Capitalization of Tangible Property Audit Technique Guide

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The taxpayer names and addresses shown in this publication are hypothetical.

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I. CHAPTER 1 EXAMINATION OF TANGIBLE PROPERTY

A. PREFACE

(1) The 2025 update of the Capitalization of Tangible Property Audit Technique Guide (ATG) includes guidance issued since the 2016 publication and changes following the enactment of the Tax Cuts and Jobs Act, P.L. 115-97, 131 Stat. 2054 (Dec. 22, 2017) (TCJA), and the Coronavirus Aid, Relief, and Economic Security Act, P.L. 116-136, (March 27, 2020) (CARES Act). Topics updated include Internal Revenue Code (IRC) Section 199 and 263A, and Accounting Method Changes. Chapter 19 was added to include the Large Business & International (LB&I) Directives related to tangible property. Minor edits were also made to improve readability.

B. INTRODUCTION

(1) This ATG is for IRS examiners to use as a tool for identifying potential tax issues. Examiners should carefully risk assess and apply the law to the facts and circumstances for issues involving capitalization and dispositions of tangible property.

(2) The IRS and Treasury began a project in 2004 to revise the tangible property regulations. In anticipation of these regulations, many taxpayers changed their method of accounting beginning as early as January 1, 2006. As a result, many of these taxpayers changed to a method of accounting for tax purposes that was inconsistent with the final regulations.

(3) On March 15, 2012, an LB&I directive instructed examiners to discontinue examining issues involving whether costs incurred to maintain, replace, or improve tangible property must be capitalized under Section 263(a) and any correlative issues involving the disposition of structural components of a building or dispositions of tangible depreciable assets.

(4) The final regulations were issued in 2013. Taxpayers were required to correct any prior method changes to comply with these regulations for tax years beginning on or after January 1, 2014. The burden of proof rests with the taxpayer, and taxpayers must maintain sufficient contemporaneous records.

C. CAPITALIZATION OF TANGIBLE PROPERTY – BACKGROUND

(1) Section 263(a) denies a deduction for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate, or any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made. Regulations previously issued under Section 263(a) provided that capital expenditures included amounts paid to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or adapt the property to a new or different use. The regulations also provided that amounts paid for certain incidental repairs of property were not required to be capitalized. While Section 263(a) generally requires taxpayers to capitalize an amount paid to

acquire, produce, or improve real or personal tangible property, Section 263A generally prescribes that direct and allocable indirect costs must be capitalized to property produced by the taxpayer and property acquired for resale. Section 162 allows a current deduction for amounts paid or incurred for incidental repairs and maintenance and does not require capitalization of these amounts.

(2) The United States Supreme Court has recognized the highly factual nature of determining whether expenditures are for capital improvements or for ordinary repairs. See *Welch v. Helvering*, 290 U.S. 111, 114 (1933) ("[T]he decisive distinctions [between capital and ordinary expenditures] are those of degree and not of kind"); *Deputy v. du Pont*, 308 U.S. 488, 496 (1940) (observing that each case "turns on its special facts"). Because of the factual nature of the issue, the courts have articulated a number of ways to distinguish between deductible repairs and non-deductible capital improvements. For example:

- *Illinois Merchants Trust Co. v. Commissioner*, 4 B.T.A. 103, 106 (1926), the court explained that repair and maintenance expenses are incurred for the purpose of keeping property in an ordinarily efficient operating condition over its probable useful life for the uses for which the property was acquired. Capital expenditures, in contrast, are for replacements, alterations, improvements, or additions that appreciably prolong the life of the property, materially increase its value, or make it adaptable to a different use.
- *Estate of Walling v. Commissioner*, 373 F.2d 190, 192-193 (3rd Cir. 1967), the court explained that the relevant distinction between capital improvements and repairs is whether the expenditures are to "put" or "keep" property in efficient operating condition.
- *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333, 338 (1962), the court stated that if the expenditure merely restores the property to the state, it was in before the situation prompting the expenditure arose and does not make the property more valuable, more useful, or longer-lived, then such an expenditure is usually considered a deductible repair. In contrast, a capital expenditure is generally considered to be a more permanent increment in the longevity, utility, or worth of the property.

(3) Over the years, the standards for applying Section 263(a), as set forth in the regulations, case law, and administrative guidance, have proved to be difficult to discern and apply in practice and have led to considerable uncertainty and controversy. To address this discord, in January of 2004, the IRS and Treasury announced their intention to propose regulations providing guidance in the area. See Notice 2004-6 (2004-3 IRB 308).

(4) On August 21, 2006, the IRS and the Treasury Department published proposed amendments to the regulations under Section 263(a) (2006 proposed regulations) relating to amounts paid to acquire, produce, or improve tangible property. See REG-168745-03 (2006-39 I.R.B. 532).The IRS and the Treasury

Department received numerous written comments on the 2006 proposed regulations and held a public hearing on December 19, 2006.

(5) After considering public comments, on March 10, 2008, the IRS and the Treasury Department withdrew the 2006 proposed regulations and published revised proposed regulations (2008 proposed regulations). See REG-168745-03 (2008-18 I.R.B. 871).After again receiving and considering public comments, in December 2011, the IRS and the Treasury Department withdrew the 2008 proposed regulations and issued temporary regulations effective for tax years beginning on or after January 1, 2012. See Treasury Decision (T.D.) 9564. These regulations were issued as both temporary and proposed, allowing time for any additional comments from the public while permitting taxpayers and the IRS to rely on them.

(6) On December 17, 2012, the IRS published Notice 2012-73, (2012-51 I.R.B. 713), alerting taxpayers that the IRS and the Treasury Department expected to issue final regulations regarding the deduction and capitalization of expenditures related to tangible property in 2013, and that the IRS and the Treasury Department anticipated that the final regulations would contain changes from the temporary regulations.

(7) Technical amendments to the temporary regulations (T.D. 9564) were released on December 17, 2012, which amended the applicability date of the 2011 temporary regulations to taxable years beginning on or after January 1, 2014, while permitting taxpayers to choose to apply the temporary regulations for taxable years beginning on or after January 1, 2012, and before the applicability date of the final regulations.

(8) On September 19, 2013, the IRS and the Treasury Department published final regulations (T.D. 9636) and removed the 2011 temporary and proposed regulations. The final regulations generally apply to taxable years beginning on or after January 1, 2014, however taxpayers may elect to apply the final regulations, or certain sections thereof, to taxable years beginning on or after January 1, 2012.

D. FINAL REGULATIONS – OVERVIEW

(1) Section 263(a) generally requires taxpayers to capitalize an amount paid to acquire, produce, or improve tangible property. The final regulations provide a general framework for distinguishing capital expenditures from supplies, repairs, maintenance, and other deductible business expenses. The final regulations coordinate with other provisions in the IRC and do not change the treatment of any amount that is specifically provided for under any provision of the IRC or the Treasury Regulations other than Section 162(a) or 212 and the regulations under those sections. In addition, under certain provisions of the IRC taxpayers may elect to treat capital expenditures as deductible expenses or as deferred expenses, or to treat deductible expenses as capital expenditures.

(2) The final regulations collectively are known as the “Tangible Property Regulations.”

- Section 1.263(a)-1 provides general rules for capital expenditures, including an election to use a de minimis safe harbor,
- Section 1.263(a)-2 provides rules for amounts paid for the acquisition or production of tangible property, and
- Section 1.263(a)-3 provides rules for amounts paid for the improvement of tangible property.

(3) Changes were made to related regulations to correspond with changes made in the final regulations. For example, the final regulations revise the definition and treatment of materials and supplies under Section 1.162-3, and permit taxpayers to elect to capitalize and depreciate amounts paid for certain materials and supplies. If the de minimis safe harbor is elected, it applies to most eligible materials and supplies property. The rules for repairs contained in Section 1.162-4, are amended to be consistent with the capitalization rules. Section 1.162-4 provides that a taxpayer is permitted to deduct amounts paid to repair and maintain tangible property provided that such amounts are not required to be capitalized under Section 263(a). These final regulations also amend the general rules for rental and leased property (Section1.162-11 and 1.167(a)-4) and provide for coordination with Section 263A.

(4) Revisions for dispositions of property subject to Section 168 are also included with changes to Section 1.168(i)-8 to include the retirement of a structural component of a building.

(5) These final regulations also contain changes to Section 1.167(a)-7 concerning accounting for depreciable property, Section 1.167(a)-8 concerning retirements, and Section 1.168(i)-1 concerning general asset accounts. These final regulations also add Section 1.168(i)-7 concerning accounting for modified accelerated cost recovery system (MACRS) property.

(6) We will explore these changes in this ATG. It is our goal to provide the reader with information on the implementation and applicability of these final regulations and to offer insight regarding procedures and techniques available to examiners to ensure taxpayer compliance.

E. RELEVANT TERMS

(1) The following are the steps identified in the flow chart below:

Concept	Authority
Ameliorates Material Condition or Defect – A taxpayer must capitalize as an improvement an amount paid for a	Section1.263(a)-3(j)(1)(i)

Concept	Authority
betterment of a unit of property ("UOP"), including if it ameliorates a material condition or defect that either existed prior to the taxpayer's acquisition of a UOP or arose during the production of the UOP. This applies whether or not the taxpayer was aware of the condition or defect at the time of acquisition or production.	Section1.263(a)-3(j)(3), Examples 1-5
Amount Paid – For taxpayers using an accrual method of accounting, the terms "amount paid" and "payment" mean a liability incurred within the meaning of Section 1.446-1(c)(1)(ii). A liability may not be taken into account under Section 263 prior to the taxable year during which the liability is incurred.	Section 1.263(a)-1(c)(1) Section 1.263(a)-2(b)(1) Section 1.263(a)-3(b)(1)
Applicable Financial Statements (AFS) – The taxpayer's financial statement listed in highest priority order: 1. A financial statement required to be filed with the Securities and Exchange Commission (SEC) which includes a Form 10-K or Annual Statement to Shareholders, 2. A certified audited financial statement that is accompanied by the report of an independent certified public accountant (or a similar foreign professional) that is used for: a. Credit purposes, b. Reporting to shareholders, or c. Any other substantial non-tax purpose, or 3. A financial statement, other than a tax return that is required to be provided to the federal or state government or any federal or state agency, other than to the IRS or the SEC.	Section 1.263(a)-1(f)(4)
Betterments – A taxpayer must capitalize as an improvement an amount paid for a betterment to a UOP. An amount is paid for a betterment if it: 1. Ameliorates a material condition or defect that either existed prior to the taxpayer's acquisition of the UOP or arose during the production of the UOP, whether or not the taxpayer was aware of the condition or defect at the time of acquisition or production, 2. Is for a material addition, including a physical enlargement, expansion, extension, or addition of a major	Section1.263(a)-3(j)(1)

Concept	Authority
component to the UOP or a material increase in the capacity, including additional cubic or linear space, of the UOP, or 3. Is reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the unit.	
Costs Incurred during an Improvement – A taxpayer must capitalize all the direct costs of an improvement and all the indirect costs (including, for example, otherwise deductible repair costs and certain component removal costs that are not dispositions for federal tax purposes) that directly benefit or are incurred by reason of an improvement. These costs may include amounts paid over a period of more than one year, depending on the facts and circumstances. 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), even if they are incurred at the same time as an improvement. By providing a standard based on the Section 263A language, the final regulations set out a clear rule for determining when otherwise deductible indirect costs must be capitalized as part of an improvement to property. The final regulations obsolete the plan of rehabilitation doctrine to the extent that the court-created doctrine provides different standards.	Section 1.263(a)-3(d) Section 1.263(a)-3(g)(1)(i) Section 1.263(a)-3(j)(3), Examples 7,8,10,17 and 23 Section 1.263(a)-3(k)(7), Examples 5,11,12 and 24
De minimis – A safe harbor annual election that hinges on the taxpayer's accounting policy and permits taxpayers to treat items for tax as it would for books provided. 1. The cost does not exceed $5000 for taxpayers with applicable financial statements (AFS) or $2500 ($500 for amounts incurred prior to January 1, 2016) for taxpayers without AFS per invoice or per item, or 2. The economic useful life of the property does not exceed 12 months. Additional rules and exceptions apply.	Section 1.263(a)-1(f)
Functionally Interdependent – Components of property are functionally interdependent if the placing in service of one component by the taxpayer is dependent on the placing in service of the other component by the taxpayer.	Section 1.263(a)-3(d)(3)(i)

Concept	Authority
Major Component/Substantial Structural Part – A taxpayer must capitalize as an improvement amounts paid to restore a UOP, including when it is for the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of a UOP. One must consider all the facts and circumstances, including the quantitative and qualitative significance of the part or combination of parts in relation to the UOP. A major component is a part or combination of parts that performs a discrete and critical function in the operation of the UOP. A substantial structural part is a part or combination of parts that comprises a large portion of the physical structure of the UOP.	Section 1.263(a)-3(k)(1)(vi) Section 1.263(a)-3(k)(6) Section 1.263(a)-3(k)(7), Examples 10-29
Like-New Condition – A taxpayer must capitalize as an improvement amounts paid to restore a UOP, including where it results in the rebuilding of the UOP to a like-new condition after the end of its class life. A UOP is rebuilt to a like-new condition if it is brought to the status of new, rebuilt, remanufactured, or a similar status under the terms of any federal regulatory guideline or the manufacturer's original specifications. The class life of a UOP is defined under Section 168(g)(2) and (3). Note that only the class life of a UOP may be used, not the economic useful life.	Section 1.263(a)-3(k)(1)(v) Section 1.263(a)-3(k)(5) Section 1.263(a)-3(k)(7), Examples 7-9
Materials & Supplies – Generally, amounts paid to acquire or produce non-incidental materials and supplies are deductible in the taxable year in which the materials and supplies are first used or consumed in the taxpayer's operations. Incidental materials and supplies that are carried on hand and for which no record of consumption is kept or of which physical inventories at the beginning and end of the year are not taken, are deductible in the taxable year in which these amounts are paid, provided taxable income is clearly reflected. A material or supply is tangible property that is used or consumed in the taxpayer's operations that is not inventory and that: 1. Is a component acquired to maintain, repair, or improve a UOP owned, leased, or serviced by the taxpayer and that is not acquired as part of any UOP,	Section 1.162-3(a) and (c) Section 1.162-3(h), Examples 1-14

Concept	Authority
2. Consists of fuel, lubricants, water, and similar items, reasonably expected to be consumed in 12 months or less, beginning when used in operations, 3. Is a UOP that has an economic useful life of 12 months or less, beginning when the property is used or consumed in the taxpayer's operations, 4. Is a UOP that has an acquisition cost or production cost of $200 or less, or 5. Is identified in published guidance.	
New or Different Use – Generally, taxpayers must capitalize amounts paid to improve a UOP, including amounts paid to adapt a UOP to a new or different use. An amount is paid to adapt a UOP to a new or different use if the adaptation is not consistent with the taxpayer's intended ordinary use of the UOP at the time originally placed in service by the taxpayer.	Section 1.263(a)-3(d) Section 1.263(a)-3(l)(1) Section 1.263(a)-3(l)(3), Examples 1-7
Personal Property – As addressed in the final regulations, the term "personal property" means tangible personal property as defined in Section1.48-1(c).	Section 1.263(a)-2(b)(2) Section 1.263(a)-3(b)(2)
Produce – The final regulations state that "produce" means construct, build, install, manufacture, develop, create, raise, or grow. This definition is intended to have the same meaning as the definition used for purposes of Section 263A(g)(1) and Section 1.263A-2(a)(1)(i), except that improvements are excluded. Improvements under the final regulations are addressed in Section1.263(a)-3.	Section 1.263(a)-1(c)(2)
Real Property – As addressed in the final regulations, the term "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. Any property that constitutes other tangible property under Section 1.48-1(d) is treated as real property. Local law is not controlling in determining whether property is real property for purposes of Section 263.	Section 1.263(a)-2(b)(3) Section 1.263(a)-3(b)(3)
Removal Costs – The final regulations provide a specific rule clarifying the treatment of removal costs. If a taxpayer disposes of a depreciable asset, including a partial	Section 1.162-3(e)(2)(ii)

Concept	Authority
disposition, and has taken into account the adjusted basis of the asset or component of the asset in realizing a gain or loss, the costs of removing the asset or component are not required to be capitalized. However, if the disposition of a component of a UOP is not treated as a disposition for Federal tax purposes, then the taxpayer must deduct or capitalize the costs of removing the component. This determination is made based on whether the removal costs directly benefit or are incurred by reason of a repair to the UOP or an improvement to the UOP.	Section 1.263(a)-3(g)(2)(i) and (ii), Examples 1-4
Refreshing/Remodeling Property – See Betterment and Revenue Procedure (Rev. Proc.) 2015-56, 2015-49, I.R.B. 827, providing a refresh-remodel safe harbor for qualifying retail/restaurant taxpayers.	Section 1.263(a)-3(j)(3), Examples 6, 7, 8
Repairs – A taxpayer may deduct amounts paid for repairs and maintenance to tangible property if the amounts paid are not otherwise required to be capitalized. A taxpayer may elect to capitalize repair and maintenance costs consistent with its books and records.	Section 1.162-4(a) Section 1.263(a)-3(n)
Restorations – A taxpayer must capitalize as an improvement amounts paid to restore a UOP. A restoration: 1. Is for the replacement of a component of a UOP for which the taxpayer has properly deducted a loss for that component (other than a casualty loss), 2. Is for the replacement of a component of a UOP 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, 3. Is for the restoration of damage to a UOP for which the taxpayer is required to take a basis adjustment as a result of a casualty loss or relating to a casualty event, subject to a limitation, 4. Returns the UOP to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use, 5. Results in the rebuilding of the UOP to a like-new condition after the end of its class life, or 6. Is for the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of a UOP.	Section 1.263(a)-3(k)(1)

Concept	Authority
Rotable Spare Parts – Materials and Supplies that are acquired for installation on a UOP, removable from that UOP, generally repaired or improved, and either reinstalled on the same or other property or stored for later installation.	Section 1.162-3(c)(2)
Routine Maintenance – A safe harbor amount paid for routine maintenance is deemed not to improve that UOP, building structure or building system. Routine maintenance is the recurring activities that a taxpayer expects to perform as a result of the taxpayer's use of the UOP, building structure or building system to keep them in their ordinarily efficient operating condition. Routine maintenance activities include, for example, the inspection, cleaning, and testing, and the replacement of damaged or worn parts with comparable and commercially available replacement parts. For building property, 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 building system is placed in service by the taxpayer. In the case of property other than buildings, activities are routine only if at the time the UOP is placed in service by the taxpayer, the taxpayer reasonably expects to perform the activities more than once during the class life of the UOP. 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, and the taxpayer's experience. For a taxpayer lessor, the taxpayer's use of the UOP includes the lessee's use of the UOP. Routine maintenance does not include the following: 1. Amounts paid for a betterment to a UOP, 2. Amounts paid for the replacement of a component of a UOP for which the taxpayer has properly deducted a loss for that component (other than a casualty loss), 3. Amounts paid for the replacement of a component of a UOP 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 components, 4. Amounts paid for the restoration of damage to a UOP for which the taxpayer is required to take a basis adjustment	Section 1.263(a)-3(i)

Concept	Authority
as a result of a casualty loss under Section 165 (subject to limitation), 5. Amounts paid to return a UOP 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, 6. Amounts paid to adapt a UOP to a new or different use, 7. Amounts paid for repairs, maintenance, or improvement of network assets, 8. Amounts paid for repairs, maintenance, or improvement of rotable and temporary spare parts to which the taxpayer applies the optional method of accounting under Section 1.162-3(e).	
Temporary Spare Parts – Certain materials and supplies that are used temporarily until a new or repaired part can be installed and then are removed and stored for later installation.	Section 1.162-3(c)(2)
Unit of Property (Building) – Each building and its structural components is a single UOP. The term "building and structural components" is defined under Section 1.48-1(e)(1) and (e)(2). An amount paid is considered an improvement to a building if the amount paid results in an improvement to the building structure or to any of the designated building systems. **Building Structure:** The building and its structural components, other than structural components designated as building systems. **Building Systems**: The designated building systems are each of the following structural components (including the components thereof): 1. Heating, ventilation, and air conditioning systems, 2. Plumbing systems, 3. Electrical systems, 4. All escalators, 5. All elevators, 6. Fire-protection and alarm systems, 7. Security systems, 8. Gas distribution systems,	Section 1.263(a)-3(d)(1) Section 1.263(a)-3(e)(2) Section 1.263(a)-3(e)(6), Examples 1-4, 18-19

Concept	Authority
Any other designated building systems identified in published guidance.	
Unit of Property (Other than Building) – Generally, the UOP is based on the functional interdependence standard. All the components that are functionally interdependent comprise a single UOP. 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. **Plant Property**: 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. The UOP is comprised of each component (or group of components) that performs a discrete and major function or operation within the functionally interdependent machinery or equipment. **Network Assets**: 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 these respective industries. The UOP is based on the taxpayer's facts and circumstances, except as otherwise provided in published guidance. The functional interdependence test is not determinative.	Section 1.263(a)-3(e)(3) Section 1.263(a)-3(e)(6), Examples 5-9
Unit of Property (Lessee): **Leased Building:** In the case of a taxpayer that is a lessee of a building or a portion of a building, the UOP 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. In the case of a taxpayer leasing the entire building, an amount is paid for an improvement if the amount paid results in an improvement to the building structure or any designated building system. In the case of a taxpayer leasing a portion of the building, an amount is paid for an improvement if the amount paid results in an improvement to the portion of the building structure subject to the lease or the portion of any designated building system subject to the lease.	Section 1.263(a)-3(d)(1) Section 1.263(a)-3(e)(2)(v) Section 1.263(a)-3(e)(3)(iv)

Concept	Authority
Leased Property other than Buildings: The UOP for leased property (other than a building) is determined under the general rules for non-building property, except that the UOP may not be larger than the property subject to the lease. Accordingly, the functional interdependence test would apply, with the same special rules for plant property and network assets.	Section 1.263(a)-3(f) Section 1.263(a)-3(e)(6), Examples 10-15, 17

II. CHAPTER 2 COMPLIANCE CONSIDERATIONS

A. IMPLEMENTATION OF THE REGULATIONS

(1) The timing of accounting method changes to comply with the final tangible property regulations ("final regulations") will vary depending on the decisions made by each taxpayer. The final regulations generally apply to taxable years beginning on or after January 1, 2014. Alternatively, taxpayers may opt to apply the temporary regulations or certain provisions of the final regulations for taxable years beginning on or after January 1, 2012, and before January 1, 2014. Accordingly, for these taxable years, taxpayers may choose to change certain methods of accounting to use either the temporary regulations or the final regulations, while postponing other method changes under the final regulations. Taxpayers, however, must comply with all aspects of the final regulations no later than their first taxable year beginning on or after January 1, 2014. In many cases, this will require filing Form(s) 3115 to change their methods of accounting for costs addressed under the final regulations. Qualifying small business taxpayers, in their first taxable year that begins on or after January 1, 2014, may make certain tangible property changes without filing a Form 3115. Chapters 16, 17 and 18 discuss accounting method changes in detail.

B. CAPITALIZATION TO REPAIR STUDIES

(1) In anticipation of the final regulations, many taxpayers completed "capitalization to repair" studies and filed accounting method changes to re-characterize previously capitalized costs to deductible repairs. Taxpayers generally made these method changes for years 2006 through 2012. Beginning on or after January 1, 2014, taxpayers are required to comply with the final regulations and are expected to change their accounting methods to implement the final regulations.

(2) The examiner should determine whether a repair study was conducted in a prior year, if Forms 3115 were filed to change the tax treatment of repairs, and the amount of the associated Section 481(a) adjustment(s). Taxpayers that filed a

method change related to repairs following the proposed or temporary regulations will need to make a change to comply with the final regulations. Examiners should consider all prior method changes for repair issues and the related depreciation and dispositions issues. In reviewing a prior method change, the examiner should consider:

- The actual Section 481(a) adjustment, reflected on the tax return may not be the same as the Section 481(a) adjustment reflected on the Form 3115.
- Taxpayers may have based repair studies on proposed regulations making certain assumptions, which frequently led to overly aggressive tax positions.
- The extent of prior repair studies including:
  - Which version of the regulations did the study rely on?
  - Which entities were included in the study?
  - Which tax years were included in the study?
  - What is the impact of the study going forward?
- Prior examination work.
  - Was the exam work completed?
  - Did the LB&I Directive requiring stand down (discussed below) apply?
  - Review Form(s) 5701 and the resolutions of any capitalization issues.
  - Review available examination work papers.

C. STAND DOWN FOR PRE-2014 TAX YEARS

(1) On March 15, 2012, Large Business and International (LB&I) examiners were directed to “stand down” or stop all examination activity for tax positions taken on original tax returns for costs incurred to maintain, replace, or improve tangible property and any correlative issues involving the disposition of those assets as defined in LB&I Directive 04-0312-004. The LB&I Division took this action to conserve exam resources and permit taxpayers time to comply with the final regulations. The 2012 directive was superseded on March 22, 2013, by LB&I Directive 04-0313-001. The 2013 directive provides modified examination instructions for taxable years beginning on or after January 1, 2012, and before January 1, 2014, and restates prior examination instructions for taxable years beginning before January 1, 2012, and on or after January 1, 2014.he stand down period for an item ended when:

(2) A taxpayer filed a method change for an item covered by the directive for a tax year beginning on or after January 1, 2012, but before January 1, 2014, or

- The taxpayer filed its tax return for the first tax year beginning on or after January 1, 2014.

(3) For example, if a taxpayer changed its method of accounting for building UOP in 2012 following the final regulations, the stand down ended with respect to building UOPs when the method change was filed. Stand down continued to apply to plant property until the taxpayer filed a Form 3115 to change its method of accounting for those units, or until the taxpayer filed its first tax return beginning on or after January 1, 2014.

D. STATISTICAL SAMPLING

(1) Rev. Proc. 2015-14, 2015-5 I.R.B. 450, or if applicable, Rev. Proc. 2016-29, 2016-21 I.R.B. 880, Rev. Proc. 2017-30, 2017-18 I.R.B. 1131, Rev. Proc. 2018-31, 2018-22 I.R.B. 637, Rev. Proc. 2019-43, 2019-48 I.R.B. 1107, or Rev. Proc. 2022-14, 2022-7 I.R.B. 502 (the List of Automatic Changes) specifically identifies the accounting method changes for which statistical sampling may be used, and requires that application of statistical sampling must meet the specifications in Rev. Proc. 2011-42, 2011-37 I.R.B. 318. Rev. Proc. 2011-42, 2011-37 I.R.B. 318 provides taxpayers with guidance regarding the use and evaluation of statistical samples and sampling estimates.

(2) The use of statistical sampling is optional, and a taxpayer is free to apply the regulations based on an analysis of 100% of applicable expenditures in any year. However, where allowed and properly applied, statistical sampling may result in reduced burden and better utilization of resources for both the taxpayer and the Service.

(3) Examiners should consider how application of the final regulations might affect the outcome with respect to different types of sample items, requiring different strata or post-sampling allocations. The similarity of items, and proper design of the sample, may have a significant effect on sampling error. For example, a cursory key word search of “project” often will not reveal the full scope of work projects undertaken by a taxpayer. Please discuss with your Computer Audit Specialist (CAS) and have the CAS contact the Statistical Sampling Coordinators for clarification and assistance, if needed.

(4) For method changes where statistical sampling is expressly permitted, taxpayers may decide to apply statistical sampling for each year included in the Section 481(a) adjustment. Generally, taxpayers cannot apply statistical sampling in one year and extrapolate or extend back those results to prior years. Extrapolation methodology is only permitted for taxpayers who are eligible for, and have elected to apply Rev. Proc. 2011-43, 2011-37 I.R.B. 326, for Transmission and Distribution Property, and Rev. Proc. 2013-24, 2013-22 I.R.B. 1142, for Generation Property. Taxpayers electing these procedures must also follow the extrapolation methodologies contained in each procedure.

E. INDUSTRY SPECIFIC GUIDANCE

(1) Regulated industry taxpayers are generally required to follow a uniform system of accounts prescribed by other federal agencies. Examples include the Federal Communications Commission (FCC), the Federal Energy Regulatory Commission (FERC) and the Surface Transportation Board (STB). These taxpayers have historically used conservative capitalization policies for tax as well as book purposes, sometimes capitalizing expenditures that the regulations have treated as repairs. To address this problem, in 2010 LB&I announced its intent to publish guidance on UOPs for these industries through the Industry Issue Resolution (IIR) process. As a result, industry specific projects for several industries address UOPs for network assets and other types of property specifically related to these industries.

E.1. Railroad Industry

(1) Guidance for the Railroad Industry discussed in Rev. Proc. 2001-46, 2001-2 I.R.B. 321, providing a safe harbor method of accounting for Tier I railroads, and in Rev. Proc. 2002-65, 2002-2 I.R.B. 700, providing a safe harbor method of accounting for Tier II and Tier III railroads, both still apply.

(2) LB&I Directive 04-1212-013 provides direction to the field in the examination of railroad industry taxpayers.

E.2. Utilities – Electric Transmission and Distribution Network Assets

(1) Rev. Proc. 2011-43, 2011-37 I.R.B. 326, provides a safe harbor method of accounting that taxpayers may elect to determine whether expenditures to maintain, replace, or improve electric transmission and distribution network assets must be capitalized under Section 263(a). The procedure includes a simplified method of determining the appropriate UOP and capitalization of expenditures for linear electric transmission and distribution property such as towers, poles and conductor wires. For non-linear property, such as substation property or property installed on a customer's premises, a method of determining the appropriate UOPs is provided but taxpayers must follow existing principles under Section 263(a) to determine whether the replacement is deductible or capitalizable. Aggregation rules, special rules for blanket work orders, and per se capital rules apply. An update to this revenue procedure is currently in progress. See also section 3.09 of Rev. Proc. 2015-14, or if applicable, Rev. Proc. 2016-29, Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, or Rev. Proc. 2022-14.

(2) LB&I Directive 04-1111-019 as modified, provides direction to the field in the examination of taxpayers eligible to change their method of accounting for transmission and distribution assets. Subsequently, LB&I Directive 04-0513-003 (superseded) and LB&I Directive 04-0814-006 were issued to modify the planning and examination guidance, extending the time taxpayers have to adopt the safe harbor method of accounting provided in Rev. Proc. 2011-43.

E.3. Utilities – Generation Assets

(1) Rev. Proc. 2013-24, 2013-22 I.R.B. 1142, provides definitions for UOPs and major components taxpayers may use to determine whether expenditures to maintain, replace, or improve steam or electric power generation property must be capitalized under Section 263(a). This revenue procedure also provides procedures for obtaining automatic consent to change to a method of accounting that uses all, or some of, the UOP definitions provided. See also, section 3.20 of Rev. Proc. 2015-14, or if applicable, section 3.10 of Rev. Proc. 2016-29, Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, or Rev. Proc. 2022-14.

(2) LB&I Directive 04-713-005 provides direction to the field in the examination of taxpayers eligible to change their method of accounting for UOPs and major components for generation property.

(3) LB&I Directive 04-315-002 provides instructions to the field on determining whether a major component pertaining to steam or electric generation property is replaced under Section 1.263(a)-3(k). Specifically, this directive provides that a major component is replaced if "substantially all," of the major component is replaced.

E.4. Utilities – Natural Gas Transmission and Distribution Network Assets

(1) Rev. Proc. 2023-15, 2023-18 I.R.B. 806, provides a safe harbor method of accounting that taxpayers may use to determine whether expenses to repair, maintain, replace, or improve natural gas transmission and distribution property must be capitalized as improvements under Section 263(a) of the Internal Revenue Code (Code) or as the costs of property produced by the taxpayer for use in its trade or business under Section 263A, or are allowable as deductions under Section 162. This revenue procedure also provides procedures for taxpayers to obtain automatic consent to change their method of accounting to the safe harbor method of accounting permitted by this revenue procedure.

