph (f)(1)(iii)(A) may not be capitalized by the lessee. See paragraphs (e)(2) of this section for the unit of property for a building and paragraph (e)(3) of this section for the unit of property for real or personal property other than a building.

(B) Unit of property for lessor improvements. An amount capitalized as a lessor improvement under paragraph (f)(1)(iii)(A) of this section is not a unit of property separate from the unit of property improved. See paragraph (e)(4) of this section.

(iv) Examples. The application of this paragraph (f)(1) is illustrated by the following examples, in which it is assumed that section 110 does not apply to the lessee.

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 for an improvement to the entire leased building if it results in 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.

(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 results in a betterment (as defined under paragraph (h) 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 results in an improvement 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 unit of leased property, T is required to capitalize the amount paid for the building extension under paragraph (f)(1)(ii)(A) of this section. In addition, paragraph (f)(1)(ii)(A) 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)-2T(d)(1). Moreover, under paragraph (f)(1)(ii)(B) of this section, the building extension is a unit of property separate from the unit of leased property (the building and its structural components).

(iii) In Year 5, T pays an amount to add a larger door to the building extension that it constructed in Year 2 in order to accommodate the loading of larger products into the warehouse space. Assume that the amount paid to add the larger door results in a betterment under paragraph (h) of this section to the building structure extension, the unit of property under paragraph (f)(1)(ii)(B) of this section. As a result, T must capitalize the amounts paid to add the larger door as an improvement to T's unit of property (the building extension) under paragraph (d) of this section. In addition, because the amount that T paid to add the larger door is for an improvement to the building extension (a lessee improvement under paragraph (f)(1)(ii)(A)), the larger door is not a unit of property separate from the unit of property improved. See paragraphs (e)(4) and (f)(1)(ii)(B) of this section.

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 (h) 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 results in an improvement to a 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 under paragraph (d) of this section. Because T, the lessee, incurs costs to improve a unit of leased property, T is required to capitalize the costs of the improvement under paragraph (f)(1)(ii)(A) of this section. Under paragraph (f)(1)(ii)(B), the extension to the leased HVAC is a unit of property separate from the unit of leased property (the leased building and its structural components). In addition, under paragraph (f)(1)(ii)(A) of this section, T must treat the amount paid for the HVAC extension as the acquisition and production of a unit of property under § 1.263(a)-2T(d)(1).

(ii) In Year 5, T pays an amount to add an additional chiller to the portion of the HVAC system that it constructed in Year 2 in order to accommodate the climate control requirements for new product offerings. Assume that the amount paid for the chiller results in a betterment under paragraph (h) of this section to the HVAC system extension, the unit of property under paragraph (f)(1)(ii)(B) of this section. Accordingly, T must capitalize the amount paid to add the chiller as an improvement to T's unit of property (the HVAC system extension) under paragraph (d) of this section. In addition, because the amount that T paid to add the chiller is for an improvement to the HVAC system extension (a lessee improvement under paragraph (f)(1)(ii)(A) of this section), the chiller is not a unit of property separate from the unit of property improved. See paragraphs (f)(1)(ii)(B) and (e)(4) of this section.

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 leased building and its structural components as a single unit of property. As provided under paragraph (e)(2)(ii) of this section, an amount paid is for an improvement to the building if it results in an improvement to the building structure or to any building system.

(ii) In Year 2, T uses L's construction allowance to construct an extension to the leased building to provide additional warehouse space in the building. Assume that the extension is a betterment (as defined under paragraph (h) of this section) to the building structure, and therefore, the amount paid for the extension results in an improvement to the building structure under paragraph (d) of this section. Under paragraph (f)(1)(iii)(A) 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)(1)(iii)(B) of this section, the extension to L's building is not a unit of property separate from the building and its structural components.

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

T is a retailer of consumer products. T leases a building from L, which T intends to use as a retail sales facility. Pursuant to the lease, L provides a construction allowance to T, which T uses to acquire and construct partitions for fitting rooms, counters, and shelving. Assume that each partition, counter, and shelving unit is a unit of property under paragraph (e)(3) of this section. Assume that for federal income tax purposes T is treated as the owner of any personal property that it acquires or constructs with the construction allowance and that the amounts paid for acquisition or construction of any personal property used in the leased property do not constitute a substitute for rent. 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)-2T.

Example 5. Lessor property; buildings on leased property.

L is the owner of a parcel of unimproved real property that L leases to T. Pursuant to the lease, L provides a construction allowance to T of \$ 500,000, which T agrees to use to construct a building costing not more than \$ 500,000 on the leased real property and to lease the building from L after it is constructed. Assume that for Federal income tax purposes, L is treated as the owner of the building that T will construct. T uses the \$ 500,000 to construct the building as required under the lease. The building consists of the building structure and the following building systems: (1) A plumbing system; (2) an electrical system; and (3) an HVAC system. Because L provides a construction allowance to T to construct a building, the total cost of the building equals \$ 500,000, and L is treated as the owner of the building, under paragraph (f)(1)(iii)(A) of this section L must capitalize the amounts that it pays indirectly to acquire and produce the building under § 1.263(a)-2T(d)(1). 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)(1)(iii)(A) of this section, T, the lessee, may not capitalize the amounts paid (with the construction allowance received from L) for construction of the building.

Example 6. Lessee contribution to construction costs.

Assume the same facts as in Example 5, except T spends \$ 600,000 to construct the building. T uses the \$ 500,000 construction allowance provided by L plus \$ 100,000 of its own funds to construct the building that L will own pursuant to the lease. Also assume that the additional \$ 100,000 that T incurs 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)-2T(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)-2T(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 paragraph (e)(2)(v)(A) 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.

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

(3) Certain costs incurred during an improvement --(i) In general. A taxpayer must capitalize all the direct costs of an improvement and all the indirect costs (including, for example, otherwise deductible repair or component removal costs) that directly benefit or are incurred by reason of an improvement in accordance with the rules under section 263A. Therefore, indirect costs that do not directly benefit and are not incurred by reason of an improvement are not required to be capitalized under section 263(a), regardless of whether they are made at the same time as an improvement.

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

(4) Aggregate of related amounts. For purposes of paragraph (d) of this section, the aggregate of related amounts paid to improve a unit of property may be incurred over a period of more than one taxable year. Whether amounts are related to the same improvement depends on the facts and circumstances of the activities being performed and whether the costs are incurred by reason of a single improvement or directly benefit a single improvement.

(g) Safe harbor for routine maintenance on property other than buildings --(1) In general. An amount paid for routine maintenance performed on a unit of property other than a building or a structural component of a building is deemed not to improve that unit of property. Routine maintenance is the recurring activities that a taxpayer expects to perform as a result of the taxpayer's use of the unit of property to keep the unit of property in its ordinarily efficient operating condition. Routine maintenance activities include, for example, the inspection, cleaning, and testing of the unit of property, and the replacement of parts of the unit of property with comparable and commercially available and reasonable replacement parts. The activities are routine only if, at the time the unit of property is placed in service by the taxpayer, the taxpayer reasonably expects to perform the activities more than once during the class life (as defined in paragraph (g)(4) of this section) of the unit of property. Among the factors to be considered in determining whether a taxpayer is performing routine maintenance are the recurring nature of the activity, industry practice, manufacturers' recommendations, the taxpayer's experience, and the taxpayer's treatment of the activity on its applicable financial statement (as defined in paragraph

(b)(4) of this section). With respect to a taxpayer that is a lessor of a unit of property, the taxpayer's use of the unit of property includes the lessee's use of the unit of property.

