

Reg. Section 1.263(a)-3(h)(7)

(h) Safe harbor for small taxpayers.

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

- (i) 2 percent of the unadjusted basis (as defined under paragraph (h)(5) of this section) of the eligible building property; or
- (ii) \$10,000.

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

(3) Qualifying taxpayer.

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

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

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

- (A) Multiplying the gross receipts for the short period by 12; and
- (B) Dividing the product determined in paragraph (h)(3)(iii)(A) of this section by the number of months in the short period.

(iv) Definition of gross receipts. For purposes of applying paragraph (h)(3)(i) of this section, the term gross receipts means the taxpayer's receipts for the taxable year that are properly recognized under the taxpayer's methods of accounting used

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

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

(5)Unadjusted basis.

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

(ii) Eligible building property leased to the taxpayer. For purposes of this section, the unadjusted basis of eligible building property leased to the taxpayer is the total amount of (undiscounted) rent paid or expected to be paid by the lessee under the lease for the entire term of the lease, including renewal periods if all the facts and circumstances in existence during the taxable year in which the lease is entered

indicate a reasonable expectancy of renewal. Section 1.263(a)-4(f)(5)(ii) provides the factors that are significant in determining whether there exists a reasonable expectancy of renewal for purposes of this paragraph.

(6)Time and manner of election. A taxpayer makes the election described in paragraph (h)(1) of this section by attaching a statement to the taxpayer's timely filed original Federal tax return (including extensions) for the taxable year in which amounts are paid for repairs, maintenance, improvements, and similar activities performed on the eligible building property providing that such amounts qualify under the safe harbor provided in paragraph (h)(1) of this section. Sections 301.9100-1 through 301.9100-3 of this chapter provide the rules governing extensions of the time to make regulatory elections. The statement must be titled, "Section 1.263(a)-3(h) Safe Harbor Election for Small Taxpayers" and include the taxpayer's name, address, taxpayer identification number, and a description of each eligible building property to which the taxpayer is applying the election. In the case of an S corporation or a partnership, the election is made by the S corporation or by the partnership, and not by the shareholders or partners. An election may not be made through the filing of an application for change in accounting method or, before obtaining the Commissioner's consent to make a late election, by filing an amended Federal tax return. A taxpayer may not revoke an election made under this paragraph (h). The time and manner of making the election under this paragraph (h) may be modified through guidance of general applicability (see §§ 601.601(d)(2) and 601.602 of this chapter).



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

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

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

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

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

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

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

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

(ii) The total amount paid by B during Year 1 for repairs, maintenance, improvements and similar activities on Building M (\$5,000) does not exceed the lesser of \$6,000 (2 percent of the building's unadjusted basis of \$300,000) or \$10,000. Therefore, under paragraph (h)(1) of this section, for Year 1, B may elect to not apply the capitalization rule under paragraph (d) of this section to the amounts it paid for repairs, maintenance, improvements, and similar activities on

Building M. If B properly makes the election under paragraph (h)(6) of this section for Building M and the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on B's trade or business, B may deduct these amounts under §1.162-1.

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

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

(i) Safe harbor for routine maintenance on property.

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

(i) Routine maintenance for buildings. Routine maintenance for a building unit of property is the recurring activities that a taxpayer expects to perform as a result of the taxpayer's use of any of the properties designated in paragraphs (e)(2)(ii), (e)(2)(iii)(B), (e)(2)(iv)(B), or (e)(2)(v)(B) of this section to keep the building structure or each building system in its ordinarily efficient operating condition. Routine maintenance activities include, for example, the inspection, cleaning, and testing of the building structure or each building system, and the replacement of

damaged or worn parts with comparable and commercially available replacement parts. Routine maintenance may be performed any time during the useful life of the building structure or building systems. However, the activities are routine only if the taxpayer reasonably expects to perform the activities more than once during the 10-year period beginning at the time the building structure or the building system upon which the routine maintenance is performed is placed in service by the taxpayer. A taxpayer's expectation will not be deemed unreasonable merely because the taxpayer does not actually perform the maintenance a second time during the 10-year period, provided that the taxpayer can otherwise substantiate that its expectation was reasonable at the time the property was placed in service. Factors to be considered in determining whether maintenance is routine and whether a taxpayer's expectation is reasonable include the recurring nature of the activity, industry practice, manufacturers' recommendations, and the taxpayer's experience with similar or identical property. With respect to a taxpayer that is a lessor of a building or a part of the building, the taxpayer's use of the building unit of property includes the lessee's use of its unit of property.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Example (1). Routine maintenance on component.

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

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

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

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

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

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

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

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

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

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

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

lining may be subject to capitalization under section 263A if the amounts paid for this maintenance comprise the direct or allocable indirect costs of the property produced by C. See § 1.263A-1(e)(3)(ii)(O).

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

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

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

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

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

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

improvement under paragraph (g)(1)(i) of this section. Accordingly, the amounts paid for the scheduled maintenance to its towboat engines in Year 5 are routine maintenance deemed not to improve the towboat and are not required to be capitalized under paragraph (d) of this section.

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

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

Example (14). Not routine maintenance; escalator system. Assume the same facts as in Example 13, except that in Year 9, G pays amounts to replace the steps of the escalators. In Year 1, when G placed its building into service, G reasonably expected that

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

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

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