(2) To apply this national gas safe harbor (NGSH) method, a taxpayer must first classify its natural gas transmission and distribution property as either linear property (for example, pipe, fittings, and valves) or non-linear property (for example, compressors, regulators, and meters). If a taxpayer chooses to use the NGSH Method for its linear property, the taxpayer (1) must use the "safe harbor method for linear property" (as defined under section 4.02 of this revenue procedure) for all of the taxpayer's linear transmission and distribution property and (2) may choose to apply the "safe harbor method for non-linear property" (as defined under section 4.03 of this revenue procedure) for all of the taxpayer's non-linear transmission and distribution property. However, if a taxpayer chooses to use the NGSH Method for its non-linear property, the taxpayer must use (1) the safe harbor method for non-linear property for all of the taxpayer's non-linear transmission and distribution property and (2) the safe

harbor method for linear property for all of the taxpayer's linear transmission and distribution property.

E.5. Telecom – Wireline and Wireless Assets

(1) Rev. Procs. 2011-27, 2011-18 I.R.B. 740, and 2011-28, 2011-18 I.R.B. 743, provide safe harbor methods of accounting that taxpayers may elect to determine whether expenditures to maintain, replace, or improve wire line or wireless network assets must be capitalized under Section 263(a). Section 5 of each procedure provides a "network asset maintenance allowance method" (NAMA) for determining the amount of expenditures required to be capitalized. See also sections 3.07 and 3.08 of Rev. Proc. 2015-14, or if applicable, Rev. Proc. 2016-29, Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, or Rev. Proc. 2022-14.

(2) LB&I Directive 04-1111-021 provides direction to the field in the examination of taxpayers eligible to change their method of accounting for wireless and/or wireline telecommunication assets.

E.6. Telecom – Cable Assets

(1) Rev. Proc. 2015-12, 2015-2 I.R.B. 266, provides an electable safe harbor method of accounting that taxpayers may use to determine whether expenditures to maintain, replace, or improve cable network assets must be capitalized under Section 263(a). Section 5 of the procedure provides a "network asset maintenance allowance method" (NAMA) for determining the amount of expenditures required to be capitalized. Section 6 of the procedures provides a UOP safe harbor method. See also, section 3.21 of Rev. Proc. 2015-14, or if applicable section 3.11 of Rev. Proc. 2016-29, Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, or Rev. Proc. 2022-14.

(2) LB&I Directive 04-0415-003 provides direction to the field in the examination of taxpayers using the safe harbor method of accounting for cable network assets described in Rev. Proc. 2015-12.

E.7. Retail/Restaurant Assets

(1) Rev. Proc. 2015-56, 2015-49 I.R.B. 827, provides a qualified taxpayer engaged in the trade or business of operating a retail establishment or a restaurant as defined in sections 4.01(1)-(3) of the revenue procedure with a safe harbor method of accounting. This safe harbor clarifies whether expenditures paid or incurred to refresh or remodel a qualified building (as defined in section 4.02 of the revenue procedure) are deductible under Section 162(a), must be capitalized as improvements under Section 263(a), or must be capitalized as the costs of property produced by the taxpayer for use in its trade or business under Section 263A. See sections 6.43 and 10.13 of Rev. Proc. 2015-14 or, if applicable, sections 6.20 and 11.10 of Rev. Proc. 2016-29, sections 6.18 and

11.10 of Rev. Proc. 2017-30, or section 11.10 of Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14. Rev. Proc. 2018-31 obsoleted section 6.18 of Rev. Proc. 2017-30, relating to the revocation of the partial disposition election under the remodel-refresh safe harbor described in Rev. Proc. 2015-56.

E.8. Mining – Subsurface, Surface, and Processing Plant Assets

(1) At the request of the Mining Industry, the Service released LB&I Directive 04-0917-004 to clarify the definition of a UOP or major component. A taxpayer may not rely on the UOP definitions provided in this directive for any other purpose of the Code or Regulations, including but not limited to, determining the UOP under other Code sections (for example, Section 263A), or determining the asset for depreciation purposes (including placed in service dates, retirement, disposition, or classification), under I.R.C. Section 168(e) or Rev. Proc. 87-56, 1987-2 C.B. 674, for the same or similar type of assets used in the mining industry.

F. COORDINATION WITH OTHER CODE SECTIONS

(1) Capitalization under Section 263(a) does not change the treatment of any amount that is specifically provided for under any provision of the Code or Regulations other than Section 162(a) or Section 212. This has always been true and continues to be true under the final regulations.

(2) Changes that affect the adjusted basis of property will alter computations made under other Code sections. The examiner will need to consider how these changes affect taxable income, and in some cases the tax computation itself. The intent of this discussion is to alert the reader to the most prevalent areas of concern. The facts and circumstances in each case are relevant in determining which related changes may apply.

F.1. Basis Adjustment Considerations

(1) The implementation of the final regulations may impact the adjusted basis of each asset. The examiner should consider how this, in turn, affects the application of other code sections. This can be difficult in situations where the asset was placed in service many years ago.

(2) Events may have occurred that could alter the adjusted basis of an asset. Examples may include a Section 165 casualty loss and the receipt of any related insurance proceeds, transactions with third parties involving Section 110, 118 or 362, research and development costs under Section 174, the demolition of buildings covered by Section 280B, or the capitalization of self-constructed assets or mixed service costs under Section 263A. Exam adjustments for prior years may also have modified the basis of an asset. The examiner should consider the facts and circumstances in each case to ensure that each asset is properly accounted for.

(3) Examiners will frequently see basis adjustments due to depreciation rules. Examiners should bear in mind that the tax basis used for computing the Section 481(a) adjustment may be affected by additional first year (bonus) depreciation under Section 168(k) or the Section 179 election to expense depreciable assets. Under Section 168(e)(3)(E) (as in effect on the day before the date of enactment of Public Law 115-97, 131 Stat. 2054 (Dec. 22, 2017), commonly referred to as the Tax Cuts and Jobs Act (TCJA)), qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property that were placed in service before January 1, 2018 were classified as 15-year property and, in certain years, qualified for bonus depreciation if all requirements were met. Under current Section 168(e)(3)(E)(vii), qualified improvement property placed in service after December 31, 2017, has a 15-year MACRS GDS recovery period and qualifies for bonus depreciation if all requirements are met.

(4) The following example illustrates the impact a depreciation adjustment could have on asset basis. In 2011, X Corporation purchased and placed in service a minor component part of a UOP used in its trade or business. The total cost of the component was $5,000. The taxpayer identified the component as included in Asset Class 24.1 of Rev. Proc. 87-56, tangible personal property used in the cutting of timber, with a MACRS GDS recovery period of 5 years. X Corporation claimed a 50% bonus depreciation deduction in 2011 under Section 168(k) resulting in a $2500 deduction. In addition, X Corporation began to depreciate the basis of the component, reduced by bonus depreciation, utilizing the MACRS 5-year recovery period and the half-year convention. The following table reflects the bonus depreciation deduction and yearly depreciation deductions through tax year 2013. The following are the steps identified in the flow chart below:

2011				Depreciation		
Property Description	Cost	Bonus Depreciation	Depreciable Basis	2011	2012	2013
Harvester Component	$5000	$2500	$2500	$500	$800	$480

(5) X Corporation filed a Form 3115 for tax year 2014 to change the treatment of the cost of the component from a capital expenditure under Section 263(a) to a deductible repair under Section 162. The negative Section 481(a) adjustment in the year of change is $720, equal to the remaining basis of the component as of the beginning of the year of change, computed as follows: The following are the steps identified in the flow chart below:

Item	Amount
Cost	$5000

Less: Bonus Depreciation	$2500
Less: Otherwise, Allowable Depreciation	$1780
Negative Section 481(a) Adjustment	$720

(1)

(6) Since the analysis of the Section 481(a) adjustment is typically presented in work papers specifically associated with the repair analysis, it is important to confirm that the asset basis is correctly determined. First, it is necessary to ensure that previously claimed bonus depreciation on an item included on the Form 3115 is properly factored into the computation of the Section 481(a) adjustment. Second, it is necessary to ensure that the actual amount of depreciation previously deducted is properly accounted for in the computation of the Section 481(a) adjustment. The fact that taxpayers often consolidate this analysis by grouping assets according to recovery periods is a complicating factor.

(7) For further information regarding the impact of the Section 481(a) adjustments on depreciation or basis calculations, please contact the Deductible & Capital Expenditures Practice Network.

F.2. Domestic Production Activities Deduction Section 199

(1) Section 199, called the domestic production activities deduction (DPAD) provides for a deduction equal to 9% (6% in the case of certain oil and gas activities) of the lesser of the taxpayer's qualified production activities income (QPAI) or the taxpayer's taxable income for the tax year. The DPAD is further limited to 50% of the W-2 wages paid by the taxpayer that were allocable to the generation of domestic production gross receipts. However, the Tax Cuts and Jobs Tax (TCJA) of 2017(P. L. 115-97) repealed the DPAD for tax years beginning after December 31, 2017.

(2) Even though DPAD was repealed, many taxpayers filed amended returns for all open tax years beginning before January 1, 2018. LB&I Directive 04-1118-016 was issued on November 21, 2018, to provide LB&I examiners with guidance when a taxpayer files an amended return or claim for refund relating to IRC Section 199, DPAD.

(3) Regulation Section 1.199-8(g) provides that for purposes of determining QPAI, a Section 481(a) adjustment, whether positive or negative, taken into account by a taxpayer during the taxable year that is solely attributable to either the taxpayer's gross receipts, the cost of goods sold (CGS), or other deductions must be allocated or apportioned between DPGR and non-DPGR for the current taxable year. Each year impacted by an adjustment will need to be re-calculated. A taxpayer-favorable Section 481(a) adjustment could result in a reduction to the permanent Section 199 deduction whereas a taxpayer unfavorable Section 481(a) adjustment may increase the Section 199 deduction. The examiner should adjust this computation as appropriate.

(4) If a Section 481(a) adjustment is spread over more than one taxable year, then a taxpayer must attribute the Section 481(a) adjustment among gross receipts, CGS, or deductions, as applicable, in the same amount for each taxable year within the spread period.

(5) For example, a taxpayer determines that a Section 481(a) adjustment is required to be spread over four taxable years. The taxpayer attributes half of the adjustment to gross receipts and half to deductions. Therefore, the taxpayer must attribute the Section 481(a) adjustment half to gross receipts and half to deductions in each of the four taxable years of the spread period. Further, if such taxpayer uses the simplified deduction method to apportion deductions between DPGR and non-DPGR in the first taxable year of the spread period, then the taxpayer must use the simplified deduction method to apportion half the Section 481(a) adjustment for that taxable year between DPGR and non-DPGR for that taxable year. Similarly, if in the second taxable year of the spread period the taxpayer uses the Section 861 method to apportion and allocate costs between DPGR and non-DPGR, then the taxpayer must use the Section 861 method to allocate and apportion half the Section 481(a) adjustment for that taxable year between DPGR and non-DPGR for that taxable year.

(6) Regulation Section 1.199-8(h) addresses disallowed losses or deductions, and provides, in part, that losses or deductions of a taxpayer that otherwise would be taken into account in computing the taxpayer's Section 199 deduction are taken into account only if and to the extent the deductions are not disallowed by Section 465 or 469, or any other provision of the Code.

(7) For further information regarding the impact of the Section 481(a) adjustments on the Section 199 calculation, please contact the Corporate Income & Loss Practice Network.

F.3. Self-Constructed Property Section 263A

(1) Section 263A applies to real property and tangible personal property produced by a taxpayer for use in its trade or business. Taxpayers subject to Section 263A generally must capitalize all direct costs and certain indirect costs properly allocable to real and tangible personal property produced. Regulation Section 1.263A-1(e)(3)(i) provides that indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production activities. Thus, Section 263A applies to the production of self-constructed assets, including assets produced for the taxpayer under a contract. For example, Section 263A requires a bank to capitalize the direct and allocable indirect costs of constructing a new branch building. Similarly, a manufacturer is required to capitalize the direct and allocable indirect costs of building a new addition to its office building.

(2) Taxpayers that file Forms 3115 to change their method of accounting to comply with the regulations may also be producing property for purposes of Section 263A. For these taxpayers, many of the costs included in a change from capital

expenditure to deduction treatment may also be the indirect costs of producing other property in their trade or business, and therefore may be capitalizable under Section 263A.

(3) To the extent that these costs are deducted in the year(s) under examination, the examiner should ensure that the correct amount is allocated to any property produced by the taxpayer in accordance with Section 263A. The examiner should secure copies of the taxpayer's Section 263A calculations for each period under examination to perform this review.

F.4. Inventory Property Section 263A

(1) Taxpayers subject to Section 263A generally must capitalize all direct costs and certain indirect costs properly allocable to real and tangible personal property produced for sale to its customers. Taxpayers that file Forms 3115 to change their method of accounting to comply with the regulations that are "producers" for purposes of Section 263A, will need to adjust their Section 263A calculation to reflect the Section 481(a) adjustment in the year of change.

(2) The examiner should note that this adjustment will affect the Section 263A costs capitalized as of the beginning of the year of change. For LIFO taxpayers, the adjustment will also affect prior period layers.

(3) Regulation Section 1.263A-7(b)(2)(i) provides special ordering rules applicable to a change in method of accounting when multiple changes in method occur in the year of change.

(4) Regulation Section 1.263A-7(b)(2)(i)(B)(4) provides an exception to the general ordering rules for changes in the case of depreciation if the taxpayer is also changing its method of accounting for Section 263A in the same year. In this case, the Section 481(a) adjustment for depreciation must be made before the adjustment is computed for Section 263A.

(5) For further information regarding the impact of Section 481(a) adjustments on Section 263A calculations, please contact the Inventory & 263A Practice Network.

G. EXAMINATION CONSIDERATIONS

(1) This Chapter addresses general audit procedures examiners should consider in identifying issues related to compliance with the regulations. Each subsequent chapter provides detailed audit procedures specific to the issue area addressed in each chapter.

G.1. Identify Potential Audit Issues

(1) Determine if the taxpayer filed Form(s) 3115 for tax years beginning on or after January 1, 2012, but before January 1, 2014, to comply with the temporary regulations.

(2) Determine if the taxpayer filed Form(s) 3115 for years beginning on or after January 1, 2012, to comply with the final regulations.

(3) Identify each accounting method change, designated change number, and the applicable revenue procedure governing the change.

(4) Determine if a taxpayer should have but did not file Form(s) 3115 to comply with the final regulations and/or the disposition regulations under any of the following:

- Rev. Proc. 2012-19 effective January 1, 2013; modifies Rev. Proc. 2011-14.
- Rev. Proc. 2012-20 effective January 1, 2013; modifies Rev. Proc. 2011-14.
- Rev. Proc. 2014-16 effective January 1, 2014; supersedes Rev. Proc. 2012-19; modifies Rev. Proc. 2011-14.
- Rev. Proc. 2014-17 effective February 28, 2014; supersedes Rev. Proc. 2012-20; modifies Rev. Proc. 2011-14.
- Rev. Proc. 2014-54 effective September 18, 2014; modifies Rev. Proc. 2014-16; modifies Rev. Proc. 2014-17; modifies Rev. Proc. 2011-14.Rev. Proc. 2015-13.
- Rev. Proc. 2015-13 effective January 16, 2015; amplifies, clarifies, modifies, and supersedes in part Rev. Proc. 2011-14.
- Rev. Proc. 2015-14 effective January 16, 2015; amplifies, clarifies, modifies, and supersedes in part Rev. Proc. 2011-14.
- Rev. Proc. 2016-29 effective May 5, 2016; amplifies, modifies, and supersedes in part Rev. Proc. 2015-14.
- Rev. Proc. 2017-30 effective April 19, 2017; amplifies, modifies, and supersedes in part Rev. Proc. 2016-29.
- Rev. Proc. 2018-31 effective May 9, 2018; amplifies, modifies, and supersedes in part Rev. Proc. 2017-30.
- Rev. Proc. 2019-43 effective November 8, 2019; amplifies, modifies, and supersedes in part Rev. Proc. 2018-31.
- Proc. 2022-14, effective January 31, 2022; amplifies, modifies, and supersedes in part Rev. Proc. 2019-43.

(5) If a Form 3115 was not filed, determine if the taxpayer adopted a new/different method of accounting for assets acquired or produced, defining UOPs, improving, maintaining, or repairing assets, disposing of assets, or materials or supplies, for amounts paid or incurred in the year(s) under examination.

(6) Read Annual Reports and Forms 10-K. Identify new facilities, expansions of old facilities, or other changes affecting the acquisition, improvement, or disposition

of fixed assets. Look for any footnotes regarding changes in accounting policy that impact fixed assets including de minimis thresholds.

(7) Consider the tax return. Review Schedule M and consider any book/tax differences for fixed assets, depreciation and materials and supplies.

G.2. Assess Audit Risk

(1) Examiners should consider as part of their Risk Analysis whether a taxpayer has changed or should have changed its method of accounting for tangible property acquired, produced, improved, or disposed.

(2) Consider any examination activity for prior years including:

- The amount of the Section 481(a) adjustment. Consider whether the taxpayer combined and/or netted any Section 481(a) adjustments on Form(s) 3115.
- Determine if a Capitalization to Repair Study was conducted, when it was conducted, and which tax years are impacted.
- Determine which entities the study included.
- Determine the population of assets the study included.
- Identify the UOP as determined by the taxpayer.
- Identify the method used to reclassify costs. Consider whether the taxpayer:
  - Used a database word search analysis.
  - Reviewed project folders.
  - Interviewed employees with knowledge of assets included in the study.
- Determine if a sampling method was used to determine the Section 481(a) adjustment.
  - For statistical samples, how was the population determined?
  - If the taxpayer used another sampling method, what type and why?
- Review the Form(s) 3115 to identify each of the methods changed. Has this been reconciled with final regulations?

(3) Analyze Schedule M adjustments for book to tax depreciation differences.

(4) Review the taxpayer's written policies regarding asset capitalizations. Consider any capitalization threshold statements.

(5) Review the taxpayer's written policies regarding asset dispositions. Consider policy changes for dispositions of property.

(6) How does the taxpayer account for materials and supplies?

(7) Review the current tax return for any new elections involving capitalization.

G.3. Determine Audit Scope and Consider Exam Timeline

(1) Identify types of assets reclassified. Consider Industry specific issues.

- All Industries – buildings and their components, land improvements, de minimis safe harbor, materials, and supplies, UOP definitions, improvements or repairs, dispositions, rental, and leased property.
- Utilities – Transmission and Distribution Assets, Generation Assets, or Gas Pipeline Assets.
- Telecommunications – Wireless Assets, Wireline Assets or Cable Assets.
- Retail – Remodel/Refresh issues.

(2) Consider any prior adjustments that impact basis.

(3) Consider all current/prior cost segregation studies and consider the propriety of the UOP determinations.

(4) Consider any prior closing agreements affecting fixed assets.

(5) Consider the treatment of prior asset dispositions, including the disposal of a component or structural component of a larger UOP.

(6) Consider the use of specialists early in the exam. You may wish to make:

- An Engineering referral or consult to consider issues involving cost segregation, industry specific property, land improvement properties, plant property and other assets.
- A Computer Audit Specialist referral or consult for assistance with a statistical sampling computation.
- A Statistical Sampling Coordinator referral or consultation to review sampling methodologies.

G.4. Consider Tax Treatment of Related Issues

(1) Consider the impact of the Section 481(a) adjustment to related tax computations including:

- Section 199 - Domestic Production Deduction QPAI,
- Section 263A - Inventory Property,
- Section 263A - Self Constructed Property,
- Impact to the AMT or ACE computation,

- Any change to the adjusted basis of the property.

(2) Consider the impact of 100% bonus depreciation for applicable property.

H. INTERVIEW QUESTIONS

(1) The examiner will want to thoroughly understand how the taxpayer has accounted for its fixed assets in the past and any current changes to comply with the final regulations. The examiner should consider the following questions (as applicable) during their interview. The examiner should determine if:

- Prior tax years were examined for issues involving capitalization, depreciation, or dispositions. If so,
  - Was the issue resolved by the Field or by Appeals?
  - Did the prior exam team stand down on the issue?
  - The examiner should request copies of the Revenue Agent Report (RAR) and/or the Appeals Conference Memo (ACM).
- The taxpayer filed claim(s), amended return(s), or made an accounting method change to:
  - Recharacterize previously capitalized assets as repairs.
  - Change the class life of assets using a cost segregation method of accounting.
  - Change the method of accounting for previously disposed assets.
- The taxpayer completed or commissioned a study for repairs or cost segregation. If so:
  - Did the taxpayer implement the study?
  - Which tax years are involved?
  - Did the taxpayer file claims or amend returns?
- Has the taxpayer implemented a portion of the temporary regulations? If so, which sections? Reminder: the temporary regulations are available in years beginning on or after January 1, 2012, but before January 1, 2014.
- Has the taxpayer implemented the final regulations? If so, which section(s)? Reminder: the final regulations are available in years beginning on or after January 1, 2012, but required for years beginning on or after January 1, 2014.
- Has the taxpayer used statistical sampling or some other sampling method for implementation of an accounting method change? If so, is the sampling methodology valid?

- Has the taxpayer changed its written accounting procedures for fixed assets, dispositions, depreciation, materials and supplies, or de minimis UOPs?
    - If so, request written support for all current and past policies.
    - Consider thresholds for the de minimis safe harbor ($500, $2500, or $5000).
- Examiners should review:
    - Copies of the book and tax depreciation and/or fixed asset schedules, for pre- and post-change in accounting method tax periods.
    - Computations for basis changes.
    - Computations for related issues.
- Examiners should contact the Methods of Accounting & Timing Practice Network with questions about accounting method changes.
- Examiners should contact the Deductible & Capital Expenditures Practice Network with questions about the regulations, dispositions, depreciation, basis, repairs, and materials and supplies.
- Examiners should discuss statistical sampling questions with their Computer Audit Specialist and contact the Statistical Sampling Coordinators using the SRS system with any questions.

III. CHAPTER 3 – UNIT OF PROPERTY

A. INTRODUCTION

(1) While not a new concept, the UOP rules are new to Section 1.263(a). In the past, the regulations did not define “property” for purposes of determining whether an amount paid adds value to the property, prolongs the useful life of the property, or adapts the property to a new or different use.

(2) In the early 2000s, the courts acknowledged that to determine whether there had been an improvement, it was first necessary to determine the property that was improved. See, for example:

- *FedEx Corp v. United States*, 291 F. Supp. 2d 699 (W.D. Tenn. 2003), aff’d, 412 F.3d 617 (6th Cir. 2005) concluding that an entire aircraft, and not the aircraft engine, was the appropriate UOP.
- *Smith v. Commissioner*, 300 F.3d 1023 (9th Cir. 2002), concluding that an aluminum reduction cell, rather than the entire cell line, was the appropriate UOP.

- *Ingram Industries, Inc. v. Commissioner*, T.C. Memo 2000-323, concluding that a towboat, and not the towboat engine, was the appropriate UOP.

(3) While these court cases focused on personal property, the final tangible property regulations ("final regulations") define the UOP for most types of property and provide improvement rules (covered in Chapters 6-11). Determining whether there is an improvement to property is a two-step process. First, the UOP is established. Second, the facts and circumstances are considered to determine whether the work constitutes an improvement to that UOP.

B. DETERMINING THE UOP

(1) Taxpayers have been applying Section 263(a) to capitalize and then depreciate tangible property for years. What has changed in this regard? Well, for some types of property, a lot. Under the final regulations, the examiner must consider certain building systems separate from the building structure in determining whether an improvement has occurred to the building. In other cases, not much has changed. For example, a truck, including its components, was generally considered a UOP, and it still is.

(2) This Chapter covers the final regulations' definition of UOP and provides the examiner with audit techniques to consider when examining this issue. Start by considering how to define a UOP. The size of the property is not determinative. For example, a building can be very small (e.g., a tool shed), or very large, (e.g., a fifty-story building). No matter the size, each building and its structural components are a single UOP. Plant property also can be very large or very small, very expensive or relatively cheap. In either case, the determination of the UOP depends on an analysis of the machinery and equipment in the plant. However, neither the size of the equipment nor the cost of the equipment is a factor in determining the UOP.

(3) Functional Interdependence

- Generally, the functional interdependence standard applies to determine the UOP. This standard provides that all the components that are "functionally interdependent" comprise a single UOP. Components are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component. For example, a locomotive is composed of functionally interdependent components. The engine, generators, batteries, and trucks in combination make up the locomotive. These parts are functionally interdependent on each other and comprise a single UOP.
- While the functional interdependence rule works well for determining the UOP for many types of personal and real property, it provides illogical results when applied to certain types of property, such as buildings, plant property and network assets. As a result, the UOP rules apply differently

for these assets. In addition, the UOP rules provide special rules when a component of functionally interdependent UOP is depreciated using a different MACRS class or using a different depreciation method than the depreciation method of the UOP of which the component is a part.

- As a result, the final regulations provide specific rules for determining the UOP for the following types of property:
  - Buildings under Section 1.263(a)-3(e)(2).
    - Condominiums under Section 1.263(a)-3(e)(2)(iii).
    - Cooperatives under Section 1.263(a)-3(e)(2)(iv).
    - Leased buildings or portions of buildings under Section 1.263(a)-3(e)(2)(v).
  - Property other than buildings under Section 1.263(a)-3(e)(3)(i).
    - Plant property under Section 1.263(a)-3(e)(3)(ii).
    - Network assets under Section 1.263(a)-3(e)(3)(ii).
    - Leased non-building property under Section 1.263(a)-3(e)(3)(iv).
  - Improvements to property under Section 1.263(a)-3(e)(4).

(4) This Chapter addresses each type of property separately and provides definitions and examples to assist the examiner in defining the appropriate UOP.

C. BUILDINGS

(1) In the case of a building, each building and its structural components is a single UOP. These units of property are limited to types of properties that fall within the definition of buildings and structural components set out in Section 1.48-1(e). This section of the regulation provides:

(2) The term ‘building’ generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space. The term includes, for example, structures such as apartment houses, factory and office buildings, warehouses, barns, garages, railway or bus stations, and stores... the term “building” does not include such structures as oil and gas storage tanks, grain storage bins, silos, fractionating towers, blast furnaces, basic oxygen furnaces, coke ovens, brick kilns, and coal tipples...

(3) The term ‘structural components’ includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefore such as paneling or tiling, windows and doors, all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts, plumbing and plumbing

fixtures, such as sinks and bathtubs, electric wiring and lighting fixtures, chimneys, stairs, escalators, and elevators, including all components thereof, sprinkler systems, fire escapes, and other components relating to the operation or maintenance of a building."

(4) However, for purposes of applying the improvement rules to a building under the final regulations, an amount is paid for an improvement to a building UOP if it is for a betterment, a restoration, or adaptation to a new or different use of a building structure or any building system. This application of the improvement rules to separate designated parts of the building is different from the UOP rules for other types of property and follows case law where the courts have often treated certain systems of buildings as separate property in analyzing whether amounts paid are for an improvement or a repair.

(5) Building Structure - To determine whether there is an improvement, the improvement analysis is applied to the building structure. The building structure consists of the building and its structural components as defined in Section 1.48-1(e)(1) and (2), but excludes any structural components designated as building systems under the final regulations.

(6) Building Systems - To determine whether there is an improvement, the improvement analysis is also applied to each specified building system. These building systems include:

- Heating, ventilation, and air conditioning (HVAC) systems, includes:
  - The motors, compressors, boilers, furnace, chillers, pipes, ducts, and radiators,
- Plumbing systems, includes:
  - The pipes, drains, valves, sinks, bathtubs, and toilets,
  - Water and sanitary sewer collection equipment,
  - Site utility equipment used to distribute water and waste to, and from the property line and between buildings and other permanent structures,
- Electrical systems, includes:
  - Wiring, outlets, junction boxes, lighting fixtures, connectors,
  - Site utility equipment used to distribute electricity from the property line to and between buildings and other permanent structures,
- All escalators,
- All elevators,
- Fire protection and alarm systems, includes:
  - Sensing devices, computer controls,

- Sprinkler heads and mains,
- Associated piping, plumbing and pumps,
- Visual and audible alarms and control panels,
- Heat and smoke detection devices,
- Fire escapes, fire doors and emergency exit lighting and signage,
- Firefighting equipment, including extinguishers and hoses,

- Security systems for the protection of the building and its occupants, includes:
  - Window and door locks,
  - Security cameras, recorders, monitors, and motion detectors,
  - Security lighting and alarm systems,
  - Entry and access systems,
  - All related junction boxes, associated wiring, and conduit,
- Gas distribution system, includes:
  - Associated pipes and equipment used to distribute gas to and from the property line and between buildings or permanent structures, and
- Other structural components identified in future published guidance.

(7) As an example, if exterior windows were replaced in a building, the examiner would look to the building structure (the building and its structural components, rather than the designated building systems) to determine whether an improvement had occurred. If a lighting fixture were replaced in the lobby, however, the examiner would look to the designated building system (in this case the electrical system) to determine whether the work constitutes an improvement.

(8) Condominiums - For the owner of a condominium unit, the UOP is the individual condominium unit including the structural components that are part of that unit. For application of the improvement rules, an amount is paid to improve the taxpayer's condominium UOP if it is for an improvement to the building structure (as defined above) that is part of the condominium unit or for an improvement to the portion of any building system (as defined above) that is part of the condominium unit.

- As an example, if exterior windows were replaced in the condominium unit, the examiner would look to the individual condominium and its structural components, other than the designated building systems, to determine whether an improvement had occurred. If a lighting fixture were replaced in the kitchen of the condominium unit, however, the examiner

would look to the portion of the building system (in this case the electrical system) that is part of the condominium unit to determine whether the work constitutes an improvement.

- In the case of improvements by the condominium management association, the units of property are determined under the general rules for buildings.

(9) Cooperatives - If a taxpayer has an ownership interest in a cooperative housing corporation, the UOP is the portion of the building, including the structural components, in which the taxpayer has possessory rights.

- For the application of the improvement rules, an amount is paid to improve the taxpayer's cooperative UOP if it is for an improvement to the portion of the building:
  - Structure in which the taxpayer has possessory rights, or
  - System that is part of the building structure subject to the taxpayer's possessory rights
- Similar to the examples above, if a taxpayer replaced an exterior window in the portion of the cooperative in which the taxpayer has possessory rights, the examiner would look to that portion of the cooperative property. However, if a taxpayer replaced a light fixture in that portion of the cooperative, the examiner would look to the electrical system that belongs to that portion of the cooperative property to determine whether the work constitutes an improvement.
- In the case of a cooperative housing corporation, the corporation must apply the improvement rules under the general rules for buildings.

(10) Leased Buildings - 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 UOP ("leased building property") is each building and its structural components or the portion of each building subject to the lease and the structural components associated with the leased portion. In applying the improvement rules to a lessee of an entire building, an amount is paid for an improvement to the leased building property if it is for an improvement (e.g., a betterment, a restoration, etc.) of the building structure or any building system that is part of the leased building. In applying the improvement rules to a lessee of a portion of a building, an amount is paid for an improvement to the leased building property if it is for an improvement to the portion of the building structure subject to the lease or the portion of any designated building system subject to the lease. Where a lessee has made improvements to leased building property that are capitalized under the final regulations, for purposes of applying the improvement rules to the leased property in future taxable years, the lessee's property generally includes these previous lessee improvements.

- In the case of a taxpayer that is a lessor of a building, the UOP and the improvement rules for the building are generally the same as the rules for any property owner. Thus, for the application of the improvement rules to a lessor of an entire building, an amount is paid for an improvement to the building UOP if it is for an improvement (i.e., a betterment, a restoration, or an adaptation) of the building structure or any designated building system. For further information, see Chapter 11, Leased Property.