(2) Rotable and temporary spare parts. Except as provided in paragraph (g)(3) of this section, for purposes of paragraph (g)(1) of this section, amounts paid for routine maintenance include routine maintenance performed on (and with regard to) rotatable and temporary spare parts. But see § 1.162-3T(a)(3), which provides generally that rotatable and temporary spare parts are used or consumed by the taxpayer in the taxable year in which the taxpayer disposes of the parts.

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

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

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

(iii) Amounts paid for the repair of damage to a unit of property for which the taxpayer has taken a basis adjustment as a result of a casualty loss under section 165, or relating to a casualty event described in section 165.

(iv) Amounts paid to return a unit of property to its ordinarily efficient operating condition, if the property has deteriorated to a state of disrepair and is no longer functional for its intended use.

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

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

(5) Examples. The following examples illustrate the rules of this paragraph (g). Unless otherwise stated, assume that X has not applied the optional method of accounting for rotatable and temporary spare parts under § 1.162-3T(e):

Example 1. Routine maintenance on component.

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

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

Example 2. Routine maintenance after class life.

Assume the same facts as in Example 1, except that in year 15, X 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 (g) of this section. Accordingly, the amounts paid for this ESV, even though performed after the class life of the aircraft, are deemed not to improve the aircraft and are not required to be capitalized under paragraph (d) of this section.

Example 3. Routine maintenance on rotatable spare parts.

(i) Assume the same facts as in Example 1, except that in addition to the four engines purchased as part of the aircraft, X separately purchases four additional new engines that X 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, X installs these four engines on an aircraft in its fleet. In Year 5, X 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 (g)(3) of this section apply to these ESVs. After the ESVs were performed, these engines were reinstalled on other aircraft or stored for later installation.

(ii) The additional aircraft engines are rotatable spare parts 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 § 1.162-3T(c)(2) (definition of rotatable and temporary spare parts). The class life of an engine is the same as the airframe, 12 years. Because the ESVs involve the recurring activities that X 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 X 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 (g) 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 § 1.162-3T(a).

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

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

(ii) The majority of X's costs do not qualify under the routine maintenance safe harbor in paragraph (g) of this section because the costs were incurred primarily as a result of the prior owner's use of the property and not X's use. X 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 the taxpayer's, use of the property and must be capitalized if those amounts result in a betterment under paragraph (h) of this section, including the amelioration of a material condition or defect, or otherwise result in an improvement under paragraph (d) of this section. See also section 263A and the regulations thereunder for the requirement to capitalize indirect costs (including otherwise deductible repair costs) that directly benefit or are incurred by reason of production activities.

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

Assume the same facts as in Example 4, except that after X pays amounts for the maintenance in Year 1, X continues to operate the machine in its manufacturing business. In Year 4, X 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 (g)(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 X performs as a result of its use of the machine, keeps the machine in an ordinarily efficient operating condition, and consists of maintenance activities that X expects to perform more than once during the 10 year class life of the machine, X's scheduled maintenance costs are within the routine maintenance safe harbor under paragraph (g) 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. But see section 263A and the regulations thereunder for the requirement to capitalize indirect costs (including otherwise deductible repair costs) that directly benefit or are incurred by reason of production activities.

Example 6. Routine maintenance; replacement of substantial structural part.

X is in the business of producing commercial products for sale. As part of the production process, X places raw materials into lined containers in which a chemical reaction is used to convert raw materials into the finished product. The lining is a substantial structural part of the container, and comprises 60 percent of the total physical structure of the container. Assume that each container, including its lining, is the unit of property and that a container has a class life of

12 years. At the time that X placed the container into service, X was aware that approximately every three years, X would be required to replace the lining in the container with comparable and commercially available and reasonable replacement materials. At the end of that period, the container will continue to function, but will become less efficient and the replacement of the lining will be necessary to keep the container in an ordinarily efficient operating condition. In Year 1, X acquired 10 new containers and placed them into service. In Year 4, Year 7, Year 9, and Year 12, X pays amounts to replace the containers' linings with comparable and commercially available and reasonable replacement parts. Assume that none of the exceptions set out in paragraph (g)(3) of this section apply to the amounts paid for the replacement linings. Because the replacement of the linings involves recurring activities that X expects to perform as a result of its use of the containers to keep the containers in their ordinarily efficient operating condition, and consists of maintenance activities that X expects to perform more than once during the 12 year class lives of the containers, X's lining replacement costs are within the routine maintenance safe harbor under paragraph (g) of this section. Accordingly, the amounts that X 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. But see section 263A and the regulations thereunder for the requirement to capitalize indirect costs (including otherwise deductible repair costs) that directly benefit or are incurred by reason of production activities.

Example 7. Routine maintenance once during class life.

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

Example 8. Routine maintenance on non-rotatable part.

X is a towboat operator that owns and leases a fleet of towboats. Each towboat is equipped with two diesel-powered engines. Assume that each towboat, including its engines, is the unit of property and that a towboat has a class life of 18 years. At the time that X places its towboats into service, X is aware that approximately every three to four years, X will need to perform scheduled maintenance on the two towboat engines to keep the engines in their ordinarily efficient operating condition. This maintenance is completed while the engines are attached to the towboat and involves the cleaning and inspecting of the engines to determine which parts are within acceptable operating tolerances and can continue to be used, which parts must be reconditioned to be brought back to acceptable tolerances, and which parts must be replaced. Engine parts replaced during these procedures are replaced with comparable and commercially available and reasonable replacement parts. Assume the towboat engines are not rotatable spare parts under § 1.162-3T(c)(2). In Year 1, X acquired a new towboat, including its two engines, and placed the towboat into service. In Year 5, X pays amounts to perform scheduled maintenance on both engines in the towboat. Assume that none of the exceptions set out in

paragraph (g)(3) of this section apply to the scheduled maintenance costs. Because the scheduled maintenance involves recurring activities that X expects to perform more than once during the 18 year class life of the towboat, the maintenance results from X's use of the towboat and the maintenance is performed to keep the towboat in an ordinarily efficient operating condition, the scheduled maintenance on X's towboat is within the routine maintenance safe harbor under paragraph (g) of this section. Accordingly, the amounts paid for the scheduled maintenance to its towboat engines in Year 5 are deemed not to improve the towboat and are not required to be capitalized under paragraph (d) of this section.

Example 9. Routine maintenance with betterments.

Assume the same facts as Example 8, except that in Year 9, X's towboat engines are due for another scheduled maintenance visit. At this time, X decides to upgrade the engines to increase their horsepower and propulsion, which would permit the towboats to tow heavier loads. Accordingly, in Year 9, X 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, X incurs costs to upgrade certain engine parts to increase the towing capacity of the boats in excess of the capacity of the boats when X placed them in service. Both the scheduled maintenance procedures and the replacement of parts with new and upgraded parts are necessary to increase the horsepower of the engines and the towing capacity of the boat. Thus, the work done on the engines encompasses more than the recurring activities that X expected to perform as a result of its use of the towboats and did more than keep the towboat in its ordinarily efficient operating condition. In addition, under paragraph (f)(3)(i) of this section, the scheduled maintenance procedures directly benefit the upgrades. Therefore, the amounts that X paid in Year 9 for the maintenance and upgrade of the engines do not qualify for the routine maintenance safe harbor described under paragraph (g) of this section. These amounts must be capitalized if they result in a betterment under paragraph (h) of this section, including a material increase in the capacity of the towboat, or otherwise result in an improvement under paragraph (d) of this section.

Example 10. Exceptions to routine maintenance.

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

(h) Capitalization of betterments --(1) In general. A taxpayer must capitalize amounts paid that result in the betterment of a unit of property. An amount paid results in the betterment of a unit of property only if it--

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

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

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

(2) Betterments to buildings. In the case of a building, an amount results in a betterment to the unit of property if it results in a betterment to any of the properties designated in paragraphs (e)(2)(ii), (e)(2)(iii)(B), (e)(2)(iv)(B), or (e)(2)(v)(B) of this section.

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

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

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

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

(C) Particular event. If the expenditure is made as a result of a particular event, the condition of the property immediately prior to the circumstances necessitating the expenditure is the condition of the property immediately prior to the particular event.

(4) Examples. The following examples illustrate the application of this paragraph (h) only and do not address whether capitalization is required under another provision of this section or another provision of the Internal Revenue Code (for example, section 263A):

Example 1. Amelioration of pre-existing material condition or defect.

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

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

X owns a building that was constructed with insulation that contained asbestos. The health dangers of asbestos were not widely known when the building was constructed. X determines that certain areas of asbestos-containing insulation had begun to deteriorate and could eventually pose a health risk to employees. Therefore, X 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 paragraph (e)(2)(ii) of this section, if the amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. Although the asbestos is determined to be unsafe under certain circumstances, the asbestos is not a preexisting or material defect of the building structure under paragraph (h)(1)(i) of this section. In addition, the removal and replacement of the asbestos does not result in a material addition to the building structure under paragraph (h)(1)(ii) of this section or result in a material increase in capacity, productivity, efficiency, strength, or quality of the building structure or the output of the building structure under paragraph (h)(1)(iii) of this section. Therefore, the amount paid to remove and replace the asbestos insulation does not result in a betterment to the building structure under paragraph (h) of this section.

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

(i) In January, Year 1, X 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. X 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 the cleaning and oiling of the machine, the inspection of parts for defects, and the replacement of minor items such as springs, bearings, and seals with comparable and commercially available and reasonable replacement parts. The scheduled maintenance does not result in any material additions or material increases in capacity, productivity, efficiency, strength or quality of the machine or the output of the machine. At the time X purchased the machine, it was approaching the end of a three-year scheduled maintenance period. As a result, in February, Year 1, X pays an amount to perform the manufacturer recommended scheduled maintenance to keep the machine in its ordinarily efficient operating condition.

(ii) The amount that X pays does not qualify under the routine maintenance safe harbor in paragraph (g) of this section because the cost primarily results from the prior owner's use of the property and not the taxpayer's use. X acquired the machine just before it had received its three-year scheduled maintenance. Accordingly, the amount that X pays for the scheduled maintenance results from the prior owner's use of the property and ameliorates conditions or defects that existed prior to X's ownership of the machine. Nevertheless, considering the facts and circumstances under paragraph (h)(2)(i) of this section, including the purpose and minor nature of the work performed, this amount does not ameliorate a material condition or defect in the machine under paragraph (h)(1)(i) of this section, result in a material addition to the machine under paragraph (h)(1)(ii) of this section, or result in a material increase in the capacity,

productivity, efficiency, strength, or quality of the machine or the output of the machine under paragraph (h)(1)(iii) of this section. Therefore, X is not required to capitalize the amount paid for the scheduled maintenance as a betterment to the machine under this paragraph (h).

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

X purchases a used ice resurfacing machine for use in the operation of its ice skating rink. To comply with local regulations, X is required to monitor routinely the air quality in the ice skating rink. One week after X places the machine into service, during a routine air quality check, X discovers that the operation of the machine is adversely affecting the air quality in the skating rink. As a result, X pays an amount to inspect and retune the machine, which includes replacing minor components of the engine, which had worn out prior to X's acquisition of the machine. Assume the resurfacing machine, including the engine, is the unit of property. The routine maintenance safe harbor in paragraph (g) of this section does not apply to the amounts paid because the activities performed do more than return the machine to the condition that existed at the time X placed it in service. The amount that X pays to inspect, retune, and replace minor components of the ice resurfacing machine ameliorates a condition or defect that existed prior to X's acquisition of the equipment. Nevertheless, considering the facts and circumstances under paragraph (h)(3)(i) of this section, including the purpose and minor nature of the work performed, this amount does not ameliorate a material condition or defect in the machine under paragraph (h)(1)(i) of this section, result in a material addition to the machine under paragraph (h)(1)(ii) of this section, or result in a material increase in the capacity, productivity, efficiency, strength, or quality of the machine or the output of the machine under paragraph (h)(1)(iii) of this section. Therefore, X is not required to capitalize the amount paid to inspect, retune, and replace minor components of the machine as a betterment under this paragraph (h).

Example 5. Amelioration of material condition or defect.

(i) X acquires a building for use in its business of providing assisted living services. Before and after the purchase, the building functions as an assisted living facility. However, at the time of the purchase, X is aware that the building is in a condition that is below the standards that X requires for facilities used in its business. Immediately after the acquisition and during the following two years, while X continues to use the building as an assisted living facility, X pays amounts for repairs, maintenance, and the acquisition of new property to bring the facility into the high-quality condition for which X's facilities are known. The work on X'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. On its applicable financial statements, X capitalizes the costs of the repairs and maintenance to the building. The work that X performs affects only the building structure under paragraph (e)(2)(ii)(A) of this section and does not affect any of the building systems described in paragraph (e)(2)(ii)(B) of this section. Assume that each section 1245 property is a separate unit of property.

(ii) Under paragraph (e)(2)(ii) of this section, if an amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. Considering the facts and circumstances, as required under paragraph (h)(3)(i) of this section, including the purpose of the expenditures, the effect of the expenditures on the building structure, and the treatment of the expenditures in X's applicable financial statements, the amounts that X paid for repairs and maintenance to the building structure comprises a betterment to the building structure under paragraph (h)(1)(i) of this section because the amounts ameliorate material conditions or defects that existed prior to X's acquisition of the building. Therefore, in

accordance with paragraph (e)(2)(ii) of this section, X must treat the amounts paid for the betterment to the building structure as an improvement to the building and must capitalize the amounts under paragraph (d)(1) of this section. Moreover, X 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)-2T(d)(1).

Example 6. Not a betterment; building refresh.

(i) X owns a nationwide chain of retail stores that sell a wide variety of items. To remain competitive in the industry and increase customer traffic and sales volume, X periodically refreshes the appearance and layout of its stores. The work that X performs to refresh a store consists of cosmetic and layout changes to the store's interiors and general repairs and maintenance to the store building to make the stores more attractive and the merchandise more accessible to customers. The work to each store building consists of replacing and reconfiguring a small number of 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 vinyl flooring throughout the store building, and power washing building exteriors. The display tables and the racks all constitute section 1245 property. X pays amounts to refresh 50 stores during the taxable year. In its applicable financial statement, X capitalizes all the costs to refresh the store buildings and amortizes them over a 5-year period. 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 X acquired the store buildings or result in any material additions to the store buildings.

(ii) Under paragraph (e)(2)(ii) of this section, if an amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. Considering the facts and circumstances, as required under paragraph (h)(3)(i) of this section, including the purpose of the expenditure, the physical nature of the work performed, the effect of the expenditure on buildings' structure and systems, and the treatment of the work on X's applicable financial statements, the amounts paid for the refresh of each building do not result in material increases in capacity, productivity, efficiency, strength, or quality of the buildings' structures or any building systems as compared to the condition of the buildings' structures and systems after the previous refresh. Rather, the work performed keeps X's store buildings' structures and buildings' systems in the ordinary efficient operating condition that is necessary for X to continue to attract customers to its stores. Therefore, X is not required to treat the amounts paid for the refresh of its store buildings' structures and buildings' systems as betterments under paragraph (h)(1)(iii) of this section. However, X is required to capitalize the amounts paid to acquire and install each section 1245 property in accordance with § 1.263(a)-2T(d)(1).