D. PROPERTY OTHER THAN BUILDINGS

(1) The category of “property other than buildings” covers real and personal property including plant property, network assets, and leased property (other than leased buildings). The functional interdependence standard generally applies to real and personal property and to leased property (other than leased buildings). This standard, however, does not apply to the determination of the UOP in the case of network assets.

(2) The functional interdependence standard is applied at a more granular level to plant property, as described below. Before exploring the plant property rules, the examiner should understand that the UOP used for applying the final regulations is not necessarily the same as the “asset” used for depreciation purposes.

(3) Plant Property - Under the final regulations, plant property is defined as functionally interdependent machinery or equipment (other than a network asset) used to perform an industrial process, such as manufacturing, generation, warehousing, distribution, automated materials handling in service industries, or other similar activities. To determine the UOP, this functionally interdependent machinery or equipment must be further divided into smaller units comprised of each component or each group of components that perform a discrete and major function or operation within the functionally interdependent machinery or equipment.

- Example 1: A manufacturer runs two production lines, each having similar equipment. These lines function independently from one another. The initial UOP is each production line because each runs independently of the other and each is made up of components that are functionally interdependent. Then, to determine the UOP under the plant property UOP rules, the examiner must look at each line to determine which component or group of components performs a discrete and major function within each line. Each of these components will comprise a UOP under the final regulations.
- Example 2: A newspaper publisher runs two printing lines. Each printing line includes various pieces of equipment each with a discrete and major function. One piece of equipment prints the paper; another piece folds the paper; and a third piece bales the finished newspapers in preparation for

shipment. Each of these pieces of equipment – the printer, the folder, and the baler – performs a discrete and major function within the line, so each constitutes a separate UOP.

- Some industrial processes incorporate many separate processes and components, or group of components, that perform discrete and major functions. For instance, in the manufacture of hardwood flooring, a sawmill may be a single UOP under the functional interdependence rule. However, under the plant property rule, the sawmill should be further divided into separate UOPs that perform several discrete and major functions with the functionally interdependent plant property. For example, the logs enter a sawmill, then travel by conveyor through equipment for debarking, a band saw for a first cut, and a gang saw for a second cut. Conveyers then move the logs to the edger, then to a sorter, and finally to the kiln. Each machine and conveyor perform a discrete and major function within the plant and comprises a separate UOP.

(4) Network Assets - 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 owned or leased by taxpayers in each of these 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, nor does it include separate property that is adjacent to, but not part of, a network asset, such as bridges, culverts, or tunnels.

- Network assets are assets unique to specific industries and in most cases, these assets traverse significant distances. For instance, an electric utility industry taxpayer’s own utility poles and electrical lines that run cross-country are network assets. Where does an electrical line begin and end? What is the UOP for purposes of determining an improvement? The final regulations recognize the difficulty defining the UOP in the network asset context and indicate that the UOP for network assets depends on the taxpayer’s particular facts and circumstances. The IRS and Treasury Department have addressed the UOP rules for network assets through the Industry Issue Resolution (IIR) program and through published guidance.
- For network assets where no industry specific guidance is available, the UOP is determined based on the taxpayer’s particular facts and circumstances. Functional interdependence is not determinative when it comes to network assets. In many situations, the UOP for network assets should be smaller than the UOP determined under the functional interdependence test. Examiners are encouraged to discuss the UOP determination for network assets, where industry guidance is in process, or not available, with the Deductible & Capital Expenditures Practice Network.

(5) Leased Non-Building Property - If a taxpayer is a lessee of non-building property, the UOP for the leased property is determined under the general rules for non-building property. The functional interdependence test, the plant property rules, or the network asset rules all apply except that, after applying the applicable rules under those paragraphs, the UOP may not be larger than the property subject to the lease. See also Chapter 11, Leased Property.

E. COST SEGREGATION STUDIES

(1) Taxpayers have used cost segregation studies to determine what constitutes Section 1245 (personal) or Section 1250 (real) property for many years. Historically, these cost segregation studies have resulted in advantageous depreciation deductions for taxpayers. With the issuance of the final regulations, the demand for cost segregation studies is on the rise.

(2) In many cases, taxpayers who previously decided not to conduct cost segregation studies for depreciation purposes are hiring specialists with engineering expertise to determine UOPs for purposes of applying the improvement rules. Even taxpayers that conducted these studies in the past are once again hiring specialty firms or CPAs to take another look at their UOPs and associated costs.

(3) Cost segregation studies now serve additional purposes. For example, not only do these studies reclassify a building's components into assets with shorter class lives, but they also identify building systems for purposes of applying the improvement rules. These studies are also used to identify functionally interdependent plant property and to determine individual components or groups of components that perform a discrete and critical function.

(4) The examiner should request and review all cost segregation (or similar) studies, past and present, and may need to engage the services of an IRS engineer to determine whether the study was conducted properly.

F. IMPROVEMENTS TO PROPERTY

(1) An improvement made to a UOP generally does not constitute a separate UOP, even though the improvements are treated as separate assets for depreciation purposes. For instance, when an addition is made to a building structure, the building structure before the addition is the UOP and the addition is not treated as a new or separate UOP apart from the original building structure. After the improvement is placed in service, the UOP is the entire improved building and its structural components. For purposes of depreciation, however, the addition is treated as an asset that qualifies for depreciation when it is placed in service and is available for use.

G. ADDITIONAL RULES

(1) Initially Placed in Service – Non-Building Property -

- If at the time the property is first placed in service, the taxpayer:

- Has properly treated the component as being within a different MACRS class than the class of the UOP 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 UOP of which the component is a part, then the component must be treated as a separate UOP.

- For example, if a taxpayer acquires a tractor with its tires, and at the time placed in service, taxpayer treats the tractor as 3-year property, but treats the tires as 5-year property, then the taxpayer must treat the tractor and the tires as separate units of property for determining whether there is an improvement under Section 263(a).

(2) Change in MACRS Classification

- If in any taxable year after the UOP is initially placed in service by the taxpayer, a change in the taxpayer's classification of the property for MACRS is made, the second rule for both building and non-building property applies. This rule applies whether the taxpayer or the IRS changes the treatment of that property to a proper MACRS class or a proper depreciation method. The taxpayer must change the UOP determination for that property to be consistent with the change in treatment for depreciation purposes. For example, should a cost segregation study properly re-characterize a portion of a UOP (e.g., from 20-year property to 5-year property), then the reclassified portion of the UOP should be treated as a separate UOP.
- Determining the UOP is the first step in determining whether a UOP is improved. Once a UOP is determined, the examiner can then determine whether the work performed constitutes an improvement to that UOP.

H. AUDIT PROCEDURES

(1) Examiners should consider the following steps when reviewing/examining the UOP issue. The examiner should only request documents that are pertinent to the facts and circumstances in each case.

H.1. Identify Potential Audit Issues

(1) Has the taxpayer determined its UOPs in accordance with the final regulations?

(2) Review Annual Reports and Forms 10-K to identify any:

- New facilities,
- Expansions of old facilities,
- New equipment,

- Self-constructed assets, and
- Acquired tangible property.

(3) Consider the taxpayer's line of business.

- Do the plant property rules apply?
- Are network assets owned?
- Are buildings owned or leased?

H.2. Assess Audit Risk

(1) What effect, if any, have the final regulations had on the taxpayer's definition of units of property?

(2) Review the taxpayer's written policies regarding asset capitalizations and dispositions. Consider any capitalization threshold statements.

(3) Review the Schedule M for book-tax differences for fixed assets owned or leased.

(4) Review the Schedule M for book-tax depreciation differences.

(5) Has the taxpayer filed Form(s) 3115 to change its method of accounting for capitalization or repairs?

- Consider whether the Form 3115 is a change prior to the publication of the final regulations or a change to correct any previous accounting method change(s) to comply with the temporary or final regulations.
- Has the taxpayer previously filed a Form 3115 to change its method of accounting for cost segregation purposes? If so, consider the impact to the units of property definition.
- Determine specifically what accounting method the taxpayer used and what accounting method the taxpayer now uses.
- Consider whether the taxpayer accounted for property previously disposed of as part of any method change. Ensure that the accounting for these units of property follows the final regulations.

(6) Consider any Section 481(a) adjustment and determine the type of property impacted by the change:

- Buildings – including condominiums, cooperatives, or leased building property,
- Property other than buildings – including personal property, non-building real property, or leased non-building property,

- Plant Property,
- Network Assets, or
- Improvements to property – by owner, by lessor, or by lessee.

H.3. Examination Considerations

(1) Consider how the taxpayer accounts for units of property. Determine:

- How additions are tracked,
- How dispositions are accounted for,
- How are improvements determined,
- Is there a method to track repairs?

(2) Has the taxpayer changed the basis of any fixed assets in response to the UOP definition? If so, how is the basis determined?

(3) Are building UOPs defined in terms of building structure and building systems?

- Was a cost segregation study performed? If so, request a copy of the study and consider the need for an engineer.
- How was basis determined? Consider the methodology used, the underlying documentation and the expertise of the preparer.
- Consider any prior cost segregation studies. When were they done, how are they different from the current study (if any)?
- Review the Cost Segregation Audit Technique Guide.

(4) Analyze plant property to determine whether machinery or equipment is functionally interdependent.

(5) Are components (or groups of components) that are plant property defined using the functional interdependence test and then by the discrete and major function test?

(6) Were any changes made to the definition of UOP for personal property? If so, why?

(7) Does the taxpayer own network property? If so, has it considered the UOP definition?

- Consider special UOP rules for network assets.
- Does a Revenue Procedure apply?

- If no guidance exists for the network assets, what method is used to determine the UOP? Is it reasonable based on the facts and circumstances?

(8) Determine if, for any component of a UOP, the MACRS class or the depreciation method has been changed.

- Consider special rules for leasehold improvements, See Chapter 11.

IV. CHAPTER 4 – AMOUNTS PAID TO ACQUIRE OR PRODUCE PROPERTY

A. INTRODUCTION

(1) The final tangible property regulations ("final regulations") include the general requirement to capitalize acquisition and production costs, including amounts paid to defend and perfect title to property, and amounts paid to sell property. These regulations also include rules to determine the extent to which taxpayers are required to capitalize transaction costs and the treatment of these capitalized transaction costs.

B. GENERAL RULES

(1) Under the general rules, capitalization is required for amounts paid to acquire or produce a unit of real or personal property, including leasehold improvements, land and land improvements, buildings, machinery and equipment, and furniture and fixtures. Taxpayers also must capitalize amounts paid to acquire real or personal property for resale. Amounts paid to acquire or produce a unit of real or personal property include the invoice price, "transaction costs" as defined in the final regulations, and costs for work performed before the unit of property ("UOP") is placed in service by the taxpayer. Regulations under Section 263(a) govern the direct and allocable indirect costs that must be capitalized to property the taxpayer produces or to property the taxpayer acquires for resale.[1] The term "unit of property" includes both real and tangible personal property that the taxpayer acquires or produces.

(2) The basis of each acquired or produced UOP must be charged to a capital account, or in the case of property that is inventory in the hands of a taxpayer, taken into account through inclusion in inventory costs. These capitalized costs 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.

(3) Commissions and other transaction costs paid to facilitate the sale of property must also be capitalized. These amounts are not added to the basis of the

[1] Section 1.263(a)-2

property sold or treated as an intangible asset but will reduce the amount realized in the taxable year in which the sale occurs or will be taken into account in the taxable year in which the sale is abandoned if a deduction is permissible.

C. EXCEPTIONS

(1) The final regulations provide exceptions to the requirement to capitalize an acquisition of property. Chapter 10 covers the rules pertaining to the deduction for materials and supplies. Additionally, a taxpayer is not required to capitalize certain expenditures that qualify for deduction under the de minimis safe harbor election. Chapter 5 addresses the de minimis safe harbor election.

(2) Unless otherwise specified, nothing in the final regulations changes the treatment of any amount that is specifically provided for under any provision of the Code or regulations other than Section 162(a) or Section 212 and the regulations thereunder.

D. DEFENSE OR PERFECTION OF TITLE

(1) Amounts paid to defend or perfect title to real or personal property are amounts paid to acquire or produce property and must be capitalized. For example, if a county files an eminent domain complaint condemning a portion of a taxpayer's real property to use as a roadway, payments to an attorney to contest the condemnation must be capitalized because the costs were incurred to defend title to the property. In contrast, amounts paid to preserve business activities, such as attorney fees to contest an ordinance that prohibits the taxpayer's business, are not required to be capitalized.

E. TRANSACTION COSTS

(1) Transaction costs paid or incurred to facilitate the acquisition of tangible real or personal property must be capitalized. An amount facilitates the acquisition of real or personal property if the amount is paid in the process of investigating or otherwise pursuing the acquisition of tangible property. This determination is made based on all of the facts and circumstances.

(2) Amounts paid to facilitate an acquisition include, but are not limited to, inherently facilitative amounts. The final regulations provide a list of costs considered inherently facilitative that must be capitalized. An amount is inherently facilitative if it is paid for:

- Transporting the property (e.g., shipping fees and moving costs).
- Securing an appraisal or determining the value or price of property.
- Negotiating the terms or structure of the acquisition and obtaining tax advice on the acquisition.
- Application fees, bidding costs, or similar expenses.

- Preparing and reviewing the documents that effectuate the acquisition of the property (e.g., preparing the bid, offer, sales contract, or purchase agreement).
- Examining and evaluating the title of property.
- Obtaining regulatory approval of the acquisition or securing permits related to the acquisition, including application fees.
- Conveying property between the parties, including sales and transfer taxes and title registration costs.
- Finders' fees or brokers' commissions, including amounts paid that are contingent on the successful closing of the acquisition of real or personal property.
- Architectural, geological, survey, engineering, environmental, or inspection services pertaining to particular properties.
- Services provided by a qualified intermediary or other facilitator of an exchange under Section 1031.

(3) Inherently facilitative costs are capitalized even if a UOP is not eventually acquired. These costs must be allocated to such property and recovered under the applicable provision of the Code (Section 165, 167 or 168).

(4) Example 1: A taxpayer pays for separate appraisals on two potential building sites. Even though it intends to construct only one building, the costs of both appraisals (inherently facilitative costs) must be capitalized. The appraisal costs for the property the taxpayer acquires are capitalized and added to basis. The appraisal costs for the real property that the taxpayer never acquires are deductible as a loss under Section 165 only when the taxpayer abandons that transaction (assuming all the requirements for deducting a loss under Section 165 are met).

(5) Example 2: A taxpayer pays an engineering firm to perform geological studies to determine if the property is suitable for oil and gas production. Assume the amounts paid qualify as amortizable geological expenditures under Section 167(h). Although the amounts paid are inherently facilitative of the property acquisition, the taxpayer is not required to include these costs in the basis of the property acquired. Under the coordination provisions of this regulation, the taxpayer is required to capitalize the costs separately and amortize as required under Section 167(h), which specifically addresses amortization of geological and geophysical expenditures.

(6) contingency fee is a type of transaction cost, the payment of which is contingent on the successful closing of an acquisition of real or personal property. Contingency fees are always capitalized and must be included in the basis of the property acquired. Unlike other inherently facilitative costs, contingency fees

F. AMOUNTS PAID TO SELL PROPERTY

(1) Taxpayers must capitalize the costs paid to facilitate the sale of property. These costs are not currently deductible under Section 162 or 212. For example, commissions, appraisal fees, legal fees and other transaction costs paid to facilitate the sale of property must be capitalized. The capitalized amounts reduce the amount realized in the taxable year in which the sale occurs or are taken into account in the taxable year in which the sale is abandoned. These costs are not considered “intangible assets” or added to the basis of the property to which they relate.

(2) Example 1: A taxpayer owns land that is not used in a trade or business. In year 1 he incurs appraisal fees and costs associated with advertising the property for sale. He must capitalize these fees until the taxable year in which he sells the property when he can reduce the amount realized from the sale by these capitalized selling costs.

(3) This rule applies to both personal and real property, whether or not the property was used in a trade or business. This rule does not apply; however, to dealers in property.

(4) Example 2: Assume the same facts as in Example 1, except that the taxpayer is a real estate dealer. Because the taxpayer is a dealer in property, the amounts paid to facilitate the sale of the property are deductible as ordinary and necessary business expenses under Section 162.

G. SPECIAL RULES

(1) Acquisition of Real Property

- A special rule applies to the acquisition of real property. An amount paid by the taxpayer in the process of investigating or otherwise pursuing the acquisition of real property does not facilitate the acquisition if it relates to activities performed in the process of determining whether to acquire real property and which real property to acquire. Accordingly, these pre-decisional or investigative costs are deductible when paid or incurred. However, this special rule does not apply if an amount paid is for an inherently facilitative cost specified in the final regulations.
- Example 1: Taxpayer pays a consulting firm to perform market studies and recommend buildings to consider as retail store locations. Because the amounts relate to activities performed in the process of determining whether to acquire real property and which real property to acquire and because the amounts are not inherently facilitative, they are deductible.
- This special rule does not apply to personal property. If a transaction includes both personal and real property, a taxpayer may use a reasonable allocation method to determine which costs facilitate the acquisition of personal property and which costs relate to the acquisition of real property and are subject to the special rule.

- Example 2: Taxpayer pays fees to an interior designer to evaluate and make recommendations regarding which conference table to purchase for use in its business. Even though the amounts paid relate to activities that are pre-decisional investigative costs, they must be capitalized because the acquisition involves personal property.

(2) Employee Compensation and Overhead Costs

- The final regulations also provide a special rule for employee compensation and overhead costs. Amounts paid for employee compensation and overhead do not facilitate the acquisition of real or personal property and are not required to be capitalized. However, a taxpayer may elect to treat either or both types of costs as facilitative and capitalize them accordingly. The election is made by capitalizing the costs on a timely filed (including extensions) federal tax return for the taxable year in which the costs were paid. Once elected, it can only be revoked by filing a request for a private letter ruling and obtaining the Commissioner's consent to revoke the election.

H. AUDIT PROCEDURES

(1) Examiners should consider the following steps when reviewing/examining amounts paid to acquire or produce a UOP. The examiner should only request documents that are pertinent to the facts and circumstances in each case.

H.1 Identify Potential Audit Issues

(1) Review the taxpayer's SEC filings (Forms 10-K, Forms 10-Q, etc.), annual reports, websites, news releases and other public sources to determine if the taxpayer has expanded its operations, opened new facilities, acquired real estate, and/or acquired equipment or plant property.

(2) Review public sources to determine if the taxpayer is involved in lawsuits or other legal proceedings involving its property.

H.2 Assess Audit Risk

(1) Amounts that may be subject to capitalization as amounts paid to acquire or produce property may be recorded in the taxpayer's books in various expense accounts.

(2) As part of the risk assessment, an examiner should focus on accounts that may include the following types of expenditures:

- Legal fees,
- Professional expenses,

- Transaction costs,
- Engineering costs,
- Design costs,
- Accounting Fees,
- Investment Advice/Fees.

(3) Obtain and review the taxpayer's capitalization policy.

(4) Review corporate minutes and annual reports for discussions regarding real or personal property acquisitions (both successful and unsuccessful).

H.3 Examination Considerations

(1) Schedule M Considerations:

- An examiner should review the Schedule M entries to determine whether the taxpayer is deducting amounts for tax that have been capitalized in its books of account. An examiner should focus on items deducted for tax that are recorded in accounts such as legal fees, professional expenses, transaction costs and similar accounts.
- An examiner should request detail for items that are large, unusual, or questionable (LUQ). An examiner should review supporting documentation to determine if the items are properly treated for tax.

(2) Determine impact of other code sections:

- An examiner must keep in mind that the rules of Section 1.263(a)-2 do not change the treatment of any amount if it is addressed in another code section, other than Section 162 or Section 212.
- For example, if a taxpayer is a producer of property or a reseller, the taxpayer must capitalize the direct and allocable indirect costs of property produced and/or acquired for resale in accordance with the rules of Section 263A.
- Likewise, costs that meet the definition of start-up costs under Section 195 are to be treated in accordance with the rules of Section 195.

(3) Consider whether:

- The taxpayer has properly elected the de minimis safe harbor. If the taxpayer has not made the proper election and/or the expenditures are not eligible under the safe harbor, capitalization may be required.

- The expenditures are eligible to be treated as incidental or non-incidental materials and supplies, which may be deducted in accordance with Section 1.162-3.
- The taxpayer deducted abandonment losses under Section 165. If so, request records to establish the contract termination or abandonment.
- Site visits and inspections of property to understand the nature of the costs are in order.

(4) Examples of Documents and Records to consider (if applicable):

- Contracts for real and/or personal property purchases,
- Purchase orders and original invoices,
- Construction project billings,
- Lease agreements,
- Asset acquisition agreements

V. CHAPTER 5 – DE MINIMIS SAFE HARBOR

A. INTRODUCTION

(1) Most businesses as part of their accounting procedures have policies concerning the threshold for capitalizing the costs of nominal value property for financial accounting purposes. Until IRS and Treasury issued the final tangible property regulations ("final regulations"), the regulations did not contain safe harbor rules for deducting de minimis or immaterial costs of property for tax purposes. The Code and regulations generally required capitalization of all amounts paid for tangible property with useful lives that extended beyond the close of the taxable year. Although case law permitted taxpayers to deduct certain immaterial expenses if those deductions resulted in the clear reflection of the taxpayer's income, materiality by itself was not a consideration.

(2) The de minimis safe harbor ("safe harbor") election eliminates the burden of determining whether every small dollar expenditure for the acquisition of property is properly deductible or capitalizable under the more detailed acquisition and improvement rules. This election allows taxpayers to follow financial accounting treatment of these expenditures for tax purposes, provided the amounts deducted under their financial accounting policies adhere to specific dollar limitations. The safe harbor is available to taxpayers in addition to Section 179, the annual expensing election, and Section 168(k) which allows additional first year depreciation.

(3) The final regulations provide one safe harbor limit for taxpayers that have an Applicable Financial Statement ("AFS") and a different safe harbor limit for

taxpayers that do not have an AFS. In both cases, a taxpayer must properly make the election to use the safe harbor for each taxable year.

(4) The safe harbor is not a limitation on the amount taxpayers are permitted to deduct under Section 162. An otherwise deductible amount is still deductible, even if the amount exceeds the safe harbor ceilings. For example, a taxpayer can deduct amounts paid for incidental or non-incidental materials and supplies under Section 1.162-3, repairs and maintenance under Section 1.162-4 or amounts that they can prove clearly reflect income under Section 446.

B. SAFE HARBOR ELECTION

(1) The election generally applies to amounts paid in taxable years beginning on or after January 1, 2014. The final regulations also provide a limited transition rule for taxpayers that have an established method in place for financial or book purposes to elect the safe harbor for amounts paid in taxable years beginning as early as January 1, 2012.

(2) This election is not an accounting method change. A taxpayer elects to apply the safe harbor by attaching a statement to its timely filed original return. Each member of a consolidated group makes its own election. In the case of a partnership or S-Corporation, the entity makes the election, not the partners or shareholders.

(3) The safe harbor is an annual election. A taxpayer may choose to apply the safe harbor in one year, but not in the next. A taxpayer must consistently apply the safe harbor to all amounts paid during an election year for the acquisition or improvement of tangible property, including the acquisition of materials and supplies that also meet the safe harbor requirements. A taxpayer cannot choose to apply the safe harbor to some items and not to others.

(4) Generally, a taxpayer may not file an amended return to either make or revoke the election. However, for tax years 2012 and 2013, special rules applied to taxpayers with established financial accounting policies. These transition rules allowed taxpayers to file an amended return to make the election on or before 180 days from the due date, including extensions, of the taxpayer's Federal income tax return for the applicable taxable year (even though the taxpayer may not have extended the due date of the return).

C. SAFE HARBOR REQUIREMENTS AND LIMITATIONS

(1) In general, the final regulations permit taxpayers who have AFS to treat property the same way for tax as they would for book, provided the cost of the item or invoice does not exceed $5000. For taxpayers without AFS, the cost cannot exceed $2500 per item or invoice.

(2) Increase to $2500 for Taxpayers Without AFS Starting with 2016

- For amounts paid in taxable years beginning on or after January 1, 2014 (or optionally, on or after January 1, 2012), the final regulations provided a

$500 limit for taxpayers that did not have applicable financial statements. In Notice 2015-82, 2015-50 I.R.B. 859, the safe harbor limit was increased to $2500 per item or invoice for qualifying amounts incurred in taxable years beginning on or after January 1, 2016. With regard to audit protection, the Notice further provides:

- For taxable years beginning before January 1, 2016, the Examiner should not raise upon examination the issue of whether a taxpayer without an AFS can utilize the safe harbor for an amount not to exceed $2500 per invoice or item if the taxpayer otherwise satisfied all the other requirements of the final regulations for utilizing the safe harbor.
- If the taxpayer's use of the safe harbor is an issue under consideration in examination, appeals, or before the U.S. Tax Court in a year that begins after December 31, 2011 and ends before January 1, 2016; and that issue relates to the taxpayer's qualification under the safe harbor of an amount that does not exceed $2500 per invoice or item; and the taxpayer otherwise satisfies the requirements of the safe harbor, then the IRS will not further pursue the issue.

(3) Specific Requirements

- The specific requirements for applying the safe harbor are as follows:

(4) De Minimis Safe Harbor for Taxpayers with AFS:

- A taxpayer electing the safe harbor may deduct and may not capitalize or treat as materials or supplies amounts paid to acquire or produce a unit of tangible property, if:
  - The taxpayer has an AFS.
  - The taxpayer has, at the beginning of the taxable year, written accounting procedures treating as an expense for non-tax purposes:
    - Amounts paid for property costing less than a certain dollar amount, or
    - Amounts paid for property with an economic useful life of 12 months or less,
  - The taxpayer treats the amounts paid during the taxable year as an expense on its AFS in accordance with its written accounting procedures, and
  - the amount paid for the property does not exceed $5000 per invoice (or per item substantiated by invoice).

(5) De Minimis Safe Harbor for Taxpayers without AFS:

- A taxpayer electing the safe harbor may deduct and may not capitalize or treat as materials or supplies amounts paid to acquire or produce a unit of tangible property, if:
  - The taxpayer does not have an AFS,
  - The taxpayer has, at the beginning of the taxable year, accounting procedures treating as an expense for non-tax purposes:
    - Amounts paid for property costing less than a certain dollar amount, or
    - Amounts paid for property with an economic useful life of 12 months or less,
  - The taxpayer treats the amounts paid for the property as an expense on its books and records in accordance with its accounting procedures, and
  - The amount paid for the property does not exceed $2500 per invoice (or per item substantiated by invoice).

D. APPLICABLE FINANCIAL STATEMENTS

(1) The final regulations permit taxpayers who have AFS to treat property the same way for tax as they would for book provided the cost does not exceed $5000. For taxpayers without AFS, the cost cannot exceed $2500. Applicable financial statements in descending priority order include:

- A financial statement required to be filed with the Securities and Exchange Commission (SEC) which includes a Form 10-K or Annual Statement to Shareholders,
- A certified audited financial statement that is accompanied by the report of an independent certified public accountant (or a similar foreign professional) that is used for:
  - Credit purposes,
  - Reporting to shareholders, or
  - Any other substantial non-tax purpose, or
- A financial statement, other than a tax return that is required to be provided to the federal or state government or any federal or state agency, other than to the IRS or the SEC.

(2) A larger safe harbor limitation is reasonable for a taxpayer with an AFS because an AFS provides independent assurance that the taxpayer's de

minimis policies are consistent with the requirement of generally accepted accounting principles and do not materially distort the taxpayer's financial statement income. Financial statements, other than those included in the final regulations such as reviewed financial statements, do not qualify as AFS. If a taxpayer has AFS that conflict, the examiner should rely on the statement with the highest priority. For example, if the Form 10-K and a financial statement provided to the Surface Transportation Board contain different de minimis thresholds, the examiner should look first to accounting policies used on the Form 10-K.

E. ACCOUNTING POLICY

(1) A taxpayer can generally rely on its financial accounting procedures in place at the beginning of a taxable year that provides a de minimis expense policy for financial or book accounting. A taxpayer is required to follow its limitations for book purposes in accordance with its accounting procedures. In addition, taxpayers that have AFS are required to put their accounting procedures in writing and to follow the procedures of their AFS.

(2) The accounting policy may be either a set dollar amount per item or, a policy that expenses amounts paid for property with an economic useful life of 12 months or less. For safe harbor purposes, either or both accounting procedure(s) is permissible. However, under either book policy, if the cost of a UOP (determined on either an invoice basis or an item basis) exceeds the safe harbor limit of $5000 for taxpayers with AFS or $2500 without, the amount paid for the property will not fall within the safe harbor for tax purposes.

(3) For example, a taxpayer that does not have AFS elects the safe harbor. It has an accounting policy in place at the beginning of the 2016 tax year, to expense amounts paid for property costing $1000 or less and to expense amounts paid for property with an economic useful life of 12 months or less. The taxpayer follows these policies for book purposes. During the tax year, it purchases 10 computers costing $1000 each, and expects to replace these computers every 2 years. It also purchases 10 computers costing $2500 each and 10 computers costing $3000 each planning to replace each of these annually.

(4) For tax purposes:

- The $1000 computers meet the taxpayer's book policy and dollar threshold. Since the cost does not exceed the $2500 limit for a taxpayer without AFS, the computers qualify for the safe harbor dollar threshold.
- The $2500 computers exceed the book policy dollar threshold, but because they will be replaced within 12 months, they meet the taxpayer's 12-month threshold for book purposes. Because the taxpayer had accounting procedures to deduct property with a useful life of 12 months or less, and the cost per item does not exceed the $2500 safe harbor limitation, the amounts paid for these computers qualify for the safe harbor.

- The $3000 computers meet the taxpayer's 12-month book policy. However, even though the economic useful life of the computers is 12 months or less, the amount paid for each computer exceeds the $2500 limit for purposes of the safe harbor and therefore is not deductible under the safe harbor.

(5) Amounts that do not qualify for the safe harbor might still be deductible under another provision of the final regulations. For example, the $3000 computers in the prior example may qualify as materials or supplies. See Chapter 10.

(6) The $2500/$5000 limit operates as a "cliff." Taxpayers cannot deduct a portion of an item up to this limitation amount. In other words, a taxpayer cannot deduct $2500 of an item costing $3000. This entire item does not qualify for the safe harbor.

(7) As an administrative matter, examiners may determine that a review of property expensed under the safe harbor is not warranted based on risk analysis thresholds. It is not intended that examining agents must revise their materiality thresholds in accordance with the de minimis safe harbor limitations. If an examiner and a taxpayer agree that certain amounts in excess of the safe harbor ceiling are immaterial for examination risk analysis and should not be subject to review, that agreement should be respected, notwithstanding the requirements of the safe harbor.

(8) Examiners should not negotiate with taxpayers to set de minimis thresholds beyond the safe harbor limits. A taxpayer that seeks a deduction for amounts above the amount allowed by the safe harbor or by agreement with IRS examining agents will have the burden of showing that such treatment clearly reflects income.

F. ADDITIONAL RULES

(1) Transaction Costs

- In determining whether tangible property costs qualify for the safe harbor, taxpayers must also allocate "additional costs" that are included in the same invoice as the tangible property. For these purposes, additional costs consist of the costs that facilitate the acquisition or production of the tangible property and the costs of work performed prior to the date the tangible property is placed in service. These costs include delivery fees, installation costs and similar related service costs. A reasonable allocation method is required, such as specific identification, pro rata allocation, or weighted average (based on cost). For example, a taxpayer that otherwise qualifies for the safe harbor purchases five UOPs with an invoice price of $5000 per unit. The invoice also includes delivery charges of $125 for the five units. It would be reasonable in this case to allocate $25 in delivery charges to each of the units bringing the amount paid to $5025 per unit for

purposes of the safe harbor limit. In this case, the UOP exceeds the safe harbor limit because the cost per unit exceeds $5000.

- In situations where multiple units of property are acquired with variable purchase prices, a pro-rata allocation would be reasonable. In some situations, transaction costs, such as set-up charges, might apply to certain UOP but not to others. For example, set-up fees may apply to the set up and assembly of systems furniture, but not to chairs billed on the same invoice.
- Separately invoiced additional costs are not required to be included as costs of acquiring or producing tangible property for purposes of determining whether the safe harbor applies. For example, a taxpayer purchases office furniture from Company A. Company B delivers and sets up the furniture. Company A and Company B each invoice the taxpayer separately. In this case, the taxpayer is not required to add the separately invoiced transaction costs to the cost of the furniture. Examiners should be alert to cases where the anti-abuse rule, discussed below in section H., may apply.

(2) Materials and Supplies

- Taxpayers that elect the safe harbor must apply the safe harbor rules to all property that meets the safe harbor requirements, including items that would otherwise be considered materials and supplies under Section 1.162-3. An amount that qualifies under the safe harbor election is not capitalized, or treated as a material or supply, but is treated as business expenses under Section 1.162-1 when the amount is paid or incurred.

(3) Sale or Disposition of Property

- Safe harbor property is not treated as a capital asset under Section 1221, or as property used in a trade or business under Section 1231, when it is sold or otherwise disposed of. Units of property or materials and supplies currently deducted under the safe harbor do not have a remaining tax basis. The taxpayer cannot claim a loss on property when it is later sold or otherwise disposed of if the cost of the property was deducted under the safe harbor. Any proceeds from the sale or disposition result in ordinary income.

(4) Rules for Members of Consolidated Groups

- If the taxpayer is a member of a consolidated group, it may use the written accounting procedures provided for the group and rely on the group's AFS.

(5) Coordination with Section 263A

- The safe harbor applies to the costs of acquiring, producing, or improving tangible property under Section 263(a) or to the costs of acquiring or producing materials and supplies defined under Section 1.162-3. However, amounts paid to acquire or produce tangible property that are eligible for the safe harbor may be subject to capitalization under Section 263A. This includes amounts that comprise the allocable indirect costs of other property produced by the taxpayer, such as if a taxpayer acquires property that it uses or reasonably expects to use in the production of inventory at some future date. For example, if a taxpayer acquires jigs, dyes, or molds that are eligible for the safe harbor, and the taxpayer uses or reasonably expects to use this property in the production of inventory, the cost of those jigs, dies, or molds may be subject to capitalization under Section 263A as an indirect cost of inventory produced by the taxpayer.

G. EXCEPTIONS TO THE SAFE HARBOR

(1) The safe harbor also excludes amounts paid for land, amounts paid for rotable, temporary, and standby emergency spare parts that the taxpayer elects to capitalize and depreciate under Section 1.162-3(d), and amounts paid for rotable and temporary spare parts accounted for under the optional method of accounting for rotables under Section 1.162-3(e).

H. ANTI-ABUSE RULE

(1) Taxpayers may not manipulate transactions with the intent to achieve a tax benefit under the safe harbor. For example, if a taxpayer attempts to componentize property that would generally be accounted for as a single UOP into smaller units of tangible property or asks a third party to bill transaction costs on separate invoices to qualify for the safe harbor, the amounts will be adjusted accordingly. Examiners should consider this rule and apply any appropriate adjustments and penalties.

I. AUDIT PROCEDURES

(1) Examiners should consider the following steps when reviewing/examining the safe harbor. The examiner should only request documents that are pertinent to the facts and circumstances in each case.

I.1. Identify Potential Audit Issues

(1) Has the taxpayer attached an election to its timely filed federal income tax return? If so, determine which entities elected the safe harbor.

(2) For tax years beginning in 2012 or 2013, determine if the taxpayer made an election for the safe harbor according to the special transition rules.

(3) Determine if the taxpayer had an AFS during the years at issue.

(4) If the taxpayer did not have an AFS:

- Review the taxpayer's accounting procedures to identify capitalization policies and any de minimis thresholds the company uses for book purposes.
- For taxable years beginning before January 1, 2016, the examiner should not raise upon examination the issue of whether a taxpayer without an AFS can utilize the safe harbor for an amount not to exceed $2500 per invoice or item if the taxpayer otherwise satisfied all the other requirements of the final regulations for utilizing the safe harbor.
- If the taxpayer used the safe harbor and the safe harbor is an issue under consideration in examination, appeals, or before the U.S. Tax Court in a year that begins after December 31, 2011 and ends before January 1, 2016; and that issue relates to the taxpayer's qualification under the safe harbor of an amount that does not exceed $2500 per invoice or item; and the taxpayer otherwise satisfies the requirements of the safe harbor, then the IRS will not further pursue the issue.

(5) If the taxpayer did have an AFS:

- Review Annual Reports and Forms 10-K to identify capitalization policies and any de minimis thresholds the company uses for book and financial reporting purposes.
- Consider other financial statements the company files such as reports.
  - For credit purposes,
  - To shareholders or partners, or
  - For other substantial non-tax purposes, or
  - To federal or state agencies other than the IRS or SEC.

I.2. Assess Audit Risk

(1) What effect, if any, do the final regulations have on the taxpayer's definition of de minimis expense?

(2) Review the taxpayer's written accounting procedures identifying de minimis amounts for book and financial purposes.

- Is the policy in writing?
- Is the policy in effect at the beginning of the tax year?

- Has the policy changed to comply with the final regulations or Notice 2015-82 (increasing the safe harbor limit from $500 to $2500) for non-AFS taxpayers?
- Has the taxpayer established a dollar threshold for expensing for book or financial purposes?
- Has the taxpayer established an economic useful life of 12 months or less for book or financial purposes?
- Does the taxpayer follow the policy established for book or financial purposes?
- Does the policy differ for financial statement purposes? If so, determine the policy used for the financial statement with the highest priority.

(3) Determine whether the taxpayer reports a Schedule M for de minimis book tax differences.

I.3. Examination Considerations

(1) Determine that the cost of tangible property items deducted as de minimis is not also deducted under Section 179 and Section 168(k).

(2) Determine that the cost of tangible property items that qualify for, and is deducted under, the safe harbor is not also capitalized as acquired or produced tangible property, materials, or supplies, or as an improvement.

(3) Determine if amounts paid to acquire or produce units of tangible property, amounts paid to repair, maintain, or improve units of tangible property, or amounts paid for materials and supplies qualify for the safe harbor.

(4) Determine that the taxpayer consistently applied the safe harbor to all amounts paid in the taxable year, including all units of tangible property acquired or produced, tangible property used to repair, maintain, or improve units of tangible property, and all eligible materials or supplies.

(5) Determine that the taxpayer properly capitalized and depreciated, or treated as materials and supplies, amounts paid for items that do not qualify for the safe harbor.

(6) Ensure that the costs of property deducted under the safe harbor did not exceed the limitation of $2500 or $5000 per invoice (or per item as substantiated by invoice).

(7) Ensure that transaction costs included in the invoice are properly allocated to each item listed in the invoice.

(8) Ensure that amounts paid for property and deducted under the safe harbor were neither direct or allocable indirect costs of property produced by the

taxpayer, nor property acquired for resale subject to capitalization under Section 263A.

(9) Ensure that amounts paid for land, or for rotable, temporary, or standby emergency spare parts that are capitalized and depreciated or are accounted for under the optional method for rotable spare parts, are not deducted under the safe harbor.

(10) Ensure that amounts deducted under the safe harbor were not included in the basis of property sold or otherwise disposed of.

(11) If amounts do not qualify for the safe harbor, determine whether the amounts are deductible as repairs and maintenance under Section 1.162-4, or materials and supplies under Section 1.162-3. See chapters 6 through 10.

(12) Consider whether the anti-abuse rule applies and if so, consider adjustment and penalties.

(13) If the taxpayer provides supporting documentation/proof, consider whether taxpayer's deduction or de minimis policy for items that cost more than the safe harbor limit clearly reflects the taxpayer's income.

VI. CHAPTER 6 – IMPROVEMENT RULES – BETTERMENTS

A. IMPROVEMENTS IN GENERAL

(1) Under the final tangible property regulations ("final regulations"), the determination of whether a unit of property ("UOP") is improved or whether amounts paid are for the repair of a UOP begins with the identification of the UOP. After the UOP is determined, the second step is to determine whether the expenditure is for an improvement to the UOP or is deductible as a repair, maintenance, or some other business expense.

(2) Unless a taxpayer qualifies for a safe harbor, amounts paid to improve a UOP must be capitalized. A UOP is improved if the amounts paid for activities performed after the property is placed in service by the taxpayer are for a betterment to the UOP, to restore the UOP, or to adapt the UOP to a new or different use. These three improvement rules are comprised of ten specific "tests" for identifying improvements.

(3) Each test must be considered separately and apart from the others. If any one of the ten tests applies to a given set of facts and circumstances, amounts paid result in an improvement to the UOP under Section 263(a), unless a particular exception or safe harbor applies. Generally, a taxpayer must also capitalize all the direct costs and allocable indirect costs that directly benefit the improvement or are incurred by reason of the improvement. See also Section 263A.

(4) Each of these ten tests is rooted in case law or other legal precedent. This Chapter addresses the particular tests to determine whether an expenditure is

for a betterment to a UOP. This Chapter provides audit techniques for examiners to consider in determining whether a betterment, and therefore, an improvement has occurred. Chapters 7 and 8 discuss the tests for restoration and adaptation to a new or different use. Chapter 9 addresses the safe harbor provisions. Chapter 11 covers special rules that apply for improvements made to leased property. Examiners must consider the rules in each of these chapters when determining whether amounts paid result in an improvement to a UOP.

B. BETTERMENTS

(1) Section 263(a)(1) provides that no deduction shall be allowed for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

(2) The final regulations contain a “betterment" standard which reflects the way Section 263(a) has been interpreted and applied under current law. The betterment tests do not measure an increase in value in terms of monetary worth. A material increases in fair market value, insured value, residual value, property value, business enterprise value, or going concern value is not pre-requisite to any of the betterment tests. Instead, the measure of betterment depends entirely on the nature of the expenditure and the effect the expenditure has on the UOP. For example, if an amount is paid to materially increase the strength of a building structure or to materially increase the efficiency of any one of the building systems, the expenditure generally results in a betterment and an improvement to the building UOP.

(3) An amount paid results in a betterment to a UOP if it satisfies any one of the following three tests:

- Ameliorates a material condition or defect that either existed prior to the taxpayer’s acquisition of the UOP or arose during its production, whether or not the taxpayer was aware of the condition or defect at the time of acquisition or production,
- Is for a material addition to the UOP, including a physical enlargement, expansion, extension, or addition of a major component or a material increase in its capacity, including additional cubic or linear space, or
- Is reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the UOP.

(4) Ameliorate a Material Condition or Defect Test

- Under the final regulations, the taxpayer must capitalize an amount paid to ameliorate a material condition or defect existing prior to the acquisition of a UOP or arising during the production of the UOP. In Stoeltzing v. Commissioner, 266 F.2d 374 (3rd Cir. 1959), the Appeals Court affirmed that in substance, the work performed by the taxpayer was to put its recently purchased building into a tenantable condition, and the costs

were required to be capitalized. When a taxpayer acquires a UOP, for example a building, examiners should carefully consider whether after the acquisition, the taxpayer renovated the building or remediated pre-existing defects. Work that ameliorates a material condition or defect that existed when the UOP was acquired results in a betterment. The analysis requires that all the facts and circumstances be taken into account. For example, consider if the taxpayer has contracted with an architect, or if the taxpayer has drawn plans to remediate any defects, even if work is put off until a later date. A delay in the project does not affect the determination as to whether the work ameliorates a material condition or defect that existed when the UOP was acquired. Further, whether or not the taxpayer is aware of any underlying conditions or defects at the time of the acquisition of the UOP does not affect the application of this betterment test.

(5) Material Addition/Increase in Capacity Test

- Capitalization is required when a material addition is made to a UOP, including a physical enlargement, an expansion, extension, or an addition of a major component. See Hotel Sulgrave, Inc. v. Commissioner, 21 T.C. 619 (1954), where the Tax Court found that an expenditure for a new fire sprinkler system to comply with a city order was a betterment because it was a permanent addition that gave the apartment building additional protection from fire.
- The final regulations also state that an amount is paid for a betterment if it is for a material increase in the capacity, including additional cubic or linear space of the UOP. An increase in capacity also is rooted in case law. See for example, Mennuto v Commissioner, 56 T.C. 910 (1971), where the Tax Court required the taxpayer to capitalize the cost of replacing 1½-inch piping, used to supply a factory with water, with 2-inch piping because the new piping was more efficient and increased the factory's water supply. Similarly, in Scovill Manufacturing Co. v. Commissioner, 25 B.T.A. 265 (1932), work on a dam was not for repairs, but instead increased the capacity of a reservoir resulting in an improvement to the UOP.
- The final regulations contain similar examples of material increase in capacity. For example, a betterment results where a taxpayer adds a stairway and a mezzanine to a retail building to increase its selling space. As required by the final regulations, the facts and circumstances in each case are determinative. The final regulations provide many examples that explore whether, based on the facts and circumstances, a material increase in capacity results.

(6) Material Increase in Productivity, Efficiency, Strength, Quality or Output Test

- The third test of the betterment rules lists additional factors that require capitalization of costs. The facts and circumstances must always be considered in the evaluation of whether there was a material increase in the productivity, efficiency, strength, quality, or output of the UOP. As stated in American Bemberg Corp. v. Commissioner, 10 T.C. 361, 376 (1948), aff'd, 177 F2d 200 (6th Cir. 1949), "it is appropriate to consider the purpose, the physical nature and the effect of the work for which the expenditures were made."
- The final regulations provide examples to assist in the determination of whether there is a material increase in the productivity, efficiency, strength, quality, or output of the UOP based on the facts provided. The examples include the treatment of a retail building refresh, a building refresh with limited improvement, and a building remodel. The regulations also provide examples of activities that result in an increase in efficiency and activities that do not result in a material increase in efficiency. The result in each case is fact-dependent. The examiner needs to consider the purpose of the expenditure, the physical nature of the work performed, and the physical effect of the work on the UOP when determining whether a betterment has occurred.

C. APPLICATION OF THE BETTERMENT RULES

(1) In applying the betterment factors, an examiner should first determine the UOP and then consider the nature of work. If a quantitative or qualitative factor cannot be measured in terms of a particular UOP, then that factor should be disregarded. For example, assume that the owner of an office building removes the drop ceiling on the first floor to expose the windows. The effect of removing the drop ceiling on the productivity and output of the building structure could not be measured in this context, and these factors would generally not be considered in determining whether there was a betterment to the building UOP.

(2) When applying the betterment rules to buildings, the examiner should consider whether the amount is paid to improve the building structure or any of the building systems, as designated in Section 1.263(a)-3(e) of the final regulations. For example, while the replacement of a roof membrane with a comparable new roof membrane is generally not a material betterment of the building structure, the replacement of a roof membrane with a new membrane made of materials designed to materially increase the strength and efficiency of the roof would result in a betterment to the entire building structure.

(3) Appropriate Comparison

- Generally, in determining whether an expenditure is for the betterment of a UOP, the determination is made by comparing the condition of the property immediately after the expenditure to the condition of the property immediately prior to the circumstances necessitating the expenditure.

- For expenditures that are made to correct the effects of normal wear and tear, the condition of the property immediately after the expenditure is compared to the condition of the property after the last time the taxpayer corrected the effects of normal wear and tear. Where the taxpayer has never corrected the effect of normal wear and tear since initially placing the UOP in service, the condition of the property immediately after the expenditure is compared to the condition of the property when the property was initially placed in service by the taxpayer. Where the taxpayer recently acquired a UOP and within a short period of time ameliorates a pre-existing material condition or defect of the UOP, the expenditure does not constitute normal wear and tear. Instead, these costs are required to be capitalized whether the taxpayer was aware of the pre-existing condition when it acquired the UOP or not.
- For a taxpayer's expenditures to correct damage to a UOP that occurred during the taxpayer's use of the UOP, the condition of the property immediately after the expenditure is compared to the condition of the property immediately prior to the damage.
- Typically, a taxpayer's expenditures would not be for a betterment if the taxpayer uses the property in its trade and business operations and incurs costs to keep the property operational in that trade or business or to return the property to its normal operating condition after the property was damaged in its normal operations.

(4) Replacement Parts

- Frequently, repairs are made to a UOP using replacement parts that are identical to the parts that they replace. As time passes, however, those parts may no longer be available, and the parts can only be replaced with parts that, when compared to the original part, are either technologically more advanced or enhanced in some other way. Examiners should note that replacing a part with an improved but comparable part does not by itself result in a betterment to the UOP. Consideration must be given to the underlying reason for the replacement. Was the part broken and in need of replacement? Were replacement parts of the same quality available? Or is the availability of replacement parts limited to parts that are technologically better than the original parts? The replacement might not result in an improvement to the UOP if similar replacement parts are unavailable, for example, because of technological advancements and product enhancements in the industry. The taxpayer cannot reasonably be expected to replace the part if it is no longer available; instead, it can use an improved but comparable, replacement part. However, if the underlying reason for replacing the part is to materially increase the capacity, productivity, efficiency, strength, quality, or output of the UOP, the replacement would most likely result in an improvement to the UOP.

(5) Application of the Safe Harbor for Routine Maintenance

- An amount paid for a betterment to a UOP does not qualify for the routine maintenance safe harbor.

(6) Relocation, Moving, and Reinstallation Costs

- Generally, a taxpayer is not required to capitalize the costs of moving tangible personal property that is already in service from one location to another. Relocation and reinstallation of personal property is not usually a betterment when, both before and after the move, the UOP is used for the same purpose and in the same manner and no improvement to the unit has occurred. Chapter 9 addresses the treatment of removal costs.
- If the reason for moving tangible personal property from one location to another is to materially increase the capacity, productivity, efficiency, strength, quality, or output of the UOP, the direct costs of the improvement must be capitalized, including the reinstallation costs. The taxpayer must also capitalize the indirect costs such as disassembly and moving costs because these costs directly benefit and are incurred by reason of the improvement. The final regulations address relocation, moving, and reinstallation costs in the examples provided under the betterment rules.

(7) Regulatory Requirement

- The final regulations provide that a Federal, state, or local regulator's requirement that a taxpayer make certain repairs to continue operating the property is not relevant in determining whether the amount paid improves the UOP.
- On occasion, taxpayers are compelled to make changes to their fixed assets to comply with federal, state, or municipal ordinances. As provided above, the fact that they are required to make the change is not controlling in determining if a betterment has occurred. Instead, the facts and circumstances in each case are determinative. As an example, in Swig Investment Co. v. United States, 98 F.3d 1359 (Fed. Cir. 1996), a city ordinance compelled the taxpayer to bring the parapets and cornices of its hotel building into compliance. Nevertheless, because the changes materially increased the structural soundness of the hotel, they were an improvement to the UOP and were required to be capitalized.

D. AUDIT PROCEDURES

(1) Examiners should consider the following steps when reviewing/examining an improvement issue. The examiner should only request documents that are pertinent to the facts and circumstances in each case.

D.1. Identify Potential Audit Issues

(2) Has the taxpayer determined improvements in accordance with the final regulations?

(3) Review Annual Reports and Forms 10-K to identify any.

- New facilities,
- Expansion of old facilities,
- New equipment,
- Self-constructed property, and
- Acquired tangible property.

(4) Consider the taxpayer's line of business.

- How frequently are buildings refreshed or remodeled?
- How frequently is plant property repaired or improved?
- How frequently is personal property repaired or improved?
- Is the taxpayer a lessor of property?
- Is the taxpayer a lessee of property?
- Was plant property or equipment moved and reinstalled, and for what purposes?

D.2. Assess Audit Risk

(1) What impact, if any, have the final regulations had on the taxpayer's definition of improved property?

(2) Review taxpayer's written policies regarding asset capitalizations. Consider any capitalization threshold statements.

(3) Review the Schedule M for book/tax differences for repairs to fixed assets owned or leased.

(4) Review the Schedule M for book/tax depreciation differences due to improvements made to assets during the tax year.

(5) Has the taxpayer filed Form(s) 3115 to change its method of accounting for capitalization or repairs?

- Consider whether the Form 3115 is the initial change or a change to "true up" or reverse any previous accounting method change(s).

- Determine specifically what accounting method the taxpayer is following for capitalization of improvements to its property.
- Consider whether the taxpayer accounted for property previously disposed as part of any method change. Ensure that the taxpayer took the improvement rules into account as a result of the disposition.

(6) Consider any Section 481(a) adjustment involving the definition of UOP and determine if the property was improved under the betterments test. Was an amount paid that:

- Ameliorates a material condition or defect of a UOP,
- Is for a material addition, physical enlargement, expansion, extension of a UOP,
- Is for a material increase in the capacity of a UOP, or
- Is reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the UOP?

D.3. Examination Considerations

(1) Consider how the taxpayer accounts for repairs to fixed assets.

- Has the definition of a repair changed in the last 10 years?
- Did the taxpayer rely on the proposed regulations?
- Did the taxpayer follow the definition in the final regulations?

(2) Is the taxpayer using the safe harbor for routine maintenance for recurring activities to keep the UOP in ordinarily efficient operating condition?

(3) Does the taxpayer qualify for the safe harbor for small taxpayers?

(4) Do special rules or elections apply?

(5) Does the taxpayer own network property?

- Consider special rules for network assets.
- Does a safe harbor Revenue Procedure apply? See Chapter 3.
- If no guidance exists for the network assets, how were improvements determined? Is it reasonable, based on the facts and circumstances?

(6) Consider the taxpayer's written policy for determining whether amounts paid result in an improvement or a repair.

(7) Does the taxpayer maintain a work order system for all capital expenditures and major repair jobs tracking all project costs?

(8) Review the repair and maintenance accounts for the period under exam to determine that capital additions are not included.

(9) Review fixed asset studies conducted by or on behalf of the taxpayer.

- Consider whether the study conforms to the final regulations UOP and improvement rules.
- Ensure that project requests, purchase orders, invoices, and related documents were reviewed as part of the study.
- Determine that the UOP and improvement rules are properly applied.
  - Consider quantitative and qualitative factors, and the availability of replacement parts.
  - Determine whether the expenditure was necessitated by normal wear and tear, or damage to the UOP, and the appropriate comparison before and after the expenditure is made for determining betterments, or
  - Whether the intent of the work was to improve the UOP and one of the betterment tests apply.

VII. CHAPTER 7 – IMPROVEMENT RULES – RESTORATIONS

A. IMPROVEMENTS IN GENERAL

(1) Under the final tangible property regulations (“final regulations”), the determination of whether a unit of property (“UOP”) is improved or whether amounts paid are for the repair of a UOP begins with the identification of the UOP. After the UOP is determined, the second step is to determine whether the expenditure is for an improvement to the UOP or is deductible as repairs, maintenance, or some other business expense.

(2) Unless a taxpayer qualifies for a safe harbor, amounts paid to improve a UOP must be capitalized. A UOP is improved if the amounts paid for activities performed after the property is placed in service by the taxpayer are for a betterment to the UOP, to restore the UOP, or to adapt the UOP to a new or different use. These three improvement rules are comprised of ten specific “tests” for identifying improvements.

(3) Each test must be considered separate and apart from the others. If any one of the ten tests applies to a given set of facts and circumstances, amounts paid result in an improvement to the UOP under Section 263(a), unless a particular exception or safe harbor applies. Generally, a taxpayer must also capitalize all

the direct costs and allocable indirect costs that directly benefit or are incurred by reason of the improvement. See also Section 263A.

(4) Each of these ten tests is rooted in case law or other legal precedent. This chapter addresses the particular tests that apply to determine whether an expenditure results in a restoration of a UOP. This chapter provides audit techniques for examiners to consider in determining whether a restoration, and therefore, an improvement has occurred. Chapters 6 and 8 discuss the tests for betterments and adaptation to a new or different use. Chapter 9 addresses the safe harbor provisions. Chapter 11 covers special rules that apply to improvements made to leased property. Examiners must consider the rules in each of these chapters when determining whether amounts paid result in an improvement to a UOP.

B. RESTORATIONS

(1) A taxpayer must capitalize as an improvement an amount paid to restore a UOP, including an amount paid to make good the exhaustion for which an allowance is or has been made. An amount paid restores a UOP only if it satisfies any one of the following:

- Is for the replacement of a component of a UOP for which the taxpayer has properly deducted a loss for that component, other than a casualty loss under Section 1.165-7,
- Is for the replacement of a component of a UOP for which the taxpayer has properly considered the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component,
- Is for the replacement of a part or a combination of parts that comprise a major component or substantial structural part of a UOP,
- Is for the restoration of damage to a UOP 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 discussed below),
- Returns a UOP 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, or
- Results in the rebuilding of a UOP to a like-new condition after the end of its class life (as defined under Section 168(g)(2) and (3)).

(2) For non-building property, a taxpayer applies these restoration rules to the UOP defined in the UOP rules under the final regulations. For building property, a taxpayer applies these restoration rules to each building structure and each of its designated building systems. If the taxpayer's expenditures are for a restoration to the building structure or any one or more building systems, the

building UOP is considered improved, and the costs are generally treated as capital expenditures. See Chapter 3.

(3) The restoration rules may affect, or be affected by, dispositions of a UOP or a portion of a UOP. A disposition occurs when an asset is transferred or permanently withdrawn from business use through a retirement or physical abandonment, or a transfer to a supplies, scrap, or similar account. A disposition also includes a sale or an exchange of an asset, or the destruction of an asset. Refer to Chapters 12-14 for more information on Dispositions.

(4) While some of the restoration rules may apply more frequently than others, each rule must be considered when a UOP or a component or substantial structural part(s) of a UOP is/are replaced, restored, or rebuilt. In addition, under certain restoration rules, the routine maintenance safe harbor under Section 1.263(a)-3(i) may apply and permit the taxpayer to deduct certain expenses that are otherwise capitalized restorations. In all cases, the facts and circumstances need to be considered and evaluated.

C. REPLACEMENT OF A COMPONENT OF A UOP – LOSS DEDUCTED (NOT A CASUALTY LOSS)

(1) A loss may be deducted when a disposition occurs. If a taxpayer has properly deducted a loss on a disposed component of a UOP (or, in the case of a building, the building structure or a building system) and replaces the component, the amounts paid for this replacement are treated as restoring the UOP. For example, assume that a taxpayer purchases a pick-up truck with a plow attached for use in its trade or business. Assume the pick-up truck is a UOP and the plow attachment is a component of that UOP. The plow attachment is no longer functional. The taxpayer abandons the plow attachment and properly deducts the remaining adjusted basis in the plow attachment on its tax return as a loss. If the taxpayer replaces the plow attachment, the taxpayer is required to capitalize the amount paid to acquire and install the new plow attachment because it has properly deducted a loss on the abandoned plow attachment.

(2) An exception applies for losses based on salvage value. A taxpayer is not required to treat amounts paid to replace the component of a UOP as an improvement, if the UOP has been fully depreciated and the loss amount is attributable only to the remaining salvage value as computed and used for federal income tax purposes. The salvage value exception is based on the amount a taxpayer is expected to receive in cash or trade-in allowance upon disposition of an asset at the end of its useful life. Amounts subject to this exception must be evaluated under other provisions of the regulations to determine if the amounts paid are otherwise subject to capitalization.

(3) Application of the Safe Harbor for Routine Maintenance

- An amount paid for the replacement of a component of a UOP where the taxpayer has properly deducted a loss for that component (other than a

casualty loss under Section 1.165-7) does not qualify for the routine maintenance safe harbor.

D. REPLACEMENT OF A COMPONENT OF A UOP – GAIN/LOSS REALIZED AND BASIS ADJUSTED

(1) A gain or loss may be realized when a replaced component of a UOP (or in the case of a building, the building structure, or a building system) is sold or exchanged. The regulations require that if the taxpayer has properly taken into account the adjusted basis of the replaced component in realizing gain or loss, the amounts paid to replace that component are treated as restoring the UOP, and the improvement must be capitalized.

(2) For example, a taxpayer uses an industrial mixer in its manufacturing process. The mixer is a UOP under the regulations and consists of the following components: the motor, the tank, and the agitator. The agitator is removed and replaced. The removed agitator is sold at a gain, and the gain is recognized for tax purposes. Under the restoration rule, the cost of the replacement agitator is treated as a restoration and must be capitalized as an improvement.

(3) This rule also applies in dispositions of components of a UOP where the taxpayer has properly taken the adjusted basis of the replaced component into account in computing the gain or loss realized but has not recognized the gain or loss, for example, where gain or loss is deferred under another applicable provision of the Code.

(4) The salvage value exception described above also applies. Amounts subject to this exception must also be evaluated under other provisions of the regulations to determine if the amounts are paid to improve tangible property.

(5) Application of the Safe Harbor for Routine Maintenance

- An amount paid for the replacement of a component of a UOP where the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale of exchange of the component does not qualify for the routine maintenance safe harbor.

E. REPLACEMENT OF A MAJOR COMPONENT/SUBSTANTIAL STRUCTURAL PART OF A UOP

(1) The regulations require the taxpayer to capitalize amounts paid to replace a part or a combination of parts that comprise a major component or a substantial structural part of a UOP.

(2) When a major component or a substantial structural part of a UOP is replaced, the UOP as a whole is improved, and the replacement costs must be capitalized. These rules are consistent with previous case law. See, e.g., P. Dougherty Co. v Commissioner, 159 F.2d 269 (4th Cir. 1946) (holding that the costs to replace an entire stern section of barge with new materials were capital

expenditures); LaSalle Trucking Co. v Commissioner, T.C. Memo 1963-274 (holding that amounts expended for the replacement of engines, petroleum tanks and truck cabs were for an improvement to the truck, and capitalization was required).

(3) To determine whether a major component or substantial structural part of a UOP has been replaced, all of the facts and circumstances must be considered. Appropriate considerations include the quantitative and qualitative evaluations of the replaced components in relation to the UOP. While there is no bright line test to make this determination, the regulations provide many examples to assist in the evaluation of specific fact patterns. Many of these examples provide fact patterns where a percentage of a component or a significant portion of a UOP is replaced. These examples are intended to illustrate that the decision to capitalize is based on all of the facts and circumstances in each situation. The examples are not meant to provide bright-line percentages or proportions of property that result in repair or improvement to the UOP. In other words, while the quantitative analysis is important, a qualitative analysis must be considered as well.

(4) Substantial Structural Part – In General

- A substantial structural part of a UOP generally refers to a part or combination of parts that comprise a large portion of the physical structure of the UOP. For building property, a substantial structural part is a part or parts that comprise a large portion of the building structure or a large portion of a building system.
- For example, assume a taxpayer owns a machine that includes a housing that encases the entire machine to minimize dust collection on the operating components. As a result, the casing is the largest part of the machine. Assume that the machine (including the casing) is a UOP under the UOP rules for non-building property because these components are functionally interdependent. If the taxpayer incurs costs to replace the entire housing of the machine, then the taxpayer will be treated as replacing a component that comprises a large portion of the physical structure of the UOP. Therefore, the costs of replacing the housing are for replacing a substantial structural part of the UOP, and therefore are restoration costs under the improvement analysis.

(5) Major Component – In General

- A major component is generally defined by the regulations as one that performs a discrete and critical function in the operation of the UOP. An incidental component of the UOP, even if it performs a discrete and critical function in the operation of the UOP, generally will not, by itself, constitute a major component. The function of the component is considered when evaluating whether the component is discrete, critical, and non-incidental

to the entire UOP. The size of the component, the quantity of identical components, the ease of installation, and the frequency of replacement are some of the factors to be considered in the overall analysis of whether a component is incidental in relationship to the UOP.