Example 7. Building refresh; limited improvement.

Assume the same facts as Example 6 except, in the course of X's refresh of its stores, X pays amounts to remove and replace the bathroom fixtures (that is, the toilets, sinks, and plumbing fixtures) with upgraded bathroom fixtures in all of the restrooms in X's retail buildings in order to update the restroom facilities. As part of the update of the restrooms, X also pays amounts to replace the floor and wall tiles that were removed or damaged in the installation of the new plumbing fixtures. Under paragraph (e)(2)(ii) of this section, if any of the amounts paid result in betterments to the building structure or any building system, X must treat the amounts as an improvement to the building. Under paragraph (e)(2)(ii)(B)(2) of this section, the plumbing

system in each of X's store buildings, including the plumbing fixtures, is a building system. X must treat the amounts paid to replace the bathroom fixtures with upgraded fixtures as a betterment because they result in a material increase in the quality of each plumbing system under paragraph (h)(1)(iii) of this section. Under paragraph (f)(3) of this section, X is required to capitalize all the indirect costs that directly benefit or are incurred by reason of the betterment, or improvement, to each plumbing system. Because the costs to remove the old plumbing fixtures and to remove and replace the bathroom tiles directly benefit and are incurred by reason of the improvement to the plumbing system, these costs must also be capitalized under paragraph (f)(3) of this section. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amounts paid for a betterment to each plumbing system as an improvement to X's retail building to which the costs relate, and must capitalize the amounts under paragraph (d)(1) of this section. However, X is not required under paragraph (f)(3) of this section to capitalize the costs described in Example 6 to refresh the appearance and layout of its stores because those costs do not directly benefit and are not incurred by reason of the improvements to the stores' plumbing systems. Thus, X is not required to capitalize under paragraphs (f)(3) of this section any costs specified in Example 6 for the reconfiguration, cosmetic changes, repairs, and maintenance to the other parts of X's store buildings.

Example 8. Betterment; building remodel.

(i) Assume the same facts as Example 6, but assume that the work performed to refresh the stores directly benefits or was incurred by reason of a substantial remodel to X's store buildings. In addition to the reconfiguration, cosmetic changes, repairs, and maintenance activities performed in Example 6, X performs significant additional work to alter the appearance and layout of its stores in order to increase customer traffic and sales volume. First, X pays amounts to upgrade the buildings' structures as defined under (e)(2)(ii)(A). This work includes removing and rebuilding walls to move built-in changing rooms and specialty departments to different areas of the stores, replacing ceilings with acoustical tiles to reduce noise and create a more pleasant shopping environment, rebuilding the interior and exterior facades around the main doors to create a more appealing entrance, replacing conventional doors with automatic doors, and replacing carpet with ceramic flooring of different textures and styles to delineate departments and direct customer traffic. Second, X pays amounts for work on the electrical systems, which are building systems under paragraph (e)(2)(ii)(B)(3) of this section. Specifically, X upgrades the wiring in the buildings so that X can add video monitors and an expanded electronics department. X also removes and replaces the recessed lighting throughout the buildings with more efficient and brighter lighting. The work performed on the buildings' structures and the electrical systems includes the removal and replacement of both section 1250 and section 1245 property. In its applicable financial statement, X capitalizes all the costs incurred over a 10-year period. Upon completion of this period, X anticipates that it will have to remodel the store buildings again.

(ii) Under paragraph (e)(2)(ii) of this section, if any of the amounts paid result in a betterment to the building structure or any building system, X must treat those amounts as an improvement to the building. Considering the facts and circumstances, as required under paragraph (h)(3)(i) of this section, including the purpose of the expenditure, the physical nature of the work performed, the effect of the work on the buildings' structures and buildings' systems, and the treatment of the work on X's applicable financial statements, the amounts that X pays for the remodeling of its stores result in betterments to the buildings' structures and electrical systems under paragraph (h) of this section. Specifically, amounts paid to upgrade the wiring and to remove and replace the recess lighting throughout the stores materially increase the productivity, efficiency, and quality of X's stores' electrical systems under paragraph (h)(1)(iii)

of this section. Also, the amounts paid to remove and rebuild walls, to replace ceilings, to rebuild facades, to replace doors, and replace flooring materially increase the productivity, efficiency, and quality of X's store buildings' structures under paragraph (h)(1)(iii) of this section. In addition, the amounts paid for the refresh of the store buildings described in Example 6 must be capitalized under paragraph (f)(3)(i) of this section because these expenditures directly benefitted or were incurred by reason of the improvements to X's store buildings' structures and electrical systems. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the costs of improving the buildings' structures and systems, including the costs to refresh, as improvements to X's retail buildings and must capitalize the amounts paid for these improvements under paragraph (d)(1) of this section. Moreover, X is required to capitalize the amounts paid to acquire and install each section 1245 property in accordance with § 1.263(a)-2T(d)(1).

Example 9. Not betterment; relocation and reinstallation of personal property.

In Year 1, X 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 2, X capitalizes the costs of acquiring and installing the new cash registers under § 1.263(a)-2T(d)(1). In Year 3, X's lease expires and X decides to relocate its retail store to a different building. In addition to various other costs, X pays \$ 5,000 to move the cash registers and \$ 1,000 to reinstall them in the new store. The cash registers are used for the same purposes and in the same manner that they were used in the former location. The amounts that X pays to move and reinstall the cash registers into its new store do not result in a betterment to the cash registers under paragraph (h) of this section.

Example 10. Betterment; relocation and reinstallation of manufacturing equipment.

X operates a manufacturing facility in Building A, which contains various machines that X uses in its manufacturing business. X 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. X 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, results in an increase in capacity of the machine, and therefore results in a betterment to the machine under paragraph (h)(3)(iii) of this section. Accordingly, X must capitalize the costs of reinstalling the machine as an improvement to the machine under paragraph (d)(1) of this section. X 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 (f)(3)(i) of this section.

Example 11. Betterment; regulatory requirement.

X owns a hotel that includes five feet high unreinforced terra cotta and concrete parapets with overhanging cornices around the entire roof perimeter. The parapets and cornices are in good condition. In Year 1, City passes an ordinance setting higher safety standards for parapets and cornices because of the hazardous conditions caused by earthquakes. To comply with the ordinance, X pays an amount to remove the old parapets and cornices and replace them with new ones made of glass fiber reinforced concrete, which makes them lighter and stronger than the original components. They are attached to the hotel using welded connections instead of wire supports, making them more resistant to damage from lateral movement. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. The parapets and

cornices are part of the building structure as defined in paragraph (e)(2)(ii)(A) of this section. The event necessitating the expenditure was the City ordinance. Prior to the ordinance, the old parapets and cornices were in good condition, but were determined by City to create a potential hazard. After the expenditure, the new parapets and cornices materially increased the structural soundness (that is, the strength) of the hotel structure. X must treat the amount paid to remove and replace the parapets and cornices as an improvement because it results in a betterment to the building structure under paragraph (h)(1)(iii) of this section. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amount paid for the betterment to the building structure as an improvement to the hotel building and must capitalize the amount paid under paragraph (d)(1) of this section. City's requirement that X correct the potential hazard to continue operating the hotel is not relevant in determining whether the amount paid improved the hotel. See paragraph (f)(2) of this section.

Example 12. Not a betterment; regulatory requirement.

X owns a meat processing plant. X discovers that oil is seeping through the concrete walls of the plant, creating a fire hazard. Federal meat inspectors advise X that it must correct the seepage problem or shut down its plant. To correct the problem, X 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 paragraph (e)(2)(ii) of this section, if the amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. The event necessitating the expenditure was the seepage of the oil. Prior to the seepage, the plant did not leak and was functioning for its intended use. X is not required to treat the amount paid as a betterment under paragraph (h) of this section because it does not result in a material addition or material increase in capacity, productivity, efficiency, strength or quality of the building structure or its output compared to the condition of the structure prior to the seepage of the oil. The federal meat inspectors' requirement that X correct the seepage to continue operating the plant is not relevant in determining whether the amount paid improves the plant. See paragraph (f)(2) of this section.

Example 13. Not a betterment; replacement with same part.

X owns a small retail shop. A storm damages the roof of X's shop by displacing numerous wooden shingles. X pays a contractor to replace all the wooden shingles on the roof with new wooden shingles. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. The roof is part of the building structure under paragraph (e)(2)(ii)(A) of this section. The event necessitating the expenditure was the storm. Prior to the storm, the building structure was functioning for its intended use. X is not required to treat the amount paid to replace the shingles as a betterment under paragraph (h) of this section because it does not result in a material addition, or material increase in the capacity, productivity, efficiency, strength, or quality of the building structure or the output of the building structure compared to the condition of the building structure prior to the storm.

Example 14. Not a betterment; replacement with comparable part.

Assume the same facts as in Example 13, except that wooden shingles are not available on the market. X pays a contractor to replace all the wooden shingles with comparable asphalt shingles. The amount that X pays to reshingle the roof with asphalt shingles does not result in a betterment to the shop building structure, even though the asphalt shingles may be stronger than the wooden shingles. Because the wooden shingles could not practicably be replaced with new wooden shingles, the replacement of the old shingles with comparable asphalt shingles does not,

by itself, result in a betterment, and therefore, an improvement, to the shop building structure under this paragraph (h).

Example 15. Betterment; replacement with improved parts.

Assume the same facts as in Example 14, except that, instead of replacing the wooden shingles with asphalt shingles, X pays a contractor to replace all the wooden shingles with shingles made of lightweight composite materials that are maintenance-free and do not absorb moisture. The new shingles have a 50-year warranty and a Class A fire rating. The amount paid for these shingles results in a betterment to the shop building structure under paragraphs (h)(1)(iii) and (h)(3)(iii) of this section because it results in a material increase in the quality of the shop building structure as compared to the condition of the shop building structure prior to the storm. Therefore, in accordance with paragraph (e)(2)(ii), X must treat the amount paid for the betterment of the building structure as an improvement to the building and must capitalize the amount paid under paragraph (d)(1) of this section.

Example 16. Material increase in capacity.

X owns a factory building with a storage area on the second floor. X pays an amount to replace 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 paragraph (e)(2)(ii) of this section, if the amount results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. The columns and girders are part of the building structure defined under paragraph (e)(2)(ii)(A) of this section. X must treat the amount paid to replace the columns and girders as a betterment under paragraph (h)(1)(iii) of this section because it materially increases the load-carrying capacity of the building structure. The comparison rule in paragraph (h)(3)(iii) of this section does not apply to this amount because the expenditure was not necessitated by a particular event. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amount paid for betterment of the building structure as an improvement to the building and must capitalize the amount paid under paragraph (d)(1) of this section.

Example 17. Material increase in capacity.

X 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. To allow for ingress and egress and for the unloading of its barges, X needs to deepen the channel to a depth of 20 feet. X pays a contractor to dredge the channel to the required depth. Assume the channel is the unit of property. X must capitalize as an improvement the amounts paid for the dredging because they result in a material increase in the capacity of the channel under paragraph (h)(1)(iii) of this section. The comparison rule in paragraph (h)(3)(iii) of this section does not apply to these amounts paid because the expenditure was not necessitated by a particular event.

Example 18. Not a material increase in capacity.

Assume the same facts as in Example 17, except that the channel was susceptible to siltation and, by the next taxable year, the channel depth had been reduced to 18 feet. X pays a contractor to redredge the channel to a depth of 20 feet. The event necessitating the expenditure was the siltation of the channel. Both prior to the siltation and after the redredging, the depth of the channel was 20 feet. X is not required to treat the amounts paid to redredge the channel as a betterment under paragraphs (h)(1)(ii) or (h)(1)(iii) of this section because they do not result in a material addition to the unit of property or a material increase in the capacity, productivity, efficiency, strength, or quality of the unit of property or the output of the unit of property.

Example 19. Not a material increase in capacity.

X owns a building used in its trade or business. The first floor has a drop-ceiling. X pays an amount to remove the drop-ceiling and repaint the original ceiling. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. The ceiling is part of the building structure as defined under paragraph (e)(2)(ii)(A) of this section. X is not required to treat the amount paid to remove the drop-ceiling as a betterment because it did not result in a material addition under paragraph (h)(1)(ii) of this section or a material increase to the capacity, productivity, efficiency, strength, or quality of the building structure or output of the building structure under paragraph (h)(1)(iii) of this section. The comparison rule in paragraph (h)(3)(iii) of this section does not apply to these amounts paid because the expenditure was not necessitated by a particular event.

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

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

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

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

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

(v) Results in the rebuilding of the unit of property to a like-new condition after the end of its class life as defined in paragraph (g)(4) of this section (see paragraph (i)(3) of this section); or

(vi) Is for the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of a unit of property (see paragraph (i)(4) of this section).

(2) Restorations of buildings. In the case of a building, an amount is paid to restore the unit of property if it restores any of the properties designated in paragraphs (e)(2)(ii), (e)(2)(iii)(B), (e)(2)(iv)(B), (e)(2)(v)(B) of this section.

(3) Rebuild to like-new condition. For purposes of paragraph (i)(1)(v) of this section, a unit of property is rebuilt to a like-new condition if it is brought to the status of new, rebuilt, remanufactured, or similar status under the terms of any federal regulatory guideline or the manufacturer's original specifications.

(4) Replacement of a major component or a substantial structural part. To determine whether an amount is for the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of the unit of property, it is appropriate to consider all the facts and circumstances. These facts and circumstances include the quantitative or qualitative significance of the part or combination of parts in relation to the unit of property. A major component or substantial structural part includes a part or combination of parts that comprise a large portion of the physical structure of the unit of property or that perform a discrete and

critical function in the operation of the unit of property. However, the replacement of a minor component of the unit of property, even though such component may affect the function of the unit of property, will not generally, by itself, constitute a major component or substantial structural part.

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

Example 1. Replacement of loss component.

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

Example 2. Replacement of sold component.

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

Example 3. Restoration after casualty loss.

X owns an office building that it uses in its trade or business. A storm damages the office building at a time when the building has an adjusted basis of \$ 500,000. X deducts under section 165 a casualty loss in the amount of \$ 50,000 and properly reduces its basis in the office building to \$ 450,000. X hires a contractor to repair the damage to the building and pays the contractor \$ 50,000 for the work. Under paragraph (i)(1)(iii) of this section, X must capitalize the \$ 50,000 amount paid to the contractor because X properly adjusted its basis in that amount as a result of a casualty loss under section 165.