- For example, assume a taxpayer owns a machine shop and makes dies. The taxpayer discovers that the power switch assembly on a drill press has become damaged and cannot operate. The taxpayer replaces the power switch assembly with comparable parts. Assume the drill press is the UOP, and the switch is a small component that may be removed and reinstalled with ease. The power switch assembly is not a major component because, although the switch may affect the function of the drill press by controlling the supply of power, the switch is an incidental component of the drill press. Based on these facts, the amounts paid to replace the switch are not for the replacement of either a major component or a substantial structural part of the UOP and are not required to be capitalized under Section 1.263(a)-3(k)(1)(vi).
- The major component rule is applied with respect to the specific UOP. If the UOP is property other than buildings, the functional interdependence test generally applies to determine the UOP. For these types of property, the UOP generally includes all the functionally interdependent components that make up the UOP (e.g., the placing in service of one component by the taxpayer is dependent on the placing in service of another component). See Chapter 3.
- For example, if the UOP is an automobile (personal property) and the engine (major component) is replaced, that replacement would generally be capitalized because Section 1.263(a)-3(k)(6) requires capitalization of a part or combination of parts that comprise a major component.

(6) Major Component – Plant Property

- If the UOP involves plant property, the functional interdependence test applies, and the functionally interdependent plant property is further divided into each component (or group of components) that perform a discrete and major function in that functionally interdependent equipment. Each component (or group of components) that performs a discrete and major function is a separate UOP within the plant.
- For example, assume that the taxpayer operates a plant that utilizes different machines and equipment in an interconnected assembly line process to prepare certain frozen foods. The machines include mixers, ovens, slicers, chillers, and packagers, which are all necessary to complete the final food products. Furthermore, assume that all the plant property is placed in service on the same date. The plant includes two interconnected chillers that operate at different temperatures to cool the products on the assembly line in separate cooling stages of the process.

Both chillers must be working at different temperatures to ensure the rate of cooling, and thus, the consistency of the products manufactured on the assembly line. In addition, an individual chiller is not reasonably expected to be replaced more than once during the class life of the property. To analyze amounts paid to replace one of the two chillers, the tests for improvement are applied to the UOP, as determined under the plant property rule.

- Under these facts, the UOP analysis begins with the assembly line because the machines and equipment on the line are functionally interdependent plant property. The assembly line is further divided into each component (or group of components) that performs a discrete and major function. Because cooling is a discrete and major function of the plant property, the two chillers are a UOP under the plant property rule.
- After the UOP is determined, and assuming no other improvement rules (betterment, adaptation) apply, the next step is determining whether a restoration of unit of plant property occurs, for example, whether the taxpayer has replaced a major component or substantial structural part of the UOP. A major component is a part or combination of
- Parts that perform a discrete and critical function in the operation of a UOP. Because each chiller must operate at a different temperature to ensure the proper rate of cooling and maintain the consistency of the product, each chiller performs a discrete, critical, and non-incidental function in the operation of the chillers. Accordingly, replacing a single chiller is the replacement of a major component, which, absent application of the routine maintenance safe harbor, results in the restoration of the chiller UOP. Therefore, the taxpayer's cost to replace a single chiller must be capitalized under Section 263(a).

(7) Major Component – Building Property

- If the UOP involves building property, special rules apply to determine whether the costs to replace a component (or components) of the building UOP comprise a major component, and therefore, result in a restoration and improvement under the regulations. An amount is paid for a restoration if it is paid for the replacement of a major component or substantial structural part of the building structure or a building system. A substantial structural part is a part or combination of parts that comprises a large portion of the physical structure of the building structure or of any one of the building systems. A major component, as discussed above, is a part or combination of parts that performs a discrete and critical function in the operation of the building structure or a building system and is not incidental. In the case of a building, an amount is for the replacement of a major component if the replacement includes a part (or combination of parts) that comprises (i) a major component of the building structure or a

building system; or (ii) a significant portion of a major component of the building structure or a building system. (Note that the significant portion rule is unique to building UOPs).

- For example, assume a taxpayer owns an office building with an HVAC system that includes three furnaces, three air conditioning units, and duct work. The entire HVAC system provides heating and cooling to the whole building, instead of each furnace or air conditioning unit of the HVAC system providing heating and cooling to a certain portion of the building. Assume that one of the furnaces fails, but the remaining two furnaces continue to provide adequate heating to the whole building, although not quite as efficiently.
- To determine whether amounts paid to replace the non-functioning furnace result in a restoration of the building UOP, the taxpayer must evaluate whether the replacement of a single furnace constitutes the replacement of a major component or a substantial structural part of the HVAC system. Because, under these facts, the one furnace is not a substantial structural part of the HVAC system, the analysis focuses on whether the one furnace is (i) a major component of the HVAC system; or (ii) a significant portion of a major component of the HVAC system. Under these facts, the three furnaces, working together, perform the discrete and critical function of heating for the HVAC system, and are not incidental to the HVAC system. Therefore, the three furnaces are a major component of the HVAC system under the final regulations, and a single furnace is a part of that major component. In addition, the replacement of one of the three furnaces that heat the building does not comprise a significant portion of a major component (the three furnaces) of the HVAC system. Therefore, the cost of replacing a single furnace would not be a restoration of the building property, and the taxpayer would not have to capitalize the costs of replacing one furnace under Section 263(a). Alternatively, if the taxpayer has to replace two of the furnaces in the HVAC system, these two furnaces would comprise a significant portion of a major component of the HVAC system, and the amount paid to replace the two furnaces would result in a restoration to the building. Absent qualification under the routine maintenance safe harbor, the taxpayer would have to capitalize the costs of replacing the two furnaces under Section 263(a).
- As a variation of these facts, assume a taxpayer owns an office building with three wings: A, B, and C. The office building contains an HVAC system comprised of three furnaces, three air conditioning units (ACUs), and associated duct work. In contrast to the facts presented above, in this building furnace 1 provides heating for wing A, ACU 1 provides cooling for wing A, and the duct work located in wing A distributes the heating and cooling throughout wing A. Similarly, furnace 2, ACU 2, and the related duct work provide the heating, cooling, and distribution for wing B. Furnace 3, ACU 3, and the related duct work provide the heating, cooling,

and distribution for wing C. Assume that furnace 1 breaks down, and as result, wing A receives no heat. The taxpayer incurs costs to replace furnace 1. Because the expenditures involve a building, the taxpayer evaluates the building systems, in this case the HVAC system, to determine whether the replacement of furnace 1 is a restoration of the building. Under these facts, furnace 1 provides the discrete, critical, and non-incidental function of heating for wing A, and is therefore, a major component of the HVAC system. As a result, assuming the routine maintenance safe harbor does not apply, the taxpayer must capitalize the costs of replacing furnace 1 under Section 263(a) as a cost of restoring the HVAC system.

(8) Application of the Safe Harbor for Routine Maintenance

- An amount paid for the replacement of a major component or substantial structural part of a UOP may fall within the safe harbor for routine maintenance. If the routine maintenance safe harbor applies, the taxpayer is not required to capitalize these costs under this restoration test. See Chapter 9 for the Safe Harbor for Routine Maintenance.

F. RESTORATION OF DAMAGE FROM A CASUALTY LOSS

(1) If a taxpayer restores damage to a UOP for which it is required to take a basis adjustment as a result of a casualty loss or relating to a casualty event as described in Section 165, the final regulations require the taxpayer to treat these amounts as restoration costs that improve the UOP, subject to the limitation in Section 1.263(a)-3(k)(4).

(2) Section 1016(a) states that “proper adjustment in respect of property shall in all cases be made, for…losses, or other items, properly chargeable to capital account…” Therefore, Section 1016 requires an adjustment to the basis of property because a loss sustained as a result of a casualty event can properly be claimed under Section 165.

(3) Under Section 1.168(i)-8, taxpayers are required to apply the partial disposition rule to dispositions of a portion of an asset resulting from a casualty event described in Section 165. In other words, taxpayers cannot forego treating this transaction as a disposition for tax purposes. Furthermore, a taxpayer cannot electively avoid the basis adjustment required for casualty losses to its property. For example, assume a taxpayer owns a building that is subject to MACRS and is a UOP under Section 1.263(a)-3(e). A storm damages the roof of the building, and the taxpayer properly reduces the depreciable basis of the building by the amount of the loss under Section 1.168(i)-8(d) and 1016(a). The amount paid for the restoration to the roof must be capitalized under Section 1.263(a)-3(k)(iii), but only amounts up to the limitation discussed below. The partial disposition rule for MACRS property is discussed in detail in Chapter 14.

(4) The amount paid for the restoration of damage caused by a casualty to a UOP that must be capitalized is limited to the excess, if any, of the adjusted basis of the single identifiable property (SIP) for determining the loss allowable on account of a casualty over the amount paid for restoration damage to the UOP that also constitutes an improvement under any other provision of Section 1.263(a)-3(k)(1) (the other restoration "tests"). In other words, casualty-related restoration costs are required to be capitalized up to the amount of basis reduction of the SIP taken as a result of the casualty loss or casualty event. The purpose of this provision is to help taxpayers that may have property impacted by a casualty where the property has a low adjusted basis, and the taxpayer incurs high restoration expenditures. If there are casualty related restoration costs paid in excess of the adjusted basis of the SIP (after reducing this amount for other capitalized restoration costs), the excess amount must then be analyzed under the other improvement criteria to determine if these amounts should be treated as repairs under Section 1.162-4 or treated as capital improvements to the UOP. If any part of the excess represents amounts that would otherwise be considered an improvement under other provisions of the regulations, this part should be capitalized, regardless of the adjusted basis of the SIP. If any part of the excess represents amounts that would otherwise be treated as repairs, this part can be deducted. If the adjusted basis of the SIP is more than the total restoration expenses, then all restoration costs are capitalized under the casualty loss restoration rule.

(5) For example, in 2014, a fire damages a building with an adjusted basis of $5 million that is used in the taxpayer's business. The taxpayer deducts a casualty loss of $1.4 million on its 2014 tax return. Under Section 165, the loss is based on the cost to restore the damage caused by the casualty. The restoration expenses consist of $1 million to completely replace the roof, and an additional $400,000 for debris clean up, patching drywall, painting, and replacing 3 broken windowpanes. The adjusted basis of the impacted property is properly reduced by $1.4 million. Under the regulations, the taxpayer is required to capitalize all of the restoration expenditures. Since the total restoration expenses are less than the adjusted basis of the property impacted, the limitation does not come into play. More specifically, the taxpayer is required to capitalize the $1 million to replace the roof as an improvement under the other restoration tests because the roof constitutes a major component and substantial structural part of the building UOP. In addition, the taxpayer must capitalize the remaining $400,000 as restoration costs since they do not exceed the $4 million excess of the adjusted basis of the building, $5 million, over the restoration expenses that constitute an improvement under the other restoration tests, $1 million.

(6) On the other hand, if the adjusted basis in the building were $1 million, the Section 165 loss is limited to $1 million. In this case, the taxpayer is required to capitalize $1 million to replace the roof (as a restoration under the other restoration tests, e.g., major component). The remaining costs exceed the adjusted basis in the building and must be characterized in accordance with otherwise applicable provisions of the improvement rules. Assuming the

$400,000 paid for debris clean-up, patching drywall, painting, and replacing the 3 broken windowpanes are not treated as capital expenditures under the other tests for improvements, these amounts likely qualify as a deductible repair under Section 1.162-4.

(7) Application of the Safe Harbor for Routine Maintenance

- An amount paid for the replacement of a component of a UOP 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 Section 1.263(a)-3(k)(1)(iii), does not qualify for the routine maintenance safe harbor.

G. RETURNS THE UOP TO OPERATIONAL CONDITION – AFTER DETERIORATED AND NON-FUNCTIONAL

(1) If the taxpayer returns the UOP to its ordinarily efficient operating condition after the property has deteriorated to a state of disrepair and is no longer functional for its intended use, the regulations require capitalization of the amounts paid to restore the UOP. These types of restorations generally occur as a result of lack of maintenance. A UOP that is damaged by a casualty or other “event” is not considered to be deteriorated to a state of disrepair.

(2) An example would be where a taxpayer owns an asphalt parking lot that has deteriorated after years of neglect and is no longer usable as a parking lot. Assume in this case the parking lot was not properly maintained, fell in a state of disrepair over many years and was returned to ordinarily efficient operating condition. The costs to restore the parking lot would be capitalized as restoration costs. For example, the parking lot has numerous potholes, fatigue cracks and other signs, such that it can no longer support the weight of parked cars and trucks. To restore the parking lot, the taxpayer pays amounts to a contractor to remove the failed asphalt, stabilize the underlying material and replace the pavement. These amounts are paid for restoration of a UOP from a state of disrepair and dysfunction to an ordinary operating condition. Accordingly, these amounts would be capitalized as improvements under the restoration analysis of the regulations.

(3) Application of the Safe Harbor for Routine Maintenance

- An amount paid to return a UOP 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, does not qualify for the routine maintenance safe harbor.

H. REBUILDS TO LIKE-NEW CONDITION – AFTER THE END OF ITS CLASS LIFE

(1) If the taxpayer rebuilds the UOP to a like new condition after the end of its class life, the regulations require capitalization of the amounts paid to restore the UOP.

(2) To meet the definition of "like new" under the regulations, the property must be brought to the status of new, rebuilt, remanufactured, or a similar status under the terms of any federal regulatory guideline or the manufacturer's original specifications. Generally, a comprehensive maintenance program is not enough to return a UOP to a like-new condition.

(3) Under the regulations, the rebuild of the UOP must take place after the end of its class life. The class life of a UOP is the recovery period prescribed for the property under Section 168(g)(2) and (3) (excluding the rules under (3)(A) for tax-exempt use property), for purposes of the alternative depreciation system, regardless of whether the property is depreciated under that section. If the UOP is composed of components with different class lives, the class life of the UOP is deemed to be the same as the component with the longest class life.

(4) Large machinery and equipment are frequently rebuilt as a cost savings measure. The extent of the work and the timing of the rebuild determine the treatment under this restoration rule. For example, a bulldozer with a class life of 6 years used in the business of land development for 8 years is completely disassembled. The power train and the engine are rebuilt, and all non-metal components are replaced. Some of the large metal components are reconditioned and reused, others are inspected and resurfaced. The frame is straightened and reinforced. Hydraulic systems are returned to their original condition meeting ISO specifications. The machine is then reassembled, painted, and tested to meet field performance levels comparable to a new machine. A new serial number is issued that certifies the machine meets the manufacturer's specifications and a warranty is provided. Because the amounts paid restore the bulldozer to like-new condition, and the restoration took place after the end of its class life, the regulations require the amounts to be capitalized.

(5) Application of the Safe Harbor for Routine Maintenance

- An amount paid to rebuild a UOP to a like-new condition after the end of its class life may fall within the safe harbor for routine maintenance. If the routine maintenance safe harbor applies to the taxpayer's facts, the taxpayer is not required to capitalize these costs under this restoration test. See Chapter 9 for the Safe Harbor for Routine Maintenance.

I. AUDIT PROCEDURES

(1) Examiners should consider the following steps when reviewing/examining an improvement/restoration project. The examiner should only request documents that are pertinent to the facts and circumstances in each case.

I.1. Identify Potential Audit Issues

(1) Has the taxpayer determined improvements in accordance with the final regulations?

(2) Review Annual Reports and Forms 10-K to identify any:

- Restorations to property owned or leased,
- Replacements of property owned or leased, or
- Casualty events.

(3) Consider the taxpayer's line of business.

- Identify any property replaced, restored, or rebuilt.
- Consider whether the routine maintenance safe harbor may apply.
- Determine if a casualty event occurred at any of the taxpayer's locations.
- Is the taxpayer a lessor of property?
- Is the taxpayer a lessee of property?

(4) Review the tax return.

- Consider assets or portions of assets, sold, or otherwise disposed of on Form 4797.
- Consider asset additions on Form 4562.
- Consider the repairs and maintenance deduction and repair and maintenance that may have been included in the inventory calculation.
- Were any assets transferred in a Section 1031 like kind exchange or a Section 1033 involuntary conversion?

I.2. Assess Audit Risk

(1) What effect, if any, have the final regulations had on the taxpayer's definition of improvements to property?

(2) Review taxpayer's written policies regarding asset capitalizations and dispositions. Consider any capitalization threshold policy statements.

(3) Review the Schedule M for book-tax depreciation differences due to assets placed in service during the tax year.

(4) Review the Schedule M for book-tax depreciation differences.

(5) Has the taxpayer filed Form(s) 3115 to change its method of accounting for capitalization or repairs?

- Consider whether the Form 3115 is the initial change or a change to "true up" or reverse any previous accounting method change(s).
- Determine specifically what accounting methods the taxpayer is following for restorations.
- Consider whether the taxpayer accounted for property previously disposed of as part of any method change. If so, ensure that the taxpayer took the improvement rules into account as a result of the disposition.

(6) Consider any Section 481(a) adjustment involving the definition of a UOP and determine if the property was improved under any of the restoration tests. Was an amount paid to:

- Replace a component, and
  - A loss was deducted,
  - A gain or loss was realized, or
  - It is a part or combination of parts that comprise a major component or substantial structural part of a UOP?
- Restore a UOP after:
  - A casualty event,
  - It has deteriorated to a state of disrepair, or
  - The end of its class life and it is returned to like-new condition?

I.3. Examination Considerations

(1) Consider how the taxpayer accounts for repairs to fixed assets.

- Has the definition of a repair changed in the last 10 years?
- Is the definition of a repair based on the proposed or temporary regulations?
- Is the definition of a repair based on the final regulations?

(2) Is the taxpayer using the safe harbor for routine maintenance for recurring activities to keep the UOP in ordinarily efficient operating condition?

(3) If the property is a building, does the taxpayer qualify for the safe harbor for small taxpayers?

(4) Do special rules or elections apply?

(5) Does the taxpayer own building property?

- Consider the UOP rules for buildings.
- Identify the structure and the systems of the building UOP.
- Consider special rules for applying the restoration rules to building property.

(6) Does the taxpayer own plant property?

- Consider the UOP rules for plant property.

(7) Does the taxpayer own network property?

- Consider special rules for network assets.
- Does an industry specific revenue procedure apply? See Chapters 2 and 19.
- If no guidance exists for the network assets, what method is used to determine improvements? Is it reasonable based on the facts and circumstances?

(8) Consider the taxpayer's written policy for determining whether amounts paid result in an improvement or a repair.

(9) Ascertain whether the taxpayer maintains a work order system for all capital expenditures and major repair jobs tracking all project costs.

(10) Ensure that all direct and allocable indirect costs for restorations to property are tracked.

(11) Review the repair and maintenance accounts for the period under exam to ensure that capital additions are not expensed.

(12) Review fixed asset studies conducted by or on behalf of the taxpayer.

- Consider whether the study conforms to the final regulations' improvement rules.
- Ensure project requests, purchase orders, invoices, and related documents were reviewed as part of the study.
- Determine whether the improvement rules were properly applied. Consider whether the work restores the UOP.

(13) Consider whether the taxpayer computes salvage value for federal income tax purposes.

(14) Determine if the taxpayer suffered damage from a casualty event:

- Did the taxpayer properly make a basis adjustment under Section 1016(a) to the UOP as a result of the casualty loss or relating to a casualty event?
- Was the limitation described in Section 1.263(a)-3(k)(4) properly applied?
- Were insurance reimbursements received or expected?
- Did the taxpayer incur restoration costs for the damage to the property?
- Consider book/tax differences in the treatment of casualty related restoration costs.

VIII. CHAPTER 8 – IMPROVEMENT RULES – ADAPT TO A NEW OR DIFFERENT USE

A. IMPROVEMENTS IN GENERAL

(1) Under the final tangible property regulations ("final regulations"), the determination of whether a unit of property ("UOP") is improved or whether amounts paid are for the repair of a UOP begins with the identification of the UOP. After the UOP is determined, the second step is to determine whether the expenditure is for an improvement to a UOP or is currently deducted as repairs, maintenance, or some other business expense. Unless a taxpayer qualifies for a safe harbor, amounts paid to improve a UOP must be capitalized. A UOP is improved if the amounts paid for activities performed after the property is placed in service by the taxpayer are for a betterment to the UOP; to restore the UOP; or to adapt the UOP to a new or different use. These three improvement rules comprise ten specific "tests" for identifying improvements.

(2) Each test must be considered separate and apart from the others. If any one of the ten tests applies to a given set of facts and circumstances, amounts paid result in an improvement to the UOP under Section 263(a) unless a particular exception or safe harbor applies. Generally, a taxpayer must also capitalize all the direct costs and allocable indirect costs that directly benefit or are incurred by reason of the improvement. See also Section 263A.

(3) Each of these ten tests is rooted in case law or other legal precedent. This chapter addresses the application of the "adapting to a new or different use" test under the final regulations. This Chapter provides audit techniques for examiners to consider in determining whether a taxpayer's expenditures adapt the UOP to a new or different use. Chapters 6 and 7 discuss the tests for betterments and restorations. Chapter 9 addresses the safe harbor provisions. Chapter 11 covers the special rules that apply for improvements to leased property. Examiners must consider the rules in each of these chapters when determining whether amounts paid result in an improvement to a UOP.

B. NEW OR DIFFERENT USE

(1) The final regulations provide that a taxpayer must capitalize as an improvement an amount paid to adapt a UOP to a new or different use. Generally, an amount is paid to adapt a UOP to a new or different use if the adaptation is inconsistent with the taxpayer's ordinary use of the UOP at the time the UOP is originally placed in service by the taxpayer. Amounts paid to adapt a UOP to a new or different use do not necessarily make the property better or increase its value, nevertheless they constitute a capitalized improvement cost. This capitalization requirement follows a long history of case law.

(2) In *Difco Laboratories, Inc. v. Commissioner*, 10 T.C. 660, 668 (1948), the court held that the expenditures for lowering one basement room to the level of another basement room, along with other alterations connected therewith, to facilitate the wheeling of trucks from one room to the other, adapted the basement for a different use and were therefore capital expenditures.

(3) In *Popular Dry Goods Co. v. Commissioner*, 6 B.T.A. 78, 83 (1927), the court stated, "The expenditures on the annex, or Hammett and Bassett properties, were principally for the conversion of those properties into an operating unit. They were not for repairs but for alterations, which made the properties adaptable to a different use. Expenditures for such alterations, although they do not increase the value of the property, are not deductible from gross income."

(4) Modifications that result in adaptations can be made for all types of tangible real or personal property including land, machinery, equipment, and buildings. In the case of a building, an adaptation is made if the expenditures are for a new or different use of the building structure or any one of the designated building systems as compared to the use that was originally anticipated by the taxpayer.

(5) When determining whether there has been an improvement that must be capitalized as an adaptation, the main consideration is whether the UOP continues to be used in the same way as it was when originally placed in service. For example, a taxpayer purchased land in 2010 and used it for farming. In 2014, the taxpayer decides to develop residential housing on the land and pays amounts to re-grade the land for that purpose. The amount paid to re-grade the land adapts the land to a new or different use because it is inconsistent with the ordinary intended use of the property. Accordingly, the amount paid to re-grade the land is capitalized as an improvement to the land.

(6) As another example, assume a taxpayer has used a building for manufacturing its products since the building was placed in service in 2000. In 2014, the taxpayer reconfigures the interior walls, replaces the floor tile and repaints the interior to use the building as a showroom for its products. The amount paid to reconfigure the walls, replace the floor tile and repaint the interior result in an adaptation because the conversion to a showroom is not consistent with the taxpayer's ordinary use of the building structure at the time it was placed in service. On the other hand, assume the taxpayer reconfigured walls and replaced flooring to replace a machine used in its manufacturing operations. In this scenario, the amounts paid do not result in an adaptation of the building

structure to a new or different use because the taxpayer still uses the building structure to manufacture its products.

(7) Even if certain amounts paid do not result in an adaptation, capitalization may still be required if the amounts result in a betterment or a restoration. Therefore, if reconfiguring the walls and replacing flooring to accommodate a replacement machine in the above example resulted in a material increase in the load capacity or strength of the building structure, then the amount paid to make the modifications is required to be capitalized as a betterment.

(8) Likewise, if the taxpayer removed the original walls as part of the reconfiguration and deducted the adjusted basis of the removed walls as a disposition loss, the cost to replace the walls results in a restoration and must be capitalized.

(9) The adaptation to a new or different use standard may apply where a taxpayer adapts a building structure or its systems (or a part thereof) to accommodate a new or different type of business activity. Section 1.263(a)-3(l)(3), examples 5 through 7, provide illustrations of situations where this test does and does not apply to the taxpayer's expenditures. Also, expenditures to adapt the building's appearance for purposes of selling the property do not, by themselves, adapt the property to a new or different use.

(10) Application of the Safe Harbor for Routine Maintenance

- An amount paid to adapt a UOP to a new and different use does not qualify for the routine maintenance safe harbor.

C. AUDIT PROCEDURES

(1) Examiners should consider the following steps when reviewing/examining a new or different use issue. The examiner should only request documents that are pertinent to the facts and circumstances in each case.

C.1. Identify Potential Audit Issues

(1) Has the taxpayer determined improvements to UOPs in accordance with the final regulations?

(2) Review Annual Reports and Forms 10-K to identify any modifications to owned or leased:

- Buildings or building structures,
- Land,
- Machinery or equipment.

(3) Consider the taxpayer's line of business.

- Has the taxpayer recently changed its business model, started new ventures or does it offer new services?
- Were new locations opened or were locations closed? If so, what is the impact on current locations?

C.2. Assess Audit Risk

(1) What effect if any, have the final regulations had on the taxpayer's definition of improvements to property?

(2) Review taxpayer's written policies regarding asset capitalizations. Consider any capitalization threshold policy statements.

(3) Review the Schedule M for book tax differences for repairs to fixed assets owned or leased.

(4) Review the Schedule M for book/tax depreciation differences due to assets placed in service during the tax year.

(5) Has the taxpayer filed Form(s) 3115 to change its method of accounting for capitalization or repairs?

- Consider whether the Form 3115 is the initial change or a change to "true up" any previous accounting method change(s).
- Determine specifically what accounting method the taxpayer is following for adaptations.
- Consider whether the taxpayer accounted for property previously disposed of as part of any method change. If so, ensure that the taxpayer took the improvement rules into account as a result of the disposition.

(6) Consider any Section 481(a) adjustment and determine if it accounts for changes in the use of property.

C.3. Examination Considerations

(1) Consider how the taxpayer accounts for any amounts paid to adapt a UOP to a new or different use.

(2) Consider the taxpayer's written policy for determining whether amounts paid result in an improvement or a repair.

(3) Ensure that the taxpayer does not apply the safe harbor for routine maintenance to any UOP adapted to a new or different use.

(4) Determine whether the taxpayer qualifies for the safe harbor for small taxpayers.

(5) Do special rules or elections apply?

(6) Ensure that the taxpayer tracks all direct and allocable indirect costs for adaptations of property.

(7) Consider whether the taxpayer maintains a work order system for all capital expenditures and major repair jobs tracking all project costs.

(8) Review the repair and maintenance accounts for the period under exam to ensure that capital additions are not expensed.

(9) Review fixed asset studies conducted by or on behalf of the taxpayer.

- Consider whether the study conforms to the final regulation's improvement rules.
- Ensure project requests, purchase orders, invoices, and related documents were reviewed as part of the study.
- Determine whether the improvement rules were properly applied. Consider whether the work adapts the UOP.

IX. CHAPTER 9 – SAFE HARBORS – SPECIAL RULES – OTHER PROVISIONS

A. INTRODUCTION

(1) This Chapter reviews the safe harbors, special rules, and other provisions, including elections and accounting methods that are integral in the determination of whether amounts paid result in an improvement to a unit of property ("UOP") and whether such costs must be capitalized under Section 263(a).

(2) To recap, Chapter 3 of this guide discusses the UOP definition for buildings, including building structures and building systems. Chapter 3 also provides rules for property other than a building, including plant property, personal property and network assets. Chapters 6, 7 and 8 explain the criteria for identifying improvements to the UOP under the final tangible property regulations ("final regulations"). A UOP is improved if the amounts paid for activities performed after the property is placed in service by the taxpayer are for a betterment to the UOP, to restore the UOP, or to adapt the UOP to a new or different use.

(3) The improvement rules comprise ten specific tests for improvements. Each test must be considered separate and apart from the others. If any one of the ten tests applies given the facts and circumstances, the amounts paid result in an improvement to the UOP under Section 263(a). However, the safe harbors, special rules and other provisions must also be considered along with these tests for improvements.

B. SAFE HARBOR FOR ROUTINE MAINTENANCE

(1) The regulations under Section 1.263(a)-3(i) contain a safe harbor for routine maintenance. This safe harbor provides that the costs of performing certain routine maintenance activities on tangible property do not improve a UOP. In Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333 (1962), the Tax Court determined that if the expenditure merely restores the property to the state, it was in before the condition necessitating the repair and does not make the property more valuable, more useful, or longer-lived, it is usually considered a deductible repair.

(2) To qualify as routine maintenance costs, the amounts must be paid for recurring activities that the taxpayer expects to perform as a result of the use of the UOP in its trade or business to keep the UOP in ordinarily efficient operating condition. Whether work is recurring is determined based on the nature of the work performed and the type of property involved. For example, recurring inspection, cleaning, testing and replacement of worn or damaged parts with comparable and commercially available replacement parts is generally routine and performed to keep the UOP in ordinarily efficient operating condition. The rules differ for building property and non-building property.

(3) Factors to consider in the determination of whether an activity is routine and whether the taxpayer's expectation is reasonable include:

- The recurring nature of the activity,
- Industry practice,
- Manufacturer's recommendations, and
- The taxpayer's experience with similar (or identical) property.

(4) Routine Maintenance for Buildings

- Routine maintenance for building UOPs includes recurring activities that a taxpayer expects to perform as a result of the taxpayer's use of the building structure or building system (including a leased building) to keep the building structure or each building system in its ordinarily efficient operating condition. Routine maintenance can happen at any time during the useful life of the building structure or building system. However, to qualify for the routine maintenance safe harbor for buildings, a taxpayer must expect to perform the activities more than once during the 10-year period beginning with the year that the building structure or building system is placed in service by the taxpayer.
- For example, in 2014 the taxpayer places in service a retail building that contains an escalator. The taxpayer expects that to keep the escalator in its ordinarily efficient operating condition, it will need to replace the handrails every four years. Four years after the building is placed in service, in 2018, the taxpayer replaces the handrails with commercially available replacement parts. Because the taxpayer expects to replace the

handrails more than once during the first 10 years after the building is placed in service, the amount paid to replace the handrails in 2018 would fall within the routine maintenance safe harbor for buildings.

- However, had the taxpayer expected to replace the handrails every 12 years, the amounts paid to replace the handrails in 2026 would not qualify as deductions under the routine maintenance safe harbor because the activity is not expected to be performed more than once during the first 10 years after the building is placed in service. Replacement expected every 12 years does not fall within the routine maintenance safe harbor. Instead, the general rules for improvements apply.
- Amounts that qualify for the routine maintenance safe harbor may still be subject to capitalization under Section 263A if those amounts comprise the direct or allocable indirect costs of property produced by the taxpayer or property acquired for resale. For example, under Section 263A a taxpayer is required to capitalize the cost of repairing equipment or facilities if such costs comprise the allocable indirect costs of producing inventory.

(5) Routine Maintenance for Property other than Buildings

- Property other than buildings includes real or personal property such as land improvements, furniture and fixtures, machinery and equipment used outside of an industrial process, and plant property such as machinery and equipment used to perform an industrial process. Most rotable and temporary spare parts, as discussed in Chapter 10, materials, and supplies, also qualify as property eligible for the routine maintenance safe harbor. Routine maintenance for property other than buildings may be performed any time during the useful life of the UOP. However, maintenance is considered routine for property other than buildings only if at the time the UOP is placed in service, the taxpayer reasonably expects to perform the activities more than once during the class life of the UOP.
- The class life period of a UOP is the recovery period prescribed for the property under Section168(g)(2) and (3) (excluding the rules under (3)(A) for tax-exempt use property), for purposes of the alternative depreciation system (“ADS”), regardless of whether the property is depreciated under that section. If the UOP comprises components with different class lives, the class life of the UOP is deemed the same as the component with the longest class life. For example, a railroad company owns a fleet of freight cars. A freight car and all its components have an ADS class life of 14 years. At the time the freight car is placed in service in 2014, the railroad expects that it will perform cyclical reconditioning to the car every 10 years to keep the freight car in ordinarily efficient operating condition. In 2024, the railroad performs a cyclical reconditioning on the car. During this reconditioning, the railroad disassembles, inspects, and reconditions or

replaces components of the freight car with comparable and commercially available replacement parts. Because the cyclical reconditioning activities are expected to be performed only once during the 14-year class life of the freight car, the costs do not qualify for the routine maintenance safe harbor. Instead, the general rules for improvements apply to determine the treatment of the expenditure.

- As with building property, amounts paid for non-building property that qualifies for the routine maintenance safe harbor may still be subject to capitalization under Section 263A if those amounts comprise the direct or allocable indirect costs of property produced by the taxpayer or property acquired for resale.

(6) Exceptions to the Routine Maintenance Safe Harbor

- The routine maintenance safe harbor does not apply to amounts paid for betterments, amounts paid to adapt a UOP to a new or different use, and most restorations. See
- Section 1.263(a)-3(i)(3). However, the routine maintenance safe harbor may apply to certain restoration costs (i.e., qualifying routine maintenance that includes the costs of replacing major components/substantial structural parts or the costs of rebuilding a UOP to a like-new condition after the end of its class life). The general rules for improvements apply to activities that do not meet the routine maintenance safe harbor.
- The routine maintenance safe harbor does not apply to network assets. The treatment of certain network assets is addressed in industry specific guidance. See Chapter 2, Compliance Considerations, for information on Industry Specific Guidance.
- Finally, the routine maintenance safe harbor does not apply to rotable and temporary spare parts if the taxpayer uses the optional method of accounting for rotable and temporary spare parts.

B.1. Examination Considerations

(1) Do the activities meet the definition of routine? Are the activities recurring in nature and performed to keep the UOP in ordinarily efficient operating condition?

(2) Does the work involve inspecting, cleaning, testing, and replacing damaged or worn parts with comparable and commercially available replacement parts?

(3) Can the taxpayer reasonably expect at the time the UOP is placed in service that the work will be performed more than once during the class life of the UOP (non-building property) or more than once during the first 10 years after the UOP is placed in service by the taxpayer (building property)?

(4) Consider the following when assessing whether the taxpayer's expectation is reasonable:

- The recurring nature of the activity,
- Industry practice,
- Manufacturer's recommendations, and
- The taxpayer's experience with identical (or similar) property.

(5) Review the proper ADS class life for each property (other than buildings) for deductions under the routine maintenance safe harbor.

(6) Is the routine maintenance a direct or allocable indirect cost of producing property or acquiring property for resale under Section 263A?

(7) Does the work qualify as an improvement to the property? Does the work constitute a betterment, restoration (other than the replacement of a major component/substantial structural part or the rebuilding to a like-new condition), or an adaptation to a new or different use?

(8) Is the UOP a network asset? Do any of the special procedures for network property apply to the taxpayer's industry?

(9) Is the UOP a rotable or temporary spare part? If so, is the taxpayer using the optional method of accounting for spare parts?

C. SAFE HARBOR FOR SMALL TAXPAYERS

(1) The regulations under Section 1.263(a)-3(h) permit qualifying small taxpayers to forego application of the improvement rules on eligible building property. To qualify for this election, the taxpayer must:

- Be a qualifying small taxpayer,
- Own (or lease) eligible building property,
- Not exceed the applicable cost of improvement threshold, and
- Properly elect the safe harbor.

(2) Qualifying Taxpayer

- A qualifying taxpayer is a taxpayer whose average annual gross receipts for the three preceding taxable years is less than or equal to $10 million. 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. A short taxable year is a taxable year that is less than 12 months. In this case, gross receipts for the short taxable year must be annualized by multiplying the gross receipts for the

short period by 12 and then dividing the product by the number of months in the short period.

- For purposes of determining whether a taxpayer is a qualifying taxpayer, the regulations define the term “gross receipts” as the receipts for the tax year that are properly recognized under the taxpayer's methods of accounting used for federal income tax purposes for the tax year. Gross receipts include total sales (net of returns and allowances) and all amounts received for services, as well as any income from investments and from incidental or outside sources. Gross receipts are not reduced by the cost of goods, or the cost of property sold if such property is described in Section 1221(a)(1), (3), (4) or (5). Gross receipts also include interest, dividends, rents, royalties, annuities, and income from the sale of capital assets or business property. If the property sold is a capital asset or certain property used in a trade or business, gross receipts are reduced by the adjusted basis of the property sold. Gross receipts do not include the repayment of a loan or gross receipts derived from non-recognition transactions such as a Section 1031 exchange. Also excluded are amounts received with respect to state and local sales tax or other similar taxes legally imposed on the purchaser of goods or services, or where the taxpayer merely collects and remits the tax to the taxing authority. Examples would include cigarette taxes and certain non-federal gasoline taxes.

(3) Eligible Building Property

- An eligible building is each building UOP that is owned or leased by the qualifying taxpayer that has an unadjusted basis of $1 million or less. The term “building UOP” includes buildings, condominiums, and cooperatives.
- The unadjusted basis of eligible building property is the cost determined under Section 1012 or other applicable code sections. Adjustments required under Section 1016(a)(2) (for exhaustion, wear and tear, obsolescence, amortization, and depletion) are disregarded. Additionally, unadjusted basis does not include amounts treated as an expense (e.g., Section 179 deduction) as elected by the taxpayer.
- The unadjusted basis of eligible building property leased to the taxpayer (i.e., taxpayer is the lessee) 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. The lease term will include renewal periods if all the facts and circumstances during the taxable year in which the lease is entered indicate a reasonable expectancy of renewal.

(4) Applicable Cost of Improvements Threshold

- To use the safe harbor for small taxpayers, the total amount paid during the taxable year for repairs, maintenance, improvements, and similar activities performed on the eligible building must not exceed a specified threshold. This threshold is the lesser of $10,000 or 2% of the unadjusted basis of the eligible building property. If the threshold is not exceeded, costs are not required to be capitalized as improvements. The total amount that must be taken into account to determine whether the applicable safe harbor threshold is exceeded includes those amounts that are not capitalized under the de minimis safe harbor election and those amounts deemed not to improve property under the routine maintenance safe harbor.
- The safe harbor threshold does not function as an “allowance” permitting a deduction for amounts up to the applicable threshold. The applicable safe harbor threshold functions like a “cliff.” If the total amount paid for repairs, maintenance, improvements, and similar activities exceeds the applicable safe harbor threshold for a taxable year, the safe harbor does not apply to that building property. Instead, the taxpayer must apply the general rules to determine whether an improvement was made, and whether the safe harbor for routine maintenance would apply. A taxpayer may also elect to apply the de minimis safe harbor to these amounts irrespective of the application of the safe harbor for small taxpayers.

(5) Annual Election

- The election to use the safe harbor for small taxpayers is made annually on a building-by-building basis by including a statement on the taxpayer's timely filed original federal tax return (including extensions) for the year the costs are incurred. The election is irrevocable. An election may not be made by filing an application for change in accounting method or by filing an amended return (without the Commissioner’s consent to make a late election). In the case of an S-Corporation or a partnership, the election is made by the S-Corporation or the partnership, and not by the shareholders or partners.

C.1. Examination Considerations

(1) Is the taxpayer a qualifying taxpayer, eligible for the safe harbor for small taxpayers?

- Verify that the taxpayer’s average gross receipts for the three preceding taxable years are less than or equal to $10 million.
- Make sure that all sources of gross receipts are considered.

(2) Determine if the property is an eligible building. Obtain and review acquisition documents or applicable leases.

(3) Obtain and review the taxpayer's calculations for the "cost of improvements threshold" (i.e., lesser of $10,000 or 2% of the unadjusted basis of the eligible building property).

(4) Determine if the threshold is computed properly. Are all required costs (i.e., repairs, maintenance, improvements, and similar activities related to the building) being considered in determining whether the threshold was met? In computing whether the threshold is met, ensure that the taxpayer included costs that would otherwise qualify for the de minimis safe harbor and costs that would qualify under the routine maintenance safe harbor. Ensure that the taxpayer properly applies the safe harbor limitations. If the threshold is exceeded for a building property, then the safe harbor does not apply to that building property.

D. CERTAIN COSTS INCURRED DURING AN IMPROVEMENT

(1) The regulations under Section 1.263(a)-3(g) require taxpayers to capitalize all direct and indirect costs of an improvement, including those costs that would otherwise be deductible as repair costs if they directly benefit or are incurred by reason of an improvement. This rule is based on the language of Section 263A and sets out a clear rule for determining when otherwise deductible indirect costs must be capitalized as part of an improvement to property. However, indirect costs, such as repair and maintenance costs that do not directly benefit and are not incurred by reason of an improvement to a UOP are not required to be capitalized under Section 263(a), regardless of whether they are incurred at the same time as an improvement. For example, painting the interior of a building is generally a currently deductible repair. But, if a taxpayer makes changes to the interior of a building resulting in an improvement to the building UOP, and the interior painting benefits the improvement or is incurred by reason of the improvement, then such painting costs must be treated as part of the improvement to the building UOP and capitalized accordingly.

(2) Examiners should no longer cite to the previously relied on "plan of rehabilitation doctrine" to determine the amounts that must be capitalized as part of an improvement. Further,

(3) Section 263A continues to apply to the direct and allocable indirect costs of property produced by the taxpayer and property acquired for resale regardless of the treatment afforded these costs under the final regulations.

(4) Accounting Method

- The treatment of costs incurred during an improvement is considered an accounting method under the regulations. A taxpayer may either adopt a permissible method of accounting for an improvement on its first return reflecting the item or change its current accounting method for the

treatment of costs incurred during an improvement by filing a Form 3115 under the applicable provisions of Rev. Proc. 2015-13 and Rev. Proc. 2015-14 or, if applicable Rev. Proc. 2016-29, Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, or Rev. Proc. 2022-14 (the List of Automatic Changes).

D.1. Examination Considerations

(1) Consider whether direct and indirect costs are for the improvement of a UOP. Were costs incurred by reason of the improvement to the UOP? If so, the costs are required to be capitalized under Section 1.263(a)-3(g) and Section 263A as improvement costs.

(2) Did the taxpayer file a Form 3115 to change its method of accounting for costs incurred during an improvement?

E. SPECIAL RULES FOR REMOVAL COSTS

(1) The regulations under Section 1.263(a)-3(g)(2) provide special rules for the treatment of removal costs.

(2) Cost of Removing a Depreciable Asset or Component

- If a taxpayer disposes of a depreciable asset, including a partial disposition, for Federal income tax purposes and takes into account the adjusted basis of the asset (or a component of the asset) in realizing gain or loss, then the costs of removing the asset (or component) are not required to be capitalized (rules also are set out for assets included in a general asset account). A taxpayer is not required under Section 263(a) or Section 263A to capitalize the cost of removing a retired depreciable asset, even where the retirement and removal occurred in connection with the installation of the replacement asset. The cost of removing a retired depreciable asset has generally been allocable to the removed asset and is generally deductible when the asset is retired.
- If a taxpayer disposes of a component of a UOP, but the disposal of the component is not a disposition or treated as a partial disposition of an asset for Federal tax purposes, then the taxpayer must capitalize the removal costs if the removal costs directly benefit or are incurred by reason of an improvement to the UOP. If the removal costs do not directly benefit or are not incurred by reason of an improvement, then the removal costs may be deducted as repair costs.
- For example, assume a taxpayer pays to remove the original supporting columns (i.e., structural components) in a storage area and replace them with columns that increase the load-carrying capacity. The replacement columns result in an improvement (i.e., a betterment under Section 1.263(a)-3(j)). Assume also that the taxpayer did not consider the adjusted

basis of the disposed components and did not realize a gain or loss on the dispositions. Because the original columns were not disposed of for tax purposes, the amounts paid to remove the columns must be capitalized because they were incurred by reason of the improvement.

- Assume the same facts except the taxpayer disposes of the columns and takes the adjusted basis of the columns into account in computing its realized gain or loss (and properly treats as a partial disposition). Because there has been a disposition of the asset for tax purposes, the amount paid to remove the columns is not required to be capitalized as part of the improvement regardless of its relationship to the improvement.

(3) Accounting Method

- The treatment of removal costs is considered an accounting method under the regulations. A taxpayer may either adopt a permissible method of accounting for removal costs on its first return reflecting the item or change its current accounting method for the treatment of removal costs by filing a Form 3115 under the applicable provisions of Rev. Proc. 2015-13 and Rev. Proc. 2015-14 or, if applicable, Rev. Proc. 2016-29, Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, or Rev. Proc. 2022-14 (the List of Automatic Changes).

E.1. Examination Considerations

(1) How does the taxpayer define components? Are components (or groups of components) defined using the discrete and major function test?

(2) Has there been a disposition for tax purposes of an asset or a component?

(3) Has the taxpayer properly elected to treat the removal of a component as a partial disposition?

(4) How does the taxpayer track additions? How are improvements determined?

(5) How does the taxpayer account for dispositions or retirements?

(6) Did the taxpayer file a Form 3115 to change its method of accounting for removal costs?

F. OPTIONAL REGULATORY ACCOUNTING METHOD

(1) The regulations under Section 1.263(a)-3(m) allow certain regulated taxpayers the option of following their method of accounting for regulatory accounting purposes for determining whether amounts paid to repair, maintain, or improve tangible property are capitalized or deductible.

(2) This optional accounting method is available only to taxpayers subject to the regulatory accounting rules of the Federal Energy Regulatory Commission (FERC), the Federal Communications Commission (FCC), or the Surface

Transportation Board (STB). If a taxpayer chooses this method, it must use this method for all property subject to regulatory accounting rules. The optional regulatory accounting method cannot be used for property that is not subject to regulatory accounting rules.

(3) For example, an electric utility that operates a power plant and is subject to regulation by FERC adopts the optional regulatory accounting method. For regulatory purposes, the taxpayer does not capitalize the cost of repairs and maintenance on its turbines. Therefore, the taxpayer may not capitalize these costs for tax purposes. On the other hand, a taxpayer that operates a power plant but is no longer regulated by FERC is not eligible to use the optional regulatory method.

(4) The optional accounting method does not apply to property to which the taxpayer has elected to apply the repair allowance under Section 1.167(a)-11(d)(2) for that year and must be used on all of its tangible property that is subject to regulatory accounting rules. If a taxpayer properly adopts the optional regulatory accounting method, it cannot use the routine maintenance safe harbor.

(5) Accounting Method

- The optional regulatory accounting method is considered an accounting method. An eligible taxpayer may adopt the regulatory accounting method on its first return reflecting the item or may change from its current method by filing a Form 3115 under the applicable provisions of Rev. Proc. 2015-13 and Rev. Proc. 2015-14, or, if applicable, Rev. Proc. 2016-29, Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, or Rev. Proc. 2022-14 (the List of Automatic Changes).

F.1. Examination Considerations

(1) Confirm if the taxpayer is eligible to use the optional regulatory accounting method. Is the taxpayer subject to regulation by FERC, FCC, or the STB?

(2) Did taxpayer properly file a Form 3115 to change to the regulatory accounting method?

(3) Did the taxpayer elect the repair allowance under Section 1.167(a)-11(d)(2) for certain property? If so, the optional method cannot be used for that property.

(4) Determine whether the taxpayer applied the optional method to all of its tangible property subject to regulatory accounting rules.

(5) Confirm that the taxpayer did not apply the routine maintenance safe harbor to any tangible property subject to regulatory accounting rules.

G. ELECTION TO CAPITALIZE REPAIR AND MAINTENANCE COSTS

(1) Under Section 1.263(a)-3(n), a taxpayer may elect to capitalize expenditures for repair and maintenance costs incurred in carrying on a trade or business. If elected for a taxable year, this provision applies to all amounts paid in that year for repair and maintenance to tangible property that the taxpayer treats as capital expenditures on the books and records it regularly uses in computing income. The capitalized costs are treated as amounts paid to improve tangible property and as an asset subject to the allowance for depreciation. A taxpayer must begin to depreciate the costs of such improvements when they are placed in service by the taxpayer under the applicable depreciation rules.

(2) For example, a taxpayer owns a fleet of ships that it uses in its trade or business. For book purposes, scheduled maintenance costs on the ship engines are treated as capital expenditures. In 2014, the taxpayer properly makes the election under Section 1.263(a)-3(n) to capitalize the scheduled maintenance costs. The taxpayer must capitalize, for tax purposes, all amounts paid for repair and maintenance to tangible property that it treats as capital on its books and records in 2014.

(3) A taxpayer that capitalizes repair and maintenance costs under the election is still eligible to apply certain safe harbors to repair and maintenance costs that are not treated as capital expenditures on its books and records. The taxpayer still may apply the de minimis safe harbor, the safe harbor for small taxpayers, and the routine maintenance safe harbor to such expenditures. The election to capitalize does not apply to repairs or maintenance of rotable or temporary spare parts to which the taxpayer applies the optional method of accounting for rotable and temporary spare parts under Section1.162-3(e).

(4) Why would a taxpayer want to make this election? Depending on the taxpayer's situation, it may not benefit from current deductions (i.e., the taxpayer has a NOL, an expiring tax credit, or has little taxable income). In such cases, it may be more beneficial to obtain the depreciation deduction over a period of years. In addition, a taxpayer may desire the administrative convenience of simply following its book capitalization treatment of certain costs.

(5) Annual Election

- A taxpayer makes this election by attaching a statement to its timely filed tax return (including extensions) for the taxable year in which the subject amounts are paid. An election may not be made by filing an application for change in accounting method, Form 3115, or by filing an amended return (without the Commissioner's consent to make a late election).
- If a consolidated group files a consolidated income tax return, the common parent of the consolidated group makes the election for each member of the group, and its statement must include the names and EINs of each member for which the election is made. In the case of an S corporation or a partnership, the S corporation or partnership makes the election and not the shareholders or partners.

G.1. Examination Considerations

(1) Determine whether the taxpayer followed the election procedures.

(2) Did the taxpayer elect the optional method of accounting for rotable and temporary spare parts under Section 1.162-3(e)? If so, confirm that the election to capitalize is applied to the repair and maintenance of these rotable or temporary spare parts.

(3) Is the taxpayer consistently capitalizing all repairs and maintenance costs for all property in accordance with their book treatment? If the taxpayer elects this treatment for a taxable year, the taxpayer must use the election for all the repairs and maintenance costs that it is capitalizing for its books and records.

H. ELECTION TO DEDUCT OR CAPITALIZE EXPENDITURES UNDER OTHER IRC SECTIONS

(1) Under other provisions of the IRC, a taxpayer may elect to treat capital expenditures as deductible expenses or as deferred expenses, or to treat deductible expenses as capital expenses. The regulations under Section 1.263(a)-6 enumerate the election provisions that are available in accordance with the specific requirements of each respective provision.

H.1. Examination Considerations

(1) Confirm if the taxpayer has elected any of the enumerated provisions.

(2) Consider how basis adjustments are determined. Many provisions require an adjustment to basis of the taxpayer's tangible property. For example, if the taxpayer properly elects Section 179 and deducts the cost of eligible business property, the depreciable basis of the impacted assets must be reduced by the amount deducted.

X. CHAPTER 10 – MATERIALS AND SUPPLIES

A. INTRODUCTION

(1) The final tangible property regulations ("final regulations") clarify the treatment of materials and supplies under Section 1.162-3. Prior regulations provided rules for the deduction of the cost of materials and supplies, but they did not specifically define what type of property qualified as materials and supplies. For that determination, taxpayers and examiners had to rely on case law and administrative guidance.

(2) The final regulations retain the general rules for the deduction of materials and supplies and incorporate the pre-existing case law and administrative guidance to clarify the definition of materials and supplies. These regulations also

address the interaction of the materials and supplies rules and the de minimis safe harbor under Section 1.263(a)-1(f).

B. AMOUNTS PAID TO ACQUIRE OR PRODUCE A UNIT OF PROPERTY – EXCEPTION FOR MATERIALS AND SUPPLIES

(1) Generally, the amounts paid to acquire or produce a unit of property ("UOP") must be capitalized under Section 1.263(a)-2. These amounts include the invoice price, transaction costs, and costs for work performed prior to the date that the UOP is placed in service. Section 1.263(a)-2 requires these costs to be capitalized and recovered (through depreciation or otherwise) when the UOP is placed in service by the taxpayer.

(2) However, the regulations under Section 1.162-3 create an exception to capitalization where amounts are paid for materials or supplies. If the costs are for the acquisition or production of materials and supplies as defined below, then incidental materials and supplies costs may be deducted when paid or incurred, and non-incidental materials and supplies costs may be deducted when first used or consumed in the taxpayer's trade or business.

C. TIMING OF DEDUCTION FOR MATERIALS AND SUPPLIES

(1) Under the general rules for materials and supplies, the timing of the deduction for the acquisition or production of materials and supplies depends, in part, on the method the taxpayer uses to account for the particular materials or supplies in its books and records. The timing of the deduction will depend on whether the materials and supplies are "incidental" or "non-incidental."

(2) Incidental materials and supplies are generally of minor or secondary importance to the taxpayer's trade or business and carried on hand by the taxpayer without recording consumption or taking beginning and ending physical inventories. Amounts paid to acquire or produce incidental materials and supplies are deductible in the year paid or incurred, provided that the taxpayer's treatment clearly reflects its taxable income.

(3) Non-incidental materials and supplies are generally tracked on the taxpayer's books and records, either through records of consumption or by periodic physical inventory. The amounts paid to acquire or produce non-incidental materials and supplies are generally deductible in the taxable year in which the materials and supplies are first used in the taxpayer's operations or are consumed in the taxpayer's operations.

(4) Certain exceptions from these timing rules apply to rotable, temporary, and standby emergency spare parts. The definitions, treatment, and alternative methods for rotable, temporary, and standby emergency spare parts are discussed in more detail below.

D. DEFINITION OF MATERIALS AND SUPPLIES

(1) Materials and supplies are defined as tangible property that is not inventory and that is used or consumed in the taxpayer's operations and meets at least one of the following:

- Is a component acquired to maintain, repair, or improve a UOP as determined under Section1.263(a)-3(e) owned, leased, or serviced by the taxpayer, and is not acquired as part of any single unit of tangible property,
- Consists of fuel, lubricants, water, and similar items, reasonably expected to be consumed in 12 months or less, beginning when used in the taxpayer's operations,
- Is a UOP, as determined under Section 1.263(a)-3(e), that has an economic useful life of 12 months or less beginning when the property is used or consumed in the taxpayer's operations,
- Is a UOP, as determined under Section 1.263(a)-3(e), that has an acquisition cost or production cost (as determined under Section 263A) of $200 or less,
- Is identified in published guidance in the Federal Register or in the Internal Revenue Bulletin.

(2) Unit of Property

- The definitions of materials and supplies refer to both UOPs and components of UOPs. For example, a material or supply may be:
  - A component acquired to maintain, repair, or improve a UOP,
  - A UOP that has an economic useful life of 12 months or less, or
  - A UOP that has an acquisition cost or production cost of $200 or less.
- For purposes of identifying materials and supplies in these contexts, an examiner must understand the terms "UOP" and "component."
- Section 1.263(a)-3(e) defines a UOP for purposes of the capitalization and the materials and supplies rules. Because the materials and supplies rules apply to the acquisition or production of certain UOPs, the examiner must determine if the taxpayer properly identified the UOP in accordance with regulations.
- In general, determining the appropriate UOP for capitalization purposes is based on the functional interdependence standard. This means that the placing in service of one component by the taxpayer is dependent on the placing in service of the other component by the taxpayer. For example, a truck frame, engine, and battery are considered separate components, but part of one UOP when they are placed in service together because these components are ready and available, and dependent on each other to

function as a truck in the taxpayer's trade or business. Special UOP rules apply to buildings and their structural components, plant property, network assets, improvements to property, and lessee improvements. See Chapters 3 and 11 for additional information on UOP.

(3) Components Acquired to Repair, Maintain, or Improve

- The definition of materials and supplies includes certain components of UOPs when they are purchased separately from the UOP in which they will be used. A component is treated as a material or supply under Section 1.162-3, if it is not inventory property, it is acquired to repair, maintain, or improve a UOP that is owned, leased, or serviced by the taxpayer, and it is not acquired as part of another single UOP. For example, if a taxpayer acquires spark plugs that it intends to use to maintain trucks that it uses in its transport business, these will generally qualify as materials and supplies. However, if the spark plugs are acquired as part of a truck, these spark plugs are part of the truck UOP, and qualify as materials and supplies only if the truck UOP qualifies as a material or supply.

E. COORDINATION OF Section 263(a) and 263A

(1) In certain circumstances, the costs of components or units of property may qualify under one of the definitions of materials and supplies but cannot be deducted when paid (if incidental) or when first used or consumed (if non-incidental). For example, if the material or supply is used, or reasonably expected to be used, in the improvement of other property under Section 1.263(a)-3, then the materials and supplies are generally capitalized under Section 263(a). Similarly, if the costs of materials or supplies comprise the direct or allocable indirect cost of property produced by the taxpayer or property acquired for resale, then these material and supply costs may be subject to capitalization under Section 263A. In these cases, the amount will be added to basis or included in inventory costs, and recovered through depreciation, cost of goods sold, or an adjustment to basis when the property is used, sold, or otherwise disposed of.

(2) Example 1 – Improvements to property: A taxpayer incurs costs for materials that it expects to use to create ergonomic workstations for its employees. Assume the materials result in substantial betterments to its workstations. Even if the amounts paid for the materials meet one of the definitions of materials and supplies, their costs must be capitalized as costs incurred for improvements under Section 1.263(a)-3 and added to capital accounts.

(3) Example 2 – Self-constructed property: A taxpayer incurs costs for three windows that it expects to use in the construction of a building that it will use to store supplies for its horse grooming business. Even if the costs of each window qualify under the definition of materials and supplies, these amounts must be capitalized as the costs of producing (i.e., constructing) property under

Section 1.263(a)-2 and Section 263A. Accordingly, these amounts would be included in the basis of the building and recovered through depreciation beginning when the building is placed in service.

(4) Example 3 – Producing inventory: A taxpayer incurs costs for containers of lubricant, used to prepare machinery it uses to manufacture goods for sale to its customers. Even if the costs of the lubricant qualify under the definition of materials and supplies, these amounts must be capitalized as the costs of producing inventory and included in inventory costs under Section 263A or Section 1.263A-1(e)(3)(i).

F. ROTABLE, TEMPORARY, AND STANDBY EMERGENCY SPARE PARTS

(1) Materials and supplies also include rotable, temporary, and standby emergency spare parts that are acquired to maintain, repair, or improve a unit of tangible property. However, under the final regulations governing materials and supplies, these parts are subject to different timing rules, elections, and accounting methods.

(2) Rotable spare parts are defined in Section 1.162-3(c)(2). These parts are installed on a UOP, removable from that UOP, generally repaired or improved, and either reinstalled on the same or other property or stored for later installation.

(3) Temporary spare parts are used temporarily until a new or repaired part can be installed and then are removed and stored for later installation.

(4) Under the final regulations, the amounts paid for rotable and temporary spare parts are deductible in the year the parts are disposed. Alternatively, taxpayers may elect to capitalize and depreciate these parts under Section 1.162-3(d) or to use the optional method of accounting for rotable and temporary spare parts under Section 1.162-3(e). These alternatives are discussed below.

(5) Standby emergency spare parts are different from rotable and temporary spare parts. They are defined in Section 1.162-3(c)(3) as parts that are:

- Acquired when particular machinery or equipment is acquired (or later acquired and set aside for use in particular machinery or equipment),
- Set aside for use as replacements to avoid substantial operational time loss caused by emergencies due to particular machinery or equipment failure,
- Located at or near the site of the installed related machinery or equipment so as to be readily available when needed,
- Directly related to the particular machinery or piece of equipment they serve,
- Normally expensive,

- Only available on special order and not readily available from a vendor or manufacturer,
- Not subject to normal periodic replacement,
- Not interchangeable in other machines or equipment,
- Not acquired in quantity (generally only one is on hand for each piece of machinery or equipment),
- Not repaired and reused.

(6) Amounts paid for standby emergency spare parts are deductible when first used or consumed in operations under the general rule for non-incidental materials and supplies. Alternatively, a taxpayer may elect to capitalize and depreciate standby emergency spare parts under Section 1.162-3(d).

G. ELECTION TO CAPITALIZE AND DEPRECIATE ROTABLE, TEMPORARY, AND EMERGENCY SPARE PARTS

(1) Section 1.162-3(d) allows taxpayers to elect to treat the cost of any rotable spare part, temporary spare part, or standby emergency spare part as a capital expenditure and an asset subject the allowance for depreciation. The election applies to amounts paid or incurred during the taxable year to acquire or produce any rotable, temporary, or standby emergency spare part that would otherwise be subject to the general material and supply rules. Any property for which this election is made will not be treated as a material or a supply.

(2) A taxpayer may not elect to capitalize and depreciate a rotable, temporary, or standby emergency spare part if:

- It is intended to be used as a component of a UOP that is a material or supply with a useful life of 12 months or less, a cost of $200 or less, or otherwise identified in published guidance,
- It is intended to be used as a component acquired to maintain, repair, or improve a UOP owned, leased, or serviced by the taxpayer and the taxpayer cannot or has not elected to capitalize and depreciate that property,
- The taxpayer uses the optional method of accounting for rotable and temporary spare parts.

(3) A taxpayer makes this election by capitalizing the costs in the taxable year the amounts are paid and by beginning to depreciate these amounts when the asset is placed in service by the taxpayer for purposes of determining depreciation under the applicable provisions of the Internal Revenue Code and the Treasury Regulations. A taxpayer must make the election in its timely filed original federal income tax return (including extensions) for the taxable year the

asset is placed in service by the taxpayer for purposes of determining depreciation.

(4) A taxpayer can revoke the election or make a late election, only by filing a request for a private letter ruling and obtaining the Commissioner's consent to revoke the election or make a late election. An election may not be made or revoked through the filing of an application for change in accounting method (Form 3115) or, before obtaining the Commissioner's consent to make the late election or to revoke the election, by filing an amended federal income tax return.

H. OPTIONAL METHOD OF ACCOUNTING FOR ROTABLE AND TEMPORARY SPARE PARTS

(1) Application

- Taxpayers may choose the optional method of accounting for rotable and temporary spare parts in lieu of applying the general rule for materials and supplies or electing to capitalize and depreciate the spare parts. The optional method for rotable and temporary spare parts is a method of accounting under Section 446(a). To change to this method, taxpayers must file a Form 3115 and follow the procedures contained in section 10.11 of Rev. Proc. 2015-14, 2014-5 I.R.B. 450, or, if applicable, section 11.08 of Rev. Proc. 2016-29, 2016-21 I.R.B. 880, Rev. Proc. 2017-30, 2017-18 I.R.B. 1131, Rev. Proc. 2018-31, 2018-22 I.R.B. 637, Rev. Proc. 2019-43, 2019-48 I.R.B. 1107, and Rev. Proc. 2022-14, 2022-7 I.R.B. 502, or any successor (the List of Automatic Changes). If the taxpayer uses the optional method of accounting for rotable and temporary spare parts for book purposes, and the taxpayer decides to use the optional method for tax purposes, the taxpayer must apply this method to all the pools of rotable and temporary spare parts in the same trade or business for which it uses such method for book purposes. If the taxpayer does not use the optional method of accounting for rotable and temporary spare parts for a trade or business for book purposes, but decides to use it for tax purposes, the taxpayer must use the optional method for all of its pools of rotable spare parts used in that trade or business.