Example 4. Restoration after casualty event.

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

Example 5. Restoration of property in a state of disrepair.

X owns and operates a farm with several barns and outbuildings. X 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. X decides to restore the outbuilding and pays an amount to shore up the walls and replace the siding. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The walls and siding are part of the building structure under paragraph (e)(2)(ii)(A) of this section. Under paragraph (i)(1)(iv) of this section, X 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, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amount paid as an improvement to the building and must capitalize the amount paid under paragraph (d)(2) of this section.

Example 6. Rebuild of property to like-new condition before end of class life.

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

Example 7. Rebuild of property to like-new condition after end of class life.

Assume the same facts as in Example 6, except that X rebuilds the freight car 15 years after X places it in service. Under paragraph (i)(1)(v) of this section, X must capitalize the amounts paid to rebuild the freight car because the amounts paid restore the freight car to like-new condition after the end of the class life of the freight car.

Example 8. Replacement of major component or substantial structural part; personal property.

X is a common carrier that owns a fleet of petroleum hauling trucks. X 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 cab constitute parts or combinations of parts that comprise a major component or substantial structural part of X's tractor. Therefore, the amounts paid for the replacement of those components must be capitalized under paragraph (i)(1)(vi) of this section. 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 (i)(1)(vi) of this section.

Example 9. Repair performed during a restoration.

Assume the same facts as in Example 8, except that, at the same time the engine and cab of the tractor are replaced, X 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 § 1.162-4T. However, under paragraph (f)(3)(i) of this section, a taxpayer must capitalize all the direct costs of an improvement and all the indirect costs that directly benefit or are incurred by reason of an improvement in accordance with the rules under section 263A. Repairs and maintenance that do not directly benefit or are not incurred by reason of an improvement are not required to be capitalized under section 263(a), regardless of whether they are made at the same time as an improvement. Under paragraph (f)(3)(i) of this section, X 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 cab. Amounts paid to repair the broken taillight, however, are not incurred by reason of the restoration of the tractor, nor do the amounts paid directly benefit the tractor restoration, even though the repair was performed at the same time as the restoration. Thus, X must capitalize the amounts paid to paint the cab under paragraph (i)(1)(vi) and (f)(3)(i) of this section, but X is not required to capitalize the amounts paid to repair the broken taillight.

Example 10. Related amounts to replace major component or substantial structural part; personal property.

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

(ii) X pays the permit fee to the county on October 15, Year 1. On December 15, Year 1, the contractor completes the removal of the old USTs and bills X for the costs of removal. On January 15, Year 2, the contractor completes the installation of the new USTs and bills X for the remainder of the work. Assume that X computes its taxes on a calendar year basis and X's gasoline distribution system is the unit of property. Under paragraph (i)(1)(vi) of this section, X must capitalize the amounts paid to replace the USTs as a restoration to the gasoline distribution system because the USTs are parts or combinations of parts that comprise a major component and substantial structural part of the gasoline distribution system. Moreover, under paragraph (f)(3) of this section, X must capitalize the costs of removing the old USTs because these amounts directly benefit and are incurred by reason of the improvement to the gasoline distribution system. Finally, under paragraph (f)(4) of this section, X must capitalize the

aggregate of related amounts paid to improve the gasoline distribution system, including the amount paid to the county, the amount paid to remove the old USTs, and the amount paid to install the new USTs, even though the amounts were separately invoiced, paid to different parties, and incurred in different tax years.

Example 11. Not replacement of major component or substantial structural part; personal property.

X owns a machine shop in which it makes dies used by manufacturers. In Year 1, X purchased a drill press for use in its production process. In Year 3, X discovers that the power switch assembly, which controls the supply of electric power to the drill press, has become damaged and could not operate. To correct this problem, X paid amounts to replace the power switch assembly with comparable, commercially available and reasonable 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. Thus, the power switch assembly is not a major component or substantial structural part of X's drill press under paragraph (i)(3) of this section. X is not required to capitalize the costs to replace the power switch assembly under paragraph (i)(1)(vi) of this section because the replacement, by itself, does not constitute the replacement of a part or a combination of parts that comprise a major component or substantial structural part of X's drill press. But see section 263A and the regulations thereunder for the requirement to capitalize indirect costs that directly benefit or are incurred by reason of production activities.

Example 12. Replacement of major component or substantial structural part; roof.

X owns a large retail store. X discovers a leak in the roof of the store and hires a contractor to inspect and fix the roof. The contractor discovers that a major portion of the sheathing and rafters has rotted, and recommends the replacement of the entire roof. X pays the contractor to replace the entire roof with a new roof. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The roof is part of the building structure under paragraph (e)(2)(ii)(A) of this section and comprises a major component or substantial structural part of X's building structure under paragraph (i)(4) of this section. Under paragraph (i)(1)(vi) of this section, X must treat the amount paid to replace the roof as a restoration because X paid the amount to replace a major component or substantial structural part of X's building structure. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amount paid to restore the building structure as an improvement to the building and must capitalize the amount paid under paragraph (d)(2) of this section.

Example 13. Replacement of major component or substantial structural part; roof.

Assume the same facts as Example 12 except the contractor recommends replacement of a significant portion of the roof, but not the entire roof. Accordingly, X pays an amount to replace a large portion of the decking, insulation, and membrane of the roof of X's retail building. The portion of the roof replaced comprises a major component or substantial structural part of the building structure under paragraph (i)(4) of this section. Thus, under paragraph (i)(1)(vi) of this section, X must treat the amount paid for the roof work as a restoration of the building structure because X paid the amount to replace a major component or substantial structural part of the building structure. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amount paid as an improvement to the building and must capitalize the amount paid under paragraph (d)(2) of this section.

Example 14. Not replacement of major component or substantial structural part; roof membrane.

X is in the business of manufacturing parts. X owns a factory facility in which the parts are manufactured. The roof over X's facility is comprised of structural elements, insulation, and a waterproof membrane. Over time, the waterproof membrane began to wear and leakage began to occur. Consequently, X pays an amount to replace the plant's worn roof membrane with a similar but new membrane. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The roof, including the membrane, is part of the building structure as defined under paragraph (e)(2)(ii)(A) of this section. Although the roof membrane may affect the function of the building structure, it is not, by itself, a major component or substantial structural part of X's building structure under paragraph (i)(4) of this section. Because the roof membrane is not a major component or substantial structural part of the building structure, X is not required to treat the amount paid to replace the roof membrane as a restoration of the building structure under paragraph (i)(1)(vi) of this section. But see section 263A and the regulations thereunder for the requirement to capitalize indirect costs that directly benefit or are incurred by reason of production activities.

Example 15. Replacement of major component or substantial structural part; HVAC system.

X owns a building in which it operates an office that provides medical services. The building contains one HVAC system, which is comprised of a furnace, an air conditioning unit, and duct work that runs throughout the building to distribute the heat or air conditioning throughout the building. The furnace in X's building breaks down and X pays an amount to replace it with a new furnace. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The heating and air conditioning system, including the furnace, is a building system under paragraph (e)(2)(ii)(B)(1) of this section. The furnace performs a discrete and critical function in the operation of the HVAC system, and is therefore a major component or substantial structural part of the building system under paragraph (i)(4) of this section. Because the furnace comprises a major component or substantial structural part of a building system, X must treat the amount paid to replace the furnace as a restoration of the building system under paragraph (i)(1)(vi) of this section. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amount paid as an improvement to the building and must capitalize the amount paid under paragraph (d)(2) of this section.

Example 16. Replacement of major component or substantial structural part; HVAC system.

X 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 functions to cool the water used to generate air conditioning throughout the building. X pays an amount to replace the chiller with a more energy efficient unit. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. 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 and is therefore a major component or substantial structural part of the HVAC system under paragraph (i)(4) of this section. Because the chiller unit comprises a major component or substantial structural part of a building system, X must treat the amount paid to replace the chiller unit as a restoration to a building system under

paragraph (i)(1)(vi) of this section. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amount paid as an improvement to the building and must capitalize the amount paid under paragraph (d)(2) of this section.

Example 17. Not replacement of major component or substantial structural part; HVAC system.

X owns an office building that it uses to provide services to customers. The building contains an HVAC system that incorporates ten 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. X 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 X replace two of the roof-mounted units. X pays an amount to replace the two specified units. No work is performed on the other roof-mounted heating/cooling units, the duct work, or the controls. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The HVAC system, including the two-roof mounted units, is a building system under paragraph (e)(2)(ii)(B)(1) of this section. The two roof-mounted heating/cooling units, by themselves, do not comprise a large portion of the physical structure of the HVAC system or perform a discrete and critical function in the operation of the system. Therefore, under paragraph (i)(4) of this section, the two units do not constitute a major component or substantial structural part of the building system. Accordingly, X is not required to treat the amount paid to replace the two roof-mounted heating/cooling units as a restoration of a building system under paragraph (i)(1)(iv) of this section.

Example 18. Replacement of major component or substantial structural part; fire protection system.

X owns a building that it uses to operate its business. X pays an amount to replace the sprinkler system in the building with a new sprinkler system. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The fire protection and alarm system, including the sprinkler system, is a building system under paragraph (e)(2)(ii)(B)(6) of this section. 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 or substantial structural part of the fire protection and alarm system under paragraph (i)(4) of this section. Because the sprinkler system comprises a major component or substantial structural part of a building system, X must treat the amount paid to replace the sprinkler system as a restoration to a building system under paragraph (i)(1)(vi) of this section. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amount paid as an improvement to the building and must capitalize the amount paid under paragraph (d)(2) of this section.

Example 19. Replacement of major component or substantial structural part; electrical system.

X owns a building that it uses to operate its business. X pays an amount to replace the wiring throughout the building with new wiring that meets building code requirements. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The electrical system, including the wiring, is a building system under paragraph (e)(2)(ii)(B)(3)

of this section. The wiring performs a discrete and critical function in the operation of the electrical system and is therefore a major component or substantial structural part of the electrical system under paragraph (i)(4) of this section. Because the wiring comprises a major component or substantial structural part of a building system, X must treat the amount paid to replace the wiring as a restoration to a building system under paragraph (i)(1)(vi) of this section. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amount paid as an improvement to the building and must capitalize the amount paid under paragraph (d)(2) of this section.

Example 20. Replacement of major component or substantial structural part; plumbing system.

X 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. X decides to update the restrooms by paying an amount to replace the plumbing fixtures in all of the restrooms, including the toilets, sinks, and associated fixtures, with modern style plumbing fixtures of similar quality and function. X does not replace the pipes connecting the fixtures to the building's plumbing system. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The plumbing system, including the plumbing fixtures, is a building system under paragraph (e)(2)(ii)(B)(2) of this section. The plumbing fixtures in all the restrooms perform a discrete and critical function in the operation of the plumbing system and comprise a large portion of the physical structure of plumbing system. Therefore, under paragraph (i)(4) of this section, the plumbing fixtures comprise a major component or substantial structural part of the plumbing system, and X must treat the amount paid to replace all of the plumbing fixtures as a restoration of a building system under paragraph (i)(1)(vi) of this section. As a result, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amount paid to restore the plumbing system as an improvement to the building and must capitalize these amounts under paragraph (d)(2) of this section.

Example 21. Not replacement of major component or substantial structural part; plumbing system.

Assume the same facts as Example 20 except that X does not update all the bathroom fixtures. Instead, X only pays an amount to replace three of the twenty sinks located in the various restrooms because these sinks had cracked. The three replaced sinks, by themselves, do not comprise a large portion of the physical structure of the plumbing system nor do they perform a discrete and critical function in the operation of the plumbing system. Therefore, under paragraph (i)(4) of this section, the sinks do not constitute a major component or substantial structural part of the building system. Accordingly, X is not required to treat the amount paid to replace the sinks as a restoration of a building system under paragraph (i)(1)(iv) of this section.

Example 22. Replacement of major component or substantial structural part; remodel.

(i) X owns and operates a hotel building. X decides that to attract customers and to remain competitive, it needs to update the guest rooms in its facility. Accordingly, X pays amounts to replace the bathtubs, toilets, sinks, plumbing fixtures, and to repair, repaint, and retile the bathroom walls and floors, which was necessitated by the installation of the new plumbing components. The replacement bathtubs, toilets, sinks, plumbing fixtures, and tile are new and in a different style, but are similar in function and quality to the replaced items. X 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. X 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, X pays amounts to perform the updates for eight of the twenty hotel room floors, and expects to complete the renovation of the remaining rooms over the next 2 years.

(ii) Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The plumbing system, including the bathtubs, toilets, sinks, and plumbing fixtures, is a building system under paragraph (e)(2)(ii)(B)(2) of this section. All the bathtubs, toilets, sinks, and plumbing fixtures in the hotel building perform a discrete and critical function in the operation of the plumbing system and comprise a large portion of the physical structure of plumbing system. Therefore, under paragraph (i)(4) of this section, these plumbing components comprise major components or substantial structural parts of the plumbing system, and X must treat the amount paid to replace these plumbing components as a restoration of a building system under paragraph (i)(1)(vi) of this section. In addition, under paragraph (f)(3)(i) of this section, X 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 plumbing system. Further, under paragraph (f)(4) of this section, X 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 part of the aggregate of related amounts paid to improve the plumbing system. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amounts it paid to improve the plumbing system as the costs of improving the building and must capitalize the amounts under paragraph (d)(2) of this section. In addition, X must capitalize the amounts paid to acquire and install each section 1245 property under § 1.263(a)-2T of the regulations.

Example 23. Not replacement of major component or substantial structural part; windows.

X owns a large office building that it uses to provide office space for employees that manage X's operations. The building has 300 exterior windows. In Year 1, X pays an amount to replace 30 of the exterior windows that had become damaged. At the time of these replacements, X has no plans to replace any other windows in the near future. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The exterior windows are part of the building structure as defined under paragraph (e)(2)(ii)(A) of this section. The 30 replacement windows do not comprise a large portion of the physical structure of the office building structure and, by themselves, do not perform a discrete and critical function in the operation of X's building structure. Therefore, under paragraph (i)(4) of this section, the replacement windows do not constitute major components or substantial structural parts of the building structure. Accordingly, X is not required to treat the amount paid to replace the windows a restoration of a building system under paragraph (i)(1)(iv) of this section.

Example 24. Replacement of major component or substantial structural part; windows.

Assume the same facts as Example 23 except that X replaces 200 of the 300 windows on the building. In addition, as a result of damage caused during the window replacements, X also pays an amount to repaint the interior trims associated with the replaced windows. The 200 replacement windows comprise a large portion of the physical structure of X's building and perform a discrete and critical function in the operation of the building structure. Therefore, under paragraph (i)(4) of this section, the 200 windows comprise a major component or substantial structural part of the building structure, and X must treat the amount paid to replace the windows as a restoration of the building structure under paragraph (i)(1)(vi) of this section. As a result, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amounts paid

to restore the building structure as an improvement to the building and must capitalize the amounts under paragraph (d)(2) of this section.