(2) Methodology

- A taxpayer using (or adopting) the optional method must deduct the amount paid to acquire or produce the part in the taxable year that the part is first installed on a UOP for use in the taxpayer's operations. If the taxpayer later removes the part, it must:
  - Include in gross income the fair market value of the part.
  - Include in the basis of the part the fair market value of the part included in income under (1), plus the amount paid to remove the part

from the UOP and any amounts paid to maintain, repair, or improve the part in the taxable year these amounts are paid.

- In the taxable year that the part is reinstalled on a UOP, the taxpayer must deduct:
  - Any amounts paid to reinstall the part.
  - Any amounts included in the basis of the part, including:
    - The fair market value of the part included in income when it was removed,
    - The amount paid to remove the part from the UOP, and
    - The amount paid to maintain, repair, or improve the part that were included in basis, to the extent that any of these amounts have not been previously deducted.
- Finally, in the taxable year in which the taxpayer disposes of the part, the taxpayer must deduct any amounts included in the basis of the part, including the following amounts:
  - The fair market value of the part that was included in income,
  - Any amounts paid to remove and reinstall the part,
  - Any amounts paid to maintain, repair, or improve the part, to the extent that any of these amounts have not been previously deducted in the taxable year(s) of reinstallation.

I. DE MINIMIS SAFE HARBOR ELECTION

(1) The examiner should consider whether the taxpayer elected to apply the de minimis safe harbor under Section 1.263(a)-1(f) for the year under exam. If the election is made, the taxpayer must apply the safe harbor to all applicable amounts paid for materials and supplies with the exception of materials and supplies that the taxpayer elects to capitalize or elects to use the optional method of accounting for rotable, temporary, and standby emergency spare parts.

(2) If the taxpayer elects to use the de minimis safe harbor, the amounts paid for all units of tangible property and materials and supplies that meet the requirements of the safe harbor are currently deductible in the taxable year the amount is paid, provided the amount otherwise constitutes an ordinary and necessary expense incurred in carrying on a trade or business.

(3) However, even if the taxpayer elects the de minimis safe harbor, the costs of otherwise eligible materials and supplies that comprise the direct or allocable indirect costs of producing property or acquiring property for resale are still subject to the uniform capitalization rules under Section 263A.

J. ACCOUNTING METHOD CHANGES AND EFFECTIVE DATES

(1) Except as otherwise provided (e.g., election to capitalize rotable and temporary spare parts), a change in treatment of materials and supplies under the final regulations is a change in method of accounting.

(2) In general, the final regulations governing the treatment of material and supplies apply to amounts paid or incurred in taxable years beginning on or after January 1, 2014. Thus, a taxpayer that changes its accounting method for a taxable year beginning on or after January 1, 2014, is required to calculate a Section 481(a) adjustment for materials and supplies that takes into account only amounts paid or incurred in taxable years beginning on or after January 1, 2014. See section 10.11(6)(b)(i) of Rev. Proc. 2015-14, or, if applicable, section 11.08(6)(b)(i) of Rev. Proc. 2016-29, Rev. Proc. 2017-30 and Rev. Proc. 2018-31, or section 11.08(5)(b)(i) of Rev. Proc. 2019-43 and Rev. Proc. 2022-14. Refer to Chapter 17 for more information.

K. MATERIALS AND SUPPLIES SUMMARY

(1) The following are the steps identified in the flow chart below:

<table>
<tr><th colspan="2">Rule</th><th>Section 1.162-3 Materials and Supplies</th><th>Deductible when:</th></tr>
<tr><td rowspan="3" colspan="2">General Rule</td><td>Incidental</td><td>Paid</td></tr>
<tr><td>Non-Incidental</td><td>First Used or Consumed</td></tr>
<tr><td>Rotable/Temporary</td><td>Disposed of</td></tr>
<tr><td colspan="2">OR</td><td>OR</td><td>Capitalized when:</td></tr>
<tr><td colspan="2">Election to Capitalize</td><td>Rotable, Temporary and Standby Emergency Spare Parts</td><td>Elect on a timely filed federal tax return by capitalizing the costs in the taxable year the amounts are paid and by beginning to depreciate the costs when the asset is placed in service</td></tr>
<tr><td colspan="2">OR</td><td>OR</td><td>Deductible when:</td></tr>
<tr><td rowspan="3" colspan="2">Optional Method of Accounting</td><td rowspan="3">Rotable/Temporary Spare Parts</td><td>First Installed</td></tr>
<tr><td>And then must include:</td></tr>
<tr><td>The FMV of the removed part in income. The new basis of this part will include:</td></tr>
</table>

Rule	Section 1.162-3 Materials and Supplies	Deductible when:
		1. The FMV of the part included in income; and 2. The removal cost; and 3. The reinstallation cost; and 4. Any amount paid to maintain, repair, or improve the part.
		Deductible when:
		Reinstalled or finally disposed of to the extent not previously deducted.

L. AUDIT PROCEDURES

(1) Examiners should consider the following steps when reviewing/examining materials and supplies issues. The examiner should only request documents that are pertinent to the facts and circumstances in each case.

L.1. Identify Potential Audit Issues

(1) Consider how the taxpayer uses materials and supplies in its business:

- Manufacturers may use materials and supplies to produce (improve, construct, build, manufacture…) buildings, machinery, equipment, and inventory.
- Construction companies may lease heavy equipment for which they acquire or produce materials and supplies.
- Distribution companies may lease trucks and trailers for which they acquire or produce materials and supplies.
- Service industries may use office supplies or office equipment that are materials and supplies.
- Taxpayers may use materials and supplies in repairs and maintenance, and
- Section 1.162-4 may also apply.

(2) Consider whether the taxpayer elected to use the de minimis safe harbor under Section 1.263(a)-1(f)?

- If the taxpayer has not elected to use the de minimis safe harbor, its materials and supplies costs are subject to Section 1.162-3.
- If the taxpayer has elected to use the de minimis safe harbor, then the de minimis safe harbor would apply to qualifying materials and supplies.
- Even if the taxpayer has elected the de minimis safe harbor, certain materials and supplies may not qualify under the safe harbor and would be subject to
- Section 1.162-3.

L.2. Assess Audit Risk

(1) Consider book treatment of materials and supplies.

(2) Determine if the taxpayer has Schedule M tax reconciliation work papers that would indicate book/tax differences in the treatment of materials and supplies.

(3) Consider the taxpayer's accounting policy for materials and supplies.

(4) Consider whether the materials and supplies would be incidental or non-incidental.

(5) Consider that materials and supplies that are research and experimental expenditures under Section 174 may be treated in accordance with the rules of that section.

(6) Determine if the taxpayer filed a Form 3115 to change its method of accounting.

- Was there a Section 481(a) adjustment?
- How was it determined?

(7) Determine if the taxpayer has a written policy for materials and supplies.

(8) Determine if the taxpayer has elected to either capitalize and depreciate or use the optional method of accounting for materials and supplies.

L.3. Examination Considerations

(1) Did the taxpayer elect the de minimis safe harbor under Section 1.263(a)-f (1)?

- If so, and the materials and supplies qualify under the safe harbor, the materials and supplies are subject to the safe harbor rules unless the taxpayer elects to capitalize and depreciate or uses the optional method of accounting.
- If the taxpayer has not elected the de minimis safe harbor, or if the materials and supplies do not qualify under the safe harbor, materials and supplies costs are subject to Section 1.162-3.

(2) Did the taxpayer acquire or produce property?

- Was the property tangible property?
- Was the property non-inventory property? Inventory property does not qualify as materials or supplies.

(3) Does the property meet one of the definitions of materials and supplies?

(4) Is the property a component acquired to maintain, repair, or improve a UOP that was owned, leased, or serviced by the taxpayer?

- Was the component acquired separate from a UOP as defined by Section 1.263(a)-3?
- Was the component used to repair or maintain a UOP?
- Was the component used to produce property or acquire property for resale and therefore, subject to capitalization under Section 263A?
- Was the component used to improve a UOP that is owned or leased by the taxpayer and subject to capitalization under Section 1.263(a)-3?
- Was the component used to service (maintain, repair, or improve) a UOP that is owned or leased by another taxpayer? If so, how did the taxpayer treat the cost of the component?
- Was the component a rotable, temporary, or standby emergency spare part?

(5) Did the taxpayer claim a deduction for property that cost $200 or less?

(6) Did the taxpayer claim a deduction for property that has an economic useful life of 12 months or less beginning when the property is used or consumed?

- Did the taxpayer properly determine the economic useful life of the property under Section 1.162-3(c)(4)?
- Consider whether the taxpayer has an applicable financial statement (AFS) as defined by Section 1.162-3(c)(4)(iii).
- If the taxpayer has an AFS, did it use the same useful life for tax purposes as was initially used in its AFS for purposes of determining depreciation?

(7) Was the UOP correctly determined under Section 1.263(a)-3(e)?

(8) Was the cost of the UOP correctly determined under Section 1.263(a)-2?

(9) Is capitalization required under any other section?

- Did the taxpayer use or expect to use the UOP in an improvement under

- Section 1.263(a)-3(d)?
- Did the taxpayer use or expect to use the UOP for the production of property or in acquiring property for resale such that the costs may be subject to capitalization under Section 263A?

(10) Did the taxpayer acquire any rotable or temporary spare parts?

- Did the taxpayer apply the general rule for timing of deductions to its rotable or temporary spare parts?
- Did the taxpayer elect to capitalize and depreciate rotable, temporary, or standby emergency spare parts?
- Did the taxpayer use the optional method for any of its pools of rotable or temporary spare parts?
- If the taxpayer used the optional method, did it use this method for all the rotable and temporary spare parts in the same trade or business? If not, did it use the method for all rotable and temporary spare parts in the trade or business for which it used this method for book purposes?
- If the taxpayer used the optional method, did it apply the method as described in the regulations?
- Did the taxpayer elect the de minimis safe harbor, and if so, did it properly exclude rotable and temporary spare parts accounted for under the capitalization election or the optional method of accounting?

(11)Determine if the taxpayer properly considered the impact of the treatment of materials and supplies on its computation of the Section 199 Domestic Production Deduction, where applicable.

XI. CHAPTER 11 – LEASED PROPERTY

A. INTRODUCTION

(1) The final tangible property regulations (“final regulations”) contain several provisions that govern the treatment of leased property for both lessees and lessors of building property and non-building property, such as leased equipment. These final regulations provide rules for determining the units of property (“UOPs”) for lessees and lessors, and for applying the improvement rules to these UOPs.

(2) Before applying the improvement rules for leased property, it is important to determine which party is the owner of the property. Tax law uses a benefits and burdens of ownership test to determine the “true owner” of the asset. The true owner is the only one entitled to claim depreciation expenses on the asset. If the lessee is determined not to be the true owner of the asset, then the entire

lease payment to the lessor would be fully deductible as rent. This type of lease is treated as an operating lease for tax purposes. Conversely, a lessee who is determined to be the true owner of the asset would deduct interest expenses and depreciation on the asset, and no deduction is allowed for the principal repayment to the lessor (a capital lease). A common book/tax difference is that a lease is being treated as a capital lease under GAAP, but as an operating lease for tax purposes.

(3) The final regulations are applicable for taxable years beginning on or after January 1, 2014, but are generally consistent with rules in place for leasehold improvements under prior regulations, case law, and other applicable precedents.

B. LEASEHOLD IMPROVEMENTS UNDER THE FINAL REGULATIONS

(1) The following regulation sections apply to leased property and are addressed in this chapter:

- Section 1.263(a)-3(e)(2)(v) Provides the UOP rules for lessees of buildings and portions of buildings.
- Section 1.263(a)-3(e)(3)(iv) Provides the UOP rules for lessees of real or personal property other than buildings.
- Section 1.263(a)-3(f)(1) Provides the general rules for the capitalization of leasehold improvements under the final tangible property regulations and confirms that the intangible property regulations under Section 1.263(a)-4 do not apply to amounts paid for improvements to leased property.
- Section 1.263(a)-3(f)(2) Provides the rules for determining whether amounts paid by lessees constitute leasehold improvements that must be capitalized by the lessee and provides rules for determining the lessee's UOP after such improvements.
- Section 1.263(a)-3(f)(3) Provides the rules for determining whether amounts paid by lessors constitute leasehold improvements that must be capitalized by the lessor and provides the rules for determining the lessor's UOP after such improvements.
- Section 1.162-11(b) Provides a lessee's cost of erecting buildings or making permanent improvements on property is a capital expenditure.
- Section 1.167(a)-4 Provides that improvements made by the lessor or lessee for the erection of a building or for other permanent improvements on leased property are recovered by the lessee or lessor under the applicable provision of the Code without regard to the period of the lease.

C. COORDINATION WITH SECTION 263A

(1) The provisions under the final regulations governing improvements to leased property do not change the treatment of any amounts specifically provided for under any provision of the Code and the regulations other than Section 162 and 212. For example, Section 263A requires taxpayers to capitalize the direct and allocable indirect costs of producing real or tangible personal property or of acquiring real or tangible personal property for resale. Section 263A and the underlying regulations define "produce," to include the constructing, building, installing, manufacturing, developing, or improving real or tangible personal property. Accordingly, when a taxpayer applies the final regulations to leased property, the taxpayer must also consider the application of Section 263A.

D. LEASEHOLD IMPROVEMENT OR ACQUISITION OF TANGIBLE PROPERTY?

(1) If the taxpayer is a lessee or a lessor of real or tangible personal property, the first consideration should be whether the taxpayer's expenditure is for the acquisition of separate tangible personal property under Section 1245 (e.g., certain appliances, non-permanent floor coverings, racks, shelving, cabinets, furniture, etc.) or for the improvement, repair, maintenance of building property under Section 1250 (e.g., the building and its structural components including walls, doors, floors, ceilings, central air conditioning and heating systems, plumbing, electric systems, etc.). If the taxpayer pays an amount to acquire tangible personal property, then the taxpayer must generally capitalize the costs of acquiring the property (and its transaction costs) unless certain exceptions, such as the de minimis safe harbor election, apply. For example, if a lessee or lessor acquires and installs personal property, such as shelving or furniture in a leased building or in a leased space, then the amounts paid are generally treated as the costs of acquiring separate units of tangible personal property.

E. LEASED BUILDING PROPERTY

(1) Lessee's Improvements to Building Property

- Where the lessee pays amounts to improve the leased building, the taxpayer must capitalize the related amounts paid to improve the building except:
  - To the extent that Section 110 applies to a construction allowance received by the lessee, or
  - Where the improvements constitute a substitution for rent.
- In the case of a taxpayer that is a lessee of an entire building, the UOP is the building and its structural components. However, for purposes of determining whether work performed on the leased building is an improvement, the lessee must determine whether the work is for an improvement (i.e., a betterment, a restoration, or an adaptation) to the building structure or any building system. Thus, if a taxpayer is the lessee of an entire building, the taxpayer needs to analyze the building structure

and each building system (e.g., the plumbing system, the electrical system, the HVAC system) to determine whether the structure or any system is improved. For example, if the taxpayer (lessee) pays an amount to improve the HVAC system, it must treat the amount as an improvement to the leased UOP.

- In the case of a taxpayer that is the lessee of only a portion of a building, for example, several floors, or just one office, the UOP is that portion of the building subject to the lease and its related structural components. However, for purposes of determining whether work performed on the leased portion of the building is an improvement, the lessee must determine whether the work is an improvement (i.e., a betterment, a restoration, or an adaptation) to the portion of the building structure subject to the lease or to the portion of each building system that is associated with the leased portion of the building. Thus, if the taxpayer is the lessee of an office space in a building, the taxpayer needs to analyze the part of the building structure subject to the lease (the office space structure) and the portion each building system associated with the lease (e.g., the portion of the building plumbing associated with the office space). For example, if the taxpayer lessee pays an amount to improve the plumbing associated with the office space, it must treat the amount as an improvement to the leased UOP.
- Where a lessee has made improvements to leased building property that are capitalized under the final regulations, for purposes of applying the improvement rules to the leased property in future taxable years, the lessee's property generally includes these previous lessee improvements.

(2) Lessor's Improvements to Building Property

- Where the taxpayer is the lessor, the taxpayer must capitalize the related amounts it pays directly, or indirectly through a construction allowance to the lessee, to improve the building and its structural components when it owns the improvement or to the extent Section 110 applies to the construction allowance. A lessor must also capitalize costs that a lessee pays for improvements when the lessee's improvements constitute a substitution for rent.
- In the case of a taxpayer that is a lessor of a building, the UOP and the improvements rules for the building are generally the same as the rules for any property owner. Thus, for the application of the improvement rules to a lessor of an entire building, an amount is paid for an improvement to the building UOP if it is for an improvement (i.e., a betterment, a restoration, or an adaptation) of the building structure or any designated building system.

(3) Exceptions to the Leasehold Improvement Rules

- If the taxpayer is a lessee or a lessor of building property, certain costs may be excepted from the general capitalization rules. For example, costs incurred by a lessor or lessee to improve their building may qualify for the safe harbor for routine maintenance or the safe harbor for small taxpayers. Certain costs may also be treated as materials or supplies or deducted under the de minimis safe harbor if applicable.

(4) Qualified Leasehold Construction Allowance

- Lessee: A lessee is not required to capitalize the amounts it pays to improve a UOP to the extent that Section 110 applies to a construction allowance received by the lessee for the purpose of the improvement. Under Section 110, a lessee of retail space may exclude from gross income any amount received from a lessor in cash for the purpose of constructing or improving qualified long-term real property at that retail space. Qualified long-term property is property that reverts to the lessor at the termination of the lease. The lease must be a short-term lease for retail space, that is, the term must be 15 years or less. Additionally, the subject retail space must be used by the lessee in its trade or business of selling tangible personal property or services to the general public. The amount can be excluded only to the extent that it does not exceed the amount expended by lessee for such construction. Property constructed and improvements made by a lessee in connection with a construction allowance are considered property of the lessor.
- If Section 110 does not apply to a construction allowance received by the lessee, the treatment of the construction allowance turns on whether the lessee or the lessor is treated as the owner of the property constructed with the construction allowance. When the lessee is treated as the owner, the construction allowance received is treated as income to the lessee and the lessee is required to capitalize the amounts it pays to improve the UOP. See the Retail Audit Technique Guide, Exhibit 2, Planning & Examination of Construction “Tenant” Allowances for Leases Greater than 15 Years.

(2) Lessor: A lessor is required to capitalize the related amounts that it pays directly, or indirectly through a construction allowance to the lessee if Section 110 applies, for improvements made to the UOP owned by the lessor. Qualified long-term real property constructed or improved with any amount excluded from a lessee’s gross income by reason of Section 110(a) must be treated as non-residential real property of the lessor for purposes of depreciation and determining gain or loss on disposition.

F. LEASED PROPERTY OTHER THAN BUILDINGS

(1) Lessee’s Improvements to Property Other than Buildings

- A taxpayer may also lease personal property such as aircraft, trucks, or equipment such as copiers from a lessor for use in the lessee's business. In the case of a taxpayer that is a lessee of real or personal property other than building property, the lessee's treatment of amounts paid to improve, maintain, or repair leased property depends on whether the lessee has the benefits and burdens of ownership of the leased property. Where the lessee does have the benefits and burdens of ownership, the application of the improvement and UOP rules to the lessee is determined under the general improvement and UOP rules for property other than buildings, including the functional interdependence test or the plant property rule (if applicable). When applying these rules, however, the UOP may not be larger than the unit of leased property. For taxpayer-lessees in certain industries (e.g., electric transmission, distribution, and generation, and telecommunications), certain safe-harbor methodologies may be applicable.
- Leases for personal property generally will contain terms that specify whether the lessee or the lessor is responsible for repairing and/or maintaining the property. The terms of the lease must be reviewed to determine whether the lessee or the lessor is the owner of the leased property for tax purposes (i.e., whether it bears the benefits and burdens of ownership) and required to capitalize amounts paid to improve such property.

(2) Lessor's Improvements to Property Other than Buildings

- In the case of a taxpayer that is a lessor of real or personal property other than building property, the lessor's treatment of amounts paid to improve or repair that property depends on whether the lessor has the benefits and burdens of ownership of the leased property. Where the lessor does have the benefits and burdens of ownership, the application of the improvement and UOP rules to the lessor is determined under the general improvement and UOP rules for property other than buildings, including the functional interdependence test or the plant property rule (if applicable). For taxpayer-lessors in certain industries (e.g., electric transmission, distribution, generation, telecommunications), certain safe-harbor methodologies may be applicable.

G. COST RECOVERY FOR LEASEHOLD IMPROVEMENTS

(1) The final regulations amend the prior rules regarding the cost recovery for leasehold improvements and remove the rules permitting amortization over the shorter of the estimated useful life of the improvement or the term of the lease. Capital expenditures made by either a lessee or lessor for the erection of a building or for other permanent improvements are recovered under the regular rules applicable to the cost recovery of the building or improvements through

depreciation deductions or amortization deductions without regard to the period of the lease. The term of the lease is no longer relevant.

(2) For example, if the building or improvement is property to which Section 168 applies, the lessee or lessor determines the depreciation deduction for the building or improvement under Section 168. If the improvement is property to which Section 167 or Section 197 applies, the lessee or lessor determines the depreciation or amortization deduction for the improvement under Section 167 or Section 197, as applicable.

H. AUDIT PROCEDURES

(1) Examiners should consider the following steps when reviewing/examining leasehold improvement issues. The examiner should only request documents that are pertinent to the facts and circumstances in each case.

H.1. Identify Potential Audit Issues

(1) Determine if the taxpayer is a lessee of buildings or personal property. For example:

- Retailers may lease buildings.
- Construction companies may lease heavy equipment.
- Distribution companies may lease trucks and trailers.

(2) Determine if the taxpayer is a lessor of buildings or personal property. For example:

- Motor vehicle dealers may lease out fleets or individual cars and trucks.
- Office equipment dealers may lease out machines such as copiers.
- Real estate developers may lease out residential or commercial properties.

(3) Determine if the costs of acquiring tangible personal property qualify as materials and supplies subject to Section 1.162-3.

(4) Determine if the de minimis safe harbor was elected and applies to tangible property costs related to leased property.

(5) Did the taxpayer make any other election(s)?

H.2. Assess Audit Risk

(1) Consider book treatment.

- Are the leases classified as capital leases?

- Are the leases classified as operating leases?

(2) How are the leases treated for tax purposes?

(3) Review Schedule M adjustments for book and tax differences for depreciation and rent expenses.

(4) Determine if the taxpayer filed a Form 3115 to change its method of accounting for leasehold improvements.

- Consider whether the Form 3115 is the initial change or a change to "true up" any previous accounting method change(s).
- Determine specifically what accounting method the taxpayer is following for adaptations.

(5) Consider any Section 481(a) adjustment and determine if it accounts for changes in the accounting for leasehold improvements.

(6) Determine if the taxpayer has a written policy for capitalization and repairs for leasehold improvements.

H.3. Examination Considerations

(1) Consider all significant leases.

(2) Is the taxpayer the lessor or the lessee?

- What are the terms of the lease?
- Which party to the lease bears the benefits and burdens of ownership of the leased property?
- Establish the length of the lease, provisions for renewals, and purchase options.
- Determine which party has the responsibility for improvements or repairs to the leased property.
- Establish the type of expenditures (i.e., repairs, maintenance, or improvements), and whether it is covered by the lease.

(3) Were improvements made to leased property?

- Identify whether the improvement relates to a leased building (or portions of buildings) or to other real or tangible personal property (or portions of other property).
- Determine whether any costs were for the acquisition of other tangible personal property.

- Is a construction allowance provided by the lessor? Was the construction allowance treated as a qualified lessee construction allowance by the lessee and the lessor under Section 110?
- Were any improvements made in lieu of rent?

(4) Do the improvement rules under Section 1.263(a)-3(d) apply?

(5) Determine if the amount paid qualifies as materials and supplies?

(6) Determine if the amount paid qualifies for any of the following safe harbors?

- Was the de minimis safe harbor properly elected and does it apply to costs incurred?
- Was the safe harbor for small taxpayer's property elected and does it apply to the costs incurred?
- Does the routine maintenance safe harbor apply to any of the costs incurred?

XII. CHAPTER 12 – DISPOSITION CONCEPTS AND MACRS ACCOUNTING RULES

A. INTRODUCTION

(1) Chapters 12, 13, 14, and 15 discuss the regulations under Section 1.168(i)-1, 1.168(i)-7 and 1.168(i)-8, collectively known as the disposition regulations. Chapter 12 provides the MACRS accounting rules, including the rules for placing assets in Single Asset Accounts ("SAAs"), Multiple Asset Accounts ("MAAs") and General Asset Accounts ("GAAs"). Chapter 13 contains general disposition rules. Chapter 14 covers disposition rules for SAAs and MAAs. Chapter 15 contains the GAA rules.

(2) The disposition regulations are contained in Section 1.168(i)-1, Section 1.168(i)-7 and Section 1.168(i)-8. Section 1.168(i)-7 was issued in conjunction with the Section 263(a) final tangible property regulations ("final regulations") in September 2013. Sections 1.168(i)-1 and 1.168(i)-8 were issued in August 2014. This chapter begins by discussing some important concepts contained in the regulations, including how the disposition regulations interact with the other tangible property regulations.

(3) The remainder of the chapter covers the MACRS accounting rules. For the first time, taxpayers may elect to dispose of part of a MACRS asset. Taxpayers will use their existing records and may also supplement their records with one of the reasonable methods described in the regulations to determine the amount of loss on a partial disposition. It is important to understand the records taxpayers should have available as well as changes to the recordkeeping requirements made by the disposition regulations.

B. DISPOSITION CONCEPTS

(1) The coordination between the capitalization and disposition rules is a key concept of the final regulations. Where the capitalization regulations require a taxpayer to capitalize an improvement to an asset, the disposition regulations may allow a taxpayer to recognize a gain or loss on the disposition of a portion of an asset if that portion has been disposed of. Similarly, electing a partial disposition will trigger capitalization of the replacement. The rules work together to require that a component or part be capitalized and depreciated once at any given time.

(2) For example, assume a taxpayer owns a building and incurs costs to replace the original roof. The taxpayer must capitalize the replacement roof under the Section 263(a) improvement rules. The taxpayer may also elect to recognize a disposition for the old roof using the new partial disposition election. The disposition and capitalization rules work together to ensure that the original roof and replacement roof are not both capitalized and depreciated at the same time.

(3) The capitalization rules generally take precedence, with the partial disposition election available at the taxpayer's option. However, certain mandatory dispositions may trigger capitalization. Thus, examiners must consider both the capitalization and disposition rules for any improvement.

(4) Structural Components and the Partial Disposition Election

- Under the disposition regulations, taxpayers may recognize a disposition on the retirement of a building structural component that is MACRS property.
- The definition of a disposition for MACRS property now includes a partial disposition. In addition to certain mandatory partial dispositions, the regulations contain a voluntary partial disposition election. A taxpayer makes the partial disposition election by reporting the gain, loss, or other deduction on its timely filed (including extensions) original Federal income tax return for the taxable year in which the partial disposition occurs. Examiners will likely see an increase in partial dispositions involving retirements of building structural components.

(5) Buildings

- The disposition regulations are especially important as applied to buildings and their structural components that are MACRS property. Taxpayers typically make a number of capitalized improvements over a building's long life. These improvements often require a significant financial outlay. It is beneficial to recognize dispositions of structural components retired as part of these improvements.

- Taxpayers face some challenges in determining the loss on the disposition of part of a building or of a building structural component. If a part of a building or a structural component is disposed of by physical abandonment, the retirement loss is computed using the adjusted depreciable basis of the disposed part or structural component at the time of its physical abandonment. While taxpayers are required to maintain records on their buildings, taxpayers may not have records regarding the basis of structural components or other parts of a building.
- The regulations contain reasonable methods that fill the gap between the records required for assets and those needed to compute loss for a partial disposition. Due to the significance of these regulations as applied to buildings, the following chapters will highlight issues that may occur in the application of the reasonable methods to buildings.

(6) Pre-MACRS Buildings

- The disposition regulations apply to the disposition of MACRS property. MACRS property is defined in Section 1.168(b)-1(a)(2) as tangible, depreciable property that is placed in service generally after December 31, 1986. The disposition regulations do not apply to any pre-MACRS property. Accordingly, taxpayers may not make the partial disposition election in the disposition regulations for depreciable property or for a portion of additions or improvements to depreciable property placed in service before January 1, 1987.
- Buildings placed in service before January 1, 1987, are subject to the pre-MACRS rules and the disposition regulations do not apply. Under the ACRS proposed regulations, a disposition does not include the retirement of a structural component or a part of a building. For buildings or structural components placed in service before 1981, the retirement regulations in Section 1.167(a)-8 apply.

(7) UOP, Assets and Buildings

- The disposition regulations discuss dispositions and partial dispositions of “assets.” The capitalization regulations measure whether an expenditure has improved a unit of property (“UOP”). The Section 263(a) UOP determination does not apply when determining the asset disposed of under Section 168. Assets and UOPs are different concepts, and each term should be considered under each respective section of the regulations.
- For capitalization purposes, a building and its structural components is the UOP. The capitalization rules also consider whether an expenditure improves any of the listed building systems. A building or a building

system continues to be a single UOP regardless of additions or improvements made to it.

- For disposition purposes, the original building, including its original structural components, is the asset. However, an improvement or addition to an asset is considered a separate asset if it is placed in service after the asset is initially placed in service. Therefore, a building may consist of a number of assets for disposition purposes.
- For example, assume the taxpayer owns a building. The taxpayer capitalizes the following improvements to the building:
  - Year 1 – Partial roof replacement
  - Year 2 – Partial roof replacement (not the same part of the roof replaced in Year 1)
  - Year 3 – Elevator replacement
- The taxpayer has only one UOP for capitalization purposes, the building, and its structural components. However, each capitalized improvement would be a separate asset for disposition purposes. The taxpayer would have four assets related to the building: the original building and its original structural components (less the elevator replaced, and portions of the original roof replaced), the Year 1 roof replacement, the Year 2 roof replacement, and the Year 3 elevator replacement.

(8) Building Audit Considerations

- The final regulations fundamentally change the way we examine the tax treatment of buildings. Under these regulations, the acquisition, depreciation, improvement, restoration, adaptation, and disposition of a building and its structural components are interrelated. As a result, an audit of one event must include consideration of the others.
- For example, assume a taxpayer acquires carpeting as part of the acquisition of a building. Also assume the carpet is Section 1245 property and would qualify as five-year MACRS property. The taxpayer incorrectly treats the carpet as a building structural component. As a result, the taxpayer incorrectly depreciates the carpet over the 39-year recovery period of the building and incorrectly treats the carpet as part of the building UOP under the capitalization regulations. The taxpayer then claims the routine maintenance safe harbor for buildings under the capitalization regulations in Section 1.263(a)-3(i)(1)(i). As a result, the taxpayer deducts all future replacements of the carpeting as a repair.
- If the taxpayer had correctly treated the carpet as Section 1245 property, depreciated the carpet over the 5-year recovery period of the carpet, and treated the carpet under the UOP rule in Section 1.263(a)-3(e)(3)(i), the routine maintenance safe harbor for property other than buildings under

the capitalization regulations in Section 1.263(a)-3(i)(1)(ii) may or may not apply.