Example 25. Not replacement of major component or substantial structural part; floors.

X owns and operates a hotel building. X decides to refresh the appearance of the hotel lobby by replacing the floors in the lobby. The hotel lobby comprises a small portion of the entire hotel building. X pays an amount to replace the wood flooring in the lobby with new wood flooring. X did not replace any other flooring in the building. Assume that the wood flooring constitutes section 1250 property. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The wood flooring is part of the building structure under paragraph (e)(2)(ii)(A) of this section. The replacement wood flooring in the lobby of the building does not comprise a large portion of the physical structure of the hotel building or perform a discrete and critical function in the operation of the hotel building structure. Therefore, under paragraph (i)(4) of this section, the wood flooring does not constitute a major component or substantial structural part of the hotel building structure. Accordingly, X is not required to treat the amount paid to replace the wood flooring in the hotel lobby as a restoration under paragraph (i)(1)(vi) of this section.

Example 26. Replacement of major component or substantial structural part; floors.

Assume the same facts as Example 25 except that X decides to refresh the appearance of all the public areas of the hotel building by replacing the floors. To that end, X 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, and other public rooms throughout the hotel interiors. The replacement wood floors in all the public areas comprise a large portion of the physical structure of the hotel building structure and perform a discrete and critical function in the operation of X's hotel building structure. Therefore, under paragraph (i)(4) of this section, replacement wood floors comprise a major component or substantial structural part of the building structure, and X must treat the amount paid to replace the floors as a restoration of the building structure under paragraph (i)(1)(vi) of this section. As a result, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amounts paid to restore the building structure as an improvement to the building and must capitalize the amounts under paragraph (d)(2) of this section.

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

(2) Adapting buildings to new or different use. In the case of a building, an amount is paid to adapt the unit of property to a new or different use if it adapts to a new or different use any of the properties designated in paragraphs (e)(2)(ii), (e)(2)(iii)(B), (e)(2)(iv)(B), or (e)(2)(v)(B) of this section.

(3) Examples. The following examples illustrate solely the rules of this paragraph (j). Even if capitalization is not required in an example under this paragraph (j), the amounts paid in the example may be subject to capitalization under a different provision of this section or another provision of the Internal Revenue Code (for example, section 263A). Unless otherwise stated, assume that X has not properly deducted a loss for any unit of property, asset, or component of a unit of property that is removed and replaced.

Example 1. New or different use.

X is a manufacturer and owns a manufacturing building that it has used for manufacturing since Year 1, when X placed it in service. In Year 30, X pays an amount to convert its manufacturing building into a showroom for its business. To convert the facility, X removes and replaces various structural components to provide a better layout for the showroom and its offices. X also repaints the building interiors as part of the conversion. None of the materials used are better than existing materials in the building. Under paragraph (e)(2)(ii) of this section, if the amount paid adapts the building structure to a new or different use, X must treat the amount as an improvement to the building. Under paragraph (j)(1) of this section, the amount paid to convert the manufacturing facility into a showroom adapts the building structure to a new or different use because the conversion is not consistent with X's intended ordinary use of the building structure at the time it was placed in service. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amount paid for the adaptation of the building structure as an amount that improves the building. Accordingly, X must capitalize the amount as an improvement under paragraph (d)(3) of this section.

Example 2. Not a new or different use.

X owns 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 to include two adjoining retail spaces. To facilitate the new lease, X 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 paragraph (e)(2)(ii) of this section, if the amount paid adapts the buildings structure to a new or different use, X must treat the amount as an improvement to the building. Under paragraph (j)(1) of this section, the amount paid to convert three retail spaces into one larger space for an existing tenant does not adapt X's building structure to a new or different use because the combination of retail spaces is consistent with X's intended, ordinary use of the building structure. Therefore, the amount paid by X to remove the walls does not improve the building under paragraph (d)(3) of this section.

Example 3. Not a new or different use.

X owns a building consisting of twenty retail spaces. X decides to sell the building. In anticipation of selling the building, X pays an amount to repaint the interior walls and to refinish the hardwood floors. Under paragraph (e)(2)(ii) of this section, if the amount paid adapts the buildings structure to a new or different use, X must treat the amount as an improvement to the building. Preparing the building for sale does not constitute a new or different use for the building structure under paragraph (j)(1) of this section. Therefore, the amount paid to prepare the building structure for sale does not improve the building under paragraphs (d)(3) of this section.

Example 4. New or different use.

X 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 X's operation of the manufacturing facility, the land became contaminated with wastes from its manufacturing processes. X discontinues manufacturing operations at the site, and decides to sell the property to a developer that intends to use the property for residential housing. In anticipation of selling the land, X pays an amount to cleanup the land to a standard that is required for the land to be used for residential purposes. In addition, X pays an amount to regrade the land so that it can be used for residential purposes. Amounts that X pays to cleanup wastes that were discharged in the course of X's manufacturing operations do not adapt the land to a new or different use, regardless of the extent

to which the land was cleaned. Therefore, X is not required to capitalize the amount paid for the cleanup under paragraph (j)(1) of this section. However, the amount paid to regrade the land so that it can be used for residential purposes adapts the land to a new or different use that is inconsistent with X'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 under paragraphs (j)(1) of this section.

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

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

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

(4) Examples. The rules of this paragraph (k) are illustrated by the following examples:

Example 1. Taxpayer subject to regulatory accounting rules of FERC.

X is an electric utility company that operates a power plant that generates electricity and that owns and operates network assets to transmit and distribute the electricity to its customers. X is subject to the regulatory accounting rules of FERC and X chooses to use the regulatory accounting method under paragraph (k) of this section. X 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, X must not capitalize for Federal income tax purposes amounts paid for repairs performed on its turbines or its network assets.

Example 2. Taxpayer not subject to regulatory accounting rules of FERC.

X is an electric utility company that operates a power plant to generate electricity. X previously was subject to the regulatory accounting rules of FERC but, for various reasons, X is no longer required to use FERC's regulatory accounting rules. X cannot use the regulatory accounting method provided in this paragraph (k).

Example 3. Taxpayer subject to regulatory accounting rules of FCC.

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

Example 4. Taxpayer subject to regulatory accounting rules of STB.

X is a Class I railroad that is subject to the regulatory accounting rules of the STB. X chooses to use the regulatory accounting method under this paragraph (k). X capitalizes on its books and records for regulatory accounting purposes the cost of locomotive rebuilds. Under the regulatory accounting method, X is required to capitalize for federal income tax purposes amounts paid to rebuild its locomotives.

(l) Methods of accounting authorized in published guidance. A taxpayer may use a repair allowance method of accounting or any other method of accounting that is authorized in published guidance in the Federal Register or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter).

(m) Treatment of capital expenditures. Amounts required to be capitalized under this section are capital expenditures and must be taken into account through a charge to capital account or basis, or in the case of property that is inventory in the hands of a taxpayer, through inclusion in inventory costs. See section 263A for the treatment of direct and indirect costs of producing property or acquiring property for resale.

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

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

(p) Effective/applicability date. This section applies to taxable years beginning on or after January 1, 2012. For the applicability of regulations to taxable years beginning before January 1, 2012, see § 1.263(a)-3 in effect prior to January 1, 2012 (§ 1.263(a)-3 as contained in 26 CFR part 1 edition revised as of April 1, 2011).

(q) Expiration date. The applicability of this section expires on or before December 23, 2014.