- Examiners should avoid focusing only on the capitalization and the depreciation aspects of MACRS property without also considering its disposition. While a 39-year recovery period for an asset might seem to have little audit potential, treating the asset as a building structural component has other implications including:
  - Is the taxpayer correctly applying the routine maintenance safe harbor in the capitalization regulations?
  - Is the replacement asset a separate asset for disposition purposes?
  - Did the taxpayer dispose of an asset or a portion of an asset?
  - If the taxpayer disposed of a portion of an asset, did the taxpayer make a partial disposition election or is the disposition a mandatory partial disposition?
  - Is the taxpayer continuing to depreciate the disposed asset or disposed portion over the remainder of the building's 39-year recovery period?
  - Are there any accounting method implications?
- These issues are all related and should be considered whenever an examiner reviews any part of the life cycle of MACRS property from capitalization through depreciation and dispositions.

(9) Records for MACRS Property

- MACRS property records are a major focus in the final disposition regulations. The ACRS proposed regulations did not allow dispositions of structural components of buildings or partial disposition elections. As a result, taxpayers may not have sufficient detail in their existing records to calculate a loss on the disposition of part of an asset. The regulations contain reasonable methods that may supplement taxpayers' existing recordkeeping requirements.
- While the partial disposition election is new, taxpayers have always been required to keep records on their assets. The regulations do not change the requirement to keep records on complete assets. The regulations use a taxpayer's existing records on assets as a starting point and contain reasonable methods to identify and carve out parts of assets.
- For example, assume a taxpayer owns and leases a number of buildings. The taxpayer's records show $10 million capitalized as 39-year property. However, the taxpayer's records do not show any additional detail to identify to which asset the $10 million relates. The taxpayer disposes of

this $10 million property. The taxpayer cannot connect the $10 million to any particular building asset or leasehold improvement that it owns.

- This taxpayer has a general recordkeeping deficiency that is not resolved by the reasonable methods provided in the final disposition regulations. The taxpayer first must present records to establish if the $10 million is an asset or is a portion of an asset. The $10 million is an asset if the $10 million is the cost of a building or the cost of an improvement or addition to an existing building. The $10 million is a portion of an asset if the $10 million is part of the cost of a building or part of the cost of an improvement or addition to an existing building.
- If the $10 million is an asset, the taxpayer then must present records to show if the taxpayer accounts for the asset in an SAA or an MAA. If the taxpayer accounts for the $10 million in an SAA, then the specific identification method is used to identify the asset. If the taxpayer accounts for the $10 million in a multiple asset account, the taxpayer then must show it is impracticable from its records to determine the placed-in-service year of the asset before any of the reasonable methods in the disposition regulations can be used to identify the asset. There is no need to resort to these reasonable methods if the taxpayer's records show the total depreciation already claimed for the $10 million. Based on that amount, the taxpayer will be able to determine in what year it began claiming depreciation for the $10 million. The taxpayer cannot use the reasonable methods in the disposition regulations to determine the asset's basis because the taxpayer's records have already determined the unadjusted depreciable basis of the asset is $10 million.
- If the $10 million is a portion of an asset, the taxpayer then must show it is impracticable from its records to determine the placed-in-service year of the asset before any of the reasonable methods in the disposition regulations can be used to identify the asset that was partially disposed of. There is no need to resort to these reasonable methods if the taxpayer's records show the total depreciation already claimed for the $10 million. Based on that amount, the taxpayer will be able to determine in what year it began claiming depreciation for the asset that was partially disposed of. The taxpayer cannot use the reasonable methods in the disposition regulations to determine the basis of the disposed portion of the asset because the taxpayer's records have already determined the unadjusted depreciable basis of the disposed portion of the asset is $10 million.
- In both cases (the $10 million is an asset or is a portion of an asset), the examiner may work with a taxpayer to attempt to match the $10 million capitalized with the taxpayer's assets; however, in the case of the $10 million being a portion of an asset, the taxpayer will be unable to support its claim for a partial disposition loss if they do not have adequate substantiation for the entire asset.

- Alternatively, assume a taxpayer owns three buildings. The taxpayer's records show $10 million capitalized as 39-year property for the following assets that are the original buildings:
  - Des Moines Building - $4 million
  - St. Louis Building - $3 million
  - Minneapolis Building - $3 million
- Assume further that in the current year, the taxpayer replaces the original roof in the Des Moines building. The taxpayer makes a partial disposition election.
- Since the taxpayer has adequate records for its assets, the taxpayer can specifically identify the asset that was partially disposed of, the Des Moines Building, and, therefore, cannot use the reasonable methods in the disposition regulations to determine the placed-in-service years of the Des Moines Buildings. If it is impracticable from the taxpayer's records to determine the unadjusted depreciable basis for the disposed roof, the taxpayer may use the reasonable methods in the disposition regulations to divide the $4 million basis of the Des Moines Building into parts and to determine the basis allocable to the disposed roof. The taxpayer may recognize a loss for the portion of the adjusted depreciable basis to the disposed roof.

C. ACCOUNTING FOR MACRS PROPERTY

(1) Assets are the building blocks of the disposition regulations. The regulations contain rules for determining the asset disposed of. These assets are contained in various accounts using the MACRS accounting rules. An SAA contains a single asset. Two or more assets may also be grouped in either an MAA or a GAA. A GAA also may contain a single asset.

(2) The rules for grouping two or more assets into MAAs or GAAs are nearly identical. However, MAAs are the default account and must be used whenever a taxpayer accounts for more than one asset in one account. A taxpayer must make a general asset account election to account for assets in a GAA. A taxpayer makes a GAA election by checking the applicable box on Form 4562 of its tax return for the year the asset is placed in service.

(3) The disposition rules for MAAs and GAAs also differ. Losses from dispositions of assets or parts of assets accounted for in a GAA are generally not recognized, and the cost of GAA assets is generally recovered over their MACRS recovery periods. As a result, GAAs are favored as a means to simplify accounting and reduce the recordkeeping burden for included assets.

(4) Unlike GAAs, dispositions of assets from MAAs and SAAs are generally recognized. Dispositions of an entire asset from an MAA or SAA are always recognized. The recognition of certain partial dispositions is mandatory, and

taxpayers may otherwise elect to recognize the disposition of part of an asset. While partial dispositions allow for a loss deduction, the partial disposition election increases the recordkeeping burden on a taxpayer from assets to parts of assets.

(5) The regulations give taxpayers the flexibility to choose between the various asset accounts. Taxpayers can establish as many or as few accounts as they wish. Taxpayers can also choose whether to recognize a partial disposition for any part or parts of an asset no matter how small. The recordkeeping burden associated with the regulations increases as assets are carved into smaller parts. Taxpayers choose the level of detail and recordkeeping burden associated with the regulations by selecting the extent to which they elect partial dispositions.

(6) General Recordkeeping Requirements

- The remainder of this chapter will cover the MACRS accounting rules for GAAs, MAAs and SAAs. Chapter 14 will cover the disposition rules for SAAs and MAAs. Chapter 15 will cover the disposition rules for GAAs.
- The disposition regulations only apply to MACRS property. MACRS property is defined in Section 1.168(b)-1(a)(2) as tangible, depreciable property that is placed in service generally after December 31, 1986. The rules apply to all MACRS property.
- The taxpayer's asset accounts, and other records are the starting point for the examination of many issues, including dispositions. The regulations do not change the records that taxpayers must maintain for each asset account. Rather, the regulations refer to and incorporate existing regulations containing the recordkeeping requirements for asset accounts.
- Section 1.167(a)-7(c) provides the recordkeeping rules for MAAs and SAAs and Section 1.168(i)-1(l)(3) provides the recordkeeping rules for GAAs. These recordkeeping rules are in addition to the general books and records requirement of Section 6001 and the regulations thereunder.
- For MAAs and SAAs:
  - Taxpayers must compute depreciation allowances separately for each account,
  - This depreciation preferably should be included in a depreciation reserve, but in appropriate circumstances may be recorded directly in the asset account, and
  - A separate reserve for each asset account shall be maintained where depreciation reserves are maintained.
- Additionally, the taxpayer's regular books of account or permanent auxiliary records must show for each account the basis of the property. The books or records must include adjustments necessary to conform to

the requirements of Section 1016 and other provisions of law related to adjustments to basis, as well as depreciation allowances for tax purposes. In the event the reserves for book purposes do not correspond with the reserves maintained for tax purposes, the taxpayer must maintain permanent auxiliary records with the regular books of account reconciling the differences in depreciation for tax and book purposes.

- For GAAs, taxpayers must maintain records that:
  - Identify the assets included in each GAA,
  - Establish the unadjusted depreciable basis and depreciation reserve of the GAA, and
  - Reflect the amount realized during the taxable year upon disposition from each GAA.
- Taxpayers should have records for their asset accounts as required by the above regulations. While the disposition regulations allow for dispositions of a single asset or a portion of an asset accounted for in an SAA or an MAA, existing records may not contain enough detail to divide SAAs or MAAs into their respective parts. Taxpayers must start with their existing records by asset account and reasonably divide the account into parts. Where the records do not contain enough detail, the regulations provide reasonable methods to fill in some of the gaps.

(7) SAAs and MAAs

- The regulations under Section 1.168(i)-7 allow a taxpayer to account for its MACRS property by treating each asset as being in an SAA or by combining two or more assets in an MAA. A taxpayer may establish as many or as few SAA or MAA accounts as its business requires.
- An SAA is where an individual asset is treated as an account. For example, a taxpayer purchases a building in 2014 to use in its business and establishes an asset account that contains just the building.
- There are situations when the use of SAA is required. A taxpayer must account for an asset in an SAA in the following situations:
  - The taxpayer uses the asset both in a trade or business (or for the production of income) and in a personal activity, or
  - The taxpayer places the asset in service and disposes of it during the same taxable year, or
  - The year of disposition in which the taxpayer disposes of an asset from a multiple asset account, or
  - The year in which general asset account treatment for the asset terminates for an asset in a general asset account.

- Additionally, if a taxpayer disposes of a portion of an asset the taxpayer must account for the disposed portion in an SAA beginning in the taxable year in which the disposition occurs.
- An MAA is an account that contains (or pools) two or more assets. Except for those assets that must be accounted for in an SAA, any asset subject to MACRS may be accounted for in a multiple asset account. This includes assets subject to either the general depreciation system or the alternative depreciation system. However, if a taxpayer chooses to use multiple assets accounts, there are certain conditions that must be met.
- Each multiple asset account must only contain assets that have the same:
  - Depreciation method,
  - Recovery period,
  - Convention, and are.
  - Placed in service in the same taxable year.
- For example, a taxpayer may purchase five freezers in June 2014 to use in its business and may include all five freezers in one multiple asset account if all 5 freezers have the same depreciation method, recovery period, convention, and additional first year depreciation percentage.
- It is not required that assets in a multiple asset account be identical or have the same use. For example, a taxpayer may account for all of its 5-year property that are placed in service in 2012 and have the same depreciation method, recovery period, and convention in one multiple asset account even though the assets may have different uses (e.g., all of its computers, forklifts, and distribution warehouse equipment).
- Multiple asset accounts may include mass assets. However, it is important to understand that the terms are not synonymous. The term “mass assets” refers to a group of individual items of depreciable assets that are numerous in quantity, individually minor in value, usually accounted for on a total dollar or quantity basis, and for which separate identification is impracticable (e.g., telephone poles used by a telecommunications utility). Mass assets do not necessarily have to be homogenous, but they must be placed in service in the same taxable year. By grouping certain assets and depreciating the grouped assets as a single account, the computation of the depreciation deduction is simplified. A taxpayer’s use of mass asset groupings takes on particular significance when it comes to dispositions of the individual items. Mass assets that are disposed of and identified by a mortality dispersion table must be grouped into a separate multiple asset account or pool. Dispositions, including those involving mass assets, are covered in Chapter 13.

D. SPECIAL RULES FOR MULTIPLE ASSET ACCOUNTS

(1) Even if assets have the same depreciation method, recovery period and convention, depreciation may be computed differently. For example, some assets may be eligible for bonus depreciation while others are not.

(2) To provide consistency for computing depreciation, there are special rules that apply when establishing multiple asset accounts:

- Assets subject to the mid-quarter convention may only be grouped into a multiple asset account with assets that are placed in service in the same quarter of the taxable year,
- Assets subject to the mid-month convention may only be grouped into a multiple asset account with assets that are placed in service in the same month of the taxable year,
- Passenger automobiles for which the depreciation allowance is limited under.
- Section 280F(a) must be grouped into a separate multiple asset account,
- Assets not eligible for an additional first-year depreciation deduction (including assets for which the taxpayer elected not to deduct the additional first-year depreciation amount) must be grouped into a separate multiple asset account,
- Assets eligible for an additional first-year depreciation deduction may only be grouped into a multiple asset account with assets for which the taxpayer claimed the same percentage of additional first-year depreciation (e.g., 30%, 50%, or 100%),
- Listed property, except for passenger automobiles for which the depreciation allowance is limited, must be grouped into separate multiple asset accounts,
- Assets for which the depreciation allowance for the placed-in-service year is not determined by using an optional depreciation table must be grouped into separate multiple asset accounts,
- Mass assets that are, or will be, identified by a mortality dispersion table upon disposition must be grouped into a separate multiple asset account.

(3) Buildings and Asset Accounts

- Buildings will generally be included in SAAs. Buildings are typically subject to a mid-month convention. The above MAA rules require grouped assets to be subject to the same mid-month convention. Taxpayers also often account for buildings using other non-tax considerations such as accounting by location. Consequently, it is unlikely that taxpayers will group buildings into an MAA.

E. ACCOUNTING FOR DISPOSITIONS

(1) Generally, when a disposition from an MAA or SAA occurs depreciation ends for the disposed asset or the disposed portion of the asset. If the disposed asset is in an SAA, the SAA will terminate at the time of the disposition.

(2) The regulations require special accounting when an asset is disposed of from an MAA or pool, or when a portion of an asset is disposed.

- As of the first day in a taxable year when a disposition occurs, the disposed asset or portion of the asset is placed in an SAA,
- Unadjusted basis of the MAA or pool is reduced by the unadjusted basis of the disposed asset, or the unadjusted basis of the asset is reduced by the unadjusted basis of the disposed portion of the asset, as applicable, and
- The depreciation reserve account of the MAA or pool, or the asset, is reduced by the greater of the depreciation allowed or allowable for the asset disposed of from the MAA or pool, or the portion of the asset disposed of, as of the end of the year immediately preceding the year of disposition.

(3) The adjusted depreciable basis of the disposed asset from an MAA is determined by taking into account the applicable depreciation method, recovery period, and convention that were used for the MAA, and by including the additional first year depreciation deduction claimed for the asset disposed of.

(4) Similarly, the adjusted depreciable basis of the disposed portion of the asset is determined by taking into account the depreciation method, recovery period, and convention applicable to the asset in which the disposed portion was included and by including the portion of the additional first year depreciation deduction claimed for the asset that is attributable to the disposed portion. In all instances, the SAA is terminated.

(5) Accounting for the disposition of an asset or a partial disposition of an asset must be done on an asset-by-asset basis or on a partial asset-by-partial asset basis, as applicable. If a taxpayer fails to account properly for the disposition or partial disposition of an asset, it may overstate the depreciation deduction attributable to the disposed asset or disposed portion of an asset in the year of disposition and future tax years. Further, it may erroneously take the adjusted basis of the disposed asset, or a portion of an asset, into account in a future disposition that was already recovered in a prior tax year.

(6) A taxpayer may have previously changed its method of accounting for its assets that must be accounted for on an asset-by-asset basis as well. For example, a taxpayer may have reclassified a portion of the depreciable basis of an asset to repair expense in a prior year after conducting a repair study. Since the

reclassified portion has been deducted as a repair, that portion of the asset and the depreciable basis associated with it no longer exists.

F. ACCOUNTING METHOD

(1) A change to comply with Section 1.168(i)-7, for depreciable MACRS assets placed in service in a taxable year ending on or after December 30, 2003, is a change in method of accounting. A taxpayer also may treat a change to comply with Section 1.168(i)-7 for depreciable MACRS assets placed in service in a taxable year ending before December 30, 2003, as a change in method of accounting. A taxpayer must file a Form 3115 under the applicable provisions of Rev. Proc. 2015-13, 2015-5 I.R.B. 419 and Rev. Proc. 2015-14, 2015-5 I.R.B. 450, or if applicable, Rev. Proc. 2016-29, 2016-21 I.R.B. 880, Rev. Proc. 2017-30, 2017-18 I.R.B. 1131, Rev. Proc. 2018-31, 2018-22 I.R.B. 637, Rev. Proc. 2019-43, 2019-48 I.R.B. 1107, or Rev. Proc. 2022-14, 2022-7 I.R.B. 502 (the List of Automatic Changes). Refer to Chapter 18 for more information.

G. AUDIT PROCEDURES

(1) Procedures in this chapter focus on developing an understanding of how taxpayers historically accounted for MACRS property and any changes made as a result of the final disposition regulations. Examiners should consider the following steps when reviewing/examining a MACRS issue. The examiner should only request documents that are pertinent to the facts and circumstances in each case.

G.1. Identify Potential Audit Issues

(1) Review existing policies on MACRS asset accounting.

(2) Understand the taxpayer's accounting system:

- How are MACRS assets recorded in the taxpayer's accounting system?
- Has the taxpayer previously filed any accounting method changes related to the asset? If so, how did the taxpayer account for the change in method of accounting? Was the method change recorded on an asset-by-asset basis?
- How are book to tax differences in accounting for the asset tracked?
- What records exist that reconcile tax reserves to book reserves for the asset?

(3) Determine how the taxpayer has historically handled dispositions and partial dispositions.

- Does the taxpayer recognize partial dispositions for book purposes? Has the taxpayer recognized dispositions of building structural components in prior years?
- How are disposed assets identified?
- Have tax dispositions followed book dispositions in the past?
- How are book to tax differences tracked?

G.2. Assess Audit Risk

(1) Determine if the taxpayer has changed or intends to change any of its book or tax accounting policies or practices related to the final regulations.

(2) Determine if the taxpayer has already filed a Form 3115 related to its method of accounting for MACRS assets in an SAA, MAA, or GAA under the regulations.

(3) Determine if a “study” was conducted to apply the final regulations with regard to the disposition of assets.

- Read the engagement letter to determine the extent of the study.
- Read the study, presentation materials, and correspondence to evaluate the depth, accuracy, and methodology of the study.
- Determine if any basis adjustments resulting from the disposition study was recorded in the taxpayer’s records on an asset-by-asset basis.

G.3. Examination Considerations

(1) Review SEC filings (Form 10-K, Forms 10-Q, etc.), annual reports, websites, new releases, and other public sources to determine if the taxpayer has:

- Expanded its operations,
- Opened new facilities,
- Acquired real estate including buildings,
- Acquired equipment or plant property, or
- Disposed/retired any fixed assets.

(2) Request a list of dispositions and assets taken off the books.

(3) Determine how the taxpayer has accounted for these acquisitions:

- Has the taxpayer grouped the acquired assets?
- Were these assets grouped according to the rules in Section1.168(i)-7?

(4) Review the Schedule M for book-tax differences. Consider:

- Any related dispositions of assets owned or leased.
- Any related partial dispositions of assets owned or leased.
- Differences for assets, still owned, disposed, or partially disposed of by the taxpayer.

XIII. CHAPTER 13 – DISPOSITIONS IN GENERAL

A. INTRODUCTION

(1) Chapters 12, 13, 14, and 15 discuss the regulations under Section 1.168(i)-1, 1.168(i)-7, and 1.168(i)-8, collectively known as the disposition regulations. Chapter 12 provides the MACRS accounting rules, including the rules for placing assets in Single Asset Accounts ("SAAs"), Multiple Asset Accounts ("MAAs") and General Asset Accounts ("GAAs"). Chapter 13 contains general disposition rules. Chapter 14 covers disposition rules for SAAs and MAAs. Chapter 15 contains the GAA rules.

(2) The disposition rules apply as a series of interrelated steps that use the MACRS accounting rules discussed in Chapter 12 as a starting point. A taxpayer without MACRS property records has a general recordkeeping issue that must be addressed before considering any of the disposition rules.

(3) While taxpayers may group MACRS property in accounts, the disposition regulations apply on an asset-by-asset basis. The regulations provide rules for determining the asset for disposition purposes and for separating the asset out of the MACRS asset accounts. The regulations also specify when a disposition of that asset has occurred.

(4) There are no simplified methods to determine whether a disposition occurred. Likewise, there are no simplified methods to determine the appropriate asset (or portion thereof) disposed. The taxpayer must rely on their existing records to begin the disposition analysis.

B. DEFINITION OF A DISPOSITION

(1) The term "disposition" describes many different types of transactions, some of which are afforded special treatment under the Internal Revenue Code. A disposition is defined as the permanent withdrawal of depreciable property from use in a business or in the production of income. This withdrawal can be by sale, exchange, retirement, physical abandonment, or the destruction of depreciable property. The withdrawal of the asset also may be accomplished without disposition (i.e., by placing the asset in a supplies, scrap, or similar account). Dispositions do not include assets removed from one group account and transferred to another.

(2) The key factor in a disposition is the taxpayer's intent to permanently remove the property from use in a business or in the production of income. The manner of disposition (i.e., normal retirement, abnormal retirement, ordinary retirement, or extraordinary retirement) is not taken into account in determining whether a disposition occurs or gain, or loss is recognized. No matter the method, a disposition occurs when the asset is permanently withdrawn from use either in the taxpayer's trade or business or in the production of income.

(3) Dispositions by Transfer to a Supplies Account

- A disposition includes assets withdrawn from use in business or the production of income through transfer to a supplies, scrap, or similar account. However, a special rule is provided for certain dispositions involving rotable spare parts, temporary spare parts, or standby emergency spare parts (as defined in Section 1.162-3(c)).
- If a taxpayer made an election under Section 1.162-3(d) to treat the cost of any rotable spare part, temporary spare part, or standby emergency spare part as a capital expenditure subject to the allowance for depreciation, the taxpayer can dispose of that asset by transferring it to a supplies account only if the taxpayer has obtained the consent of the Commissioner to revoke the election.

(4) Demolition of Structure

- Although the destruction of an asset is a disposition, Section 280B prohibits a deduction for any amount expended or any loss sustained on account of the demolition of any structure. A structure for purposes of Section 280B is defined as a building including its structural components. Both the demolition costs and the remaining basis of the demolished structure must be added to the basis of the underlying land.
- Only losses "on account of demolition" are prohibited by Section 280B. While an abandonment is often a necessary first step in a demolition, Section 280B will not prohibit an abandonment loss that is unrelated to a demolition. An abandonment loss is not "on account of demolition" where the abandonment results from involuntary events, such as the discovery of latent defects that make a structure uninhabitable.
- A demolition does not include every modification to a building. There is no bright line for determining when a building modification rises to the level of a demolition. Revenue Procedure 95-27, 1995-1 C.B. 704, provides a safe harbor for structural modifications to a building. Under Rev. Proc. 95-27, certain structural modifications to a building will not be treated as a Section 280B demolition if:
    - 75% or more of the existing external walls of the building are retained in place as internal or external walls, and

- 75% or more of the existing internal structural framework of the building remains in place. The modification of a building that meets these criteria is not considered a demolition.

- While Rev. Proc. 95-27 provides a safe harbor for modifications that do not rise to the level of a demolition, this Rev. Proc. does not provide a bright line to determine when a demolition has occurred. Rather, exam teams must evaluate the facts and circumstances as compared to relevant case law for all structural modifications falling outside the safe harbor.

(5) Disposition of Leasehold Improvements

- Section 168(i)(8)(B) allows a lessor to recognize gain or loss upon the disposition of certain leasehold improvements at the termination of the lease instead of when the entire building is disposed of. For purposes of determining gain or loss, Section 168(i)(8)(B) provides that an improvement is treated as disposed of by the lessor - if the improvement is:
  - Made by the lessor of leased property for the lessee of the leased property, and
  - Irrevocably disposed of or abandoned by the lessor at the termination of the lease by the lessee.
- For example, at the termination of a lease, the lessor removes and permanently disposes of restroom partitions that the lessor placed in service at the inception of the lease for the lessee in the restroom located within the lessee's leased space of the lessor's building. These restroom partitions are treated as being disposed of by the lessor at the termination of the lease. The lessor may recognize gain or loss in the year the partitions are disposed.
- The legislative history to Section 168(i)(8)(B) provides that a similar result occurs for the lessee-owner of a structural component that is not retained by the lessee-owner upon termination of the lease. H.R. Conf. Rep. No. 104-737, 2nd Sess. (1996), 1996-3 C.B. 741, 937-38.
- The disposition regulations apply to the disposition of a leasehold improvement or of a portion of the leasehold improvement by a lessor or lessee before or upon the termination of the lease.

C. DETERMINATION OF THE DISPOSED ASSET

(1) The disposition regulations apply on an asset-by-asset basis. These assets are contained in the asset accounts discussed in Chapter 12. The regulations provide rules for determining the appropriate asset or portion of an asset disposed of by the taxpayer. In general, taxpayers determine the appropriate

asset or portion of asset disposed of based on the facts and circumstances supported by the taxpayer's books and records.

(2) The asset may not consist of items placed in service by the taxpayer on different dates, without taking into account the applicable convention (half-year, mid-quarter, etc.). For purposes of determining the asset disposed, the unit of property ("UOP") determination under Section 1.263(a)-3(e) does not apply.

(3) The regulations provide special rules to determine the disposed asset:

- Each building (including its structural components) is the asset for disposition purposes, unless more than one building (including its structural components) is treated as the asset under Section 1.1250-1(a)(2)(ii) or the item is an improvement or addition to an existing building or structural component,
- If a building includes two or more condominium or cooperative units, each condominium or cooperative unit (including its structural components) is the asset provided it is not an improvement or addition to an existing asset or Section 1.1250-1(a)(2)(ii) does not apply,
- If a taxpayer properly includes an item in one of the asset classes 00.11 through 00.4 of Rev. Proc. 87-56, 1987-2 C.B. 674, or classifies an item in one of the categories under Section 168(e)(3) other than a category that includes buildings or structural components (e.g., retail motor fuels outlet and qualified leasehold improvement property), each item is the asset provided it is not an improvement or addition to an existing asset, and
- If a taxpayer places in service an improvement or addition to an asset after the taxpayer placed the asset in service, the improvement or addition and, if applicable, its structural components are a separate asset.

(4) A single UOP for Section 263(a) purposes can be composed of multiple assets. For example, assume a taxpayer purchases a building and places that building in service in year one. The building and its structural components are both the UOP and the asset in year one. In year three, however, the taxpayer replaces the roof and capitalizes the roof replacement as an improvement. The building and its structural components, including the replacement roof, is the UOP. However, since the roof replacement was an improvement placed in service after the building, it is a separate asset from the building. While there are two assets related to the building in year three, there is still just one UOP.

(5) An examiner must distinguish whether a disposition involves an asset or a portion of an asset. The disposition of a complete asset is mandatory whereas a partial disposition is often elective. Consider again the example of a building where the taxpayer replaces the roof in year three and capitalizes the replacement roof as an improvement. Since the original roof was part of the original building asset, the retirement of the old roof would be the disposition of a portion of an asset.

(6) After the disposition of the roof, the taxpayer would have two assets related to the building, the original building, and original structural components (less the original roof) and the replacement roof. If the taxpayer replaced the roof again in year 15, the taxpayer would recognize a disposition of an asset (the year 3 replacement roof) versus a portion of an asset. Since the replacement roof is an entire asset, the disposition would be mandatory.

D. AUDIT PROCEDURES

(1) Examiners should consider the following steps when reviewing/examining a disposition issue. The examiner should only request documents that are pertinent to the facts and circumstances in each case.

D.1. Identify Potential Audit Issues

(2) Review the tax return.

- Has the taxpayer attached a Form 3115 related to the tangible property or disposition regulations?
- Did the taxpayer report any assets sold or otherwise disposed on Form 4797?
- Were any assets transferred in a Section 1031 transaction as reported on Form 8824?
- Was any asset involuntarily converted in a Section 1033 transaction as reported on Form 4797?
- Were any casualty losses reported on Form 4684?
- Are abandonments reported in “Other Deductions”?
- Are abandonments identified in a detail schedule attached to the return?

(3) Review Schedule L of the tax return:

- Compare beginning and ending balance of “Buildings and Other Depreciable Assets.”
- Compare any fluctuations in depreciable assets with the Schedule M depreciation differences. Is the Schedule M difference within an expected range considering the change in the Schedule L balance?

(4) Compare current year tax return with prior year returns.

- Has the taxpayer implemented the tangible property or disposition regulations?

- Did the taxpayer file a Form 3115 in 2012, 2013, 2014 or later tax year related to these regulations?
- For publicly held taxpayers, does the tax footnote to the financial statements state when the regulations were adopted?

(5) Consider the taxpayer's industry.

- Does the taxpayer's industry require large capital investments, such as the Utility or Retail Industries?
- Are there any industry directives or revenue procedures that specifically address capitalization of expenditures and dispositions of MACRS property in the taxpayer's industry?

(6) Review Annual Reports and Forms 10-K to identify any:

- Dispositions of property owned or leased.
- Replacement, betterment, restoration, or adaptation of property owned or leased.
- Casualty events.

(7) Consider the taxpayers line of business. Is the taxpayer:

- An owner of property?
- A lessor of property?
- A lessee of property?

D.2. Assess Audit Risk

(1) Evaluate any Section 481(a) adjustment on a Form 3115 related to the implementation of the tangible property or disposition regulations.

- Are there multiple changes included in one Form 3115?
- Bear in mind that a small Section 481(a) may not indicate small audit risk.
  - Section 481(a) adjustments for different changes in method may be combined.
  - Consider related Forms 3115 filed in earlier years. Determine whether these Forms 3115 were considered in the current year change in method. For example, determine whether the taxpayer considered the effect of any prior year capitalization to repair or cost segregation changes in method.

- Determine whether the Section 481(a) adjustment is based on estimates.

(2) Consider the total value of “Buildings and Other Depreciable Property.” Are these assets a material element of the taxpayer’s total assets?

(3) Consider the availability of other resources that the examiner may need to work disposition-related issues, including a CAS, a Statistical Sampling Coordinator, or an Engineer.

(4) Review the Schedule M for book-tax differences for gains or losses on disposition of assets owned by the taxpayer.

(5) Review the Schedule M for book-tax depreciation differences due to dispositions of property.

D.3. Examination Considerations

(1) Obtain and review the taxpayer’s written policies regarding dispositions and partial dispositions of assets. Has the taxpayer considered the impact of the final regulations for dispositions or partial dispositions?

(2) Obtain and review the taxpayer’s books and records, including its fixed asset and depreciation schedules. Determine if there were any dispositions of assets or partial dispositions of assets.

(3) Evaluate the taxpayer’s books and records, including fixed assets and depreciation schedules. Has the taxpayer grouped assets in MAAs or GAAs? What policies or practices does the taxpayer follow in recording property in their fixed asset system?

- Does the taxpayer have records on an asset-by-asset or asset account-by-asset account basis?
- Were there any adjustments to fixed assets for either book or tax purposes that were not recorded in the fixed asset system?
  - Top-side entries (i.e., manual entries generally recorded at the corporate, rather than the subsidiary level)?
  - Prior Forms 3115?
  - Prior audit adjustments or settlements?
- If there were adjustments, were those adjustments taken into account in the basis of the individual assets or asset accounts that were disposed or partially disposed?
- Do existing records allow the taxpayer to establish that a disposition has occurred?

(4) Determine how tangible property moves through the taxpayer's accounting system.

- Does tax follow book in regard to dispositions?
- If not, how does the taxpayer track book to tax differences in dispositions?
- How are partial dispositions tracked?

(5) If the taxpayer's electronic records do not contain sufficient detail to support dispositions of assets or parts of assets, consider reviewing other records including:

- Asset sales agreements or contracts,
- Internal disposal decision/approval forms or worksheets,
- Capital project request and approval forms,
- Repair/replacement request and approval forms,
- Basis schedules,
- Internal memoranda, analysis, and presentation materials, and
- Board or committee minutes.

XIV. CHAPTER 14 – MACRS DISPOSITION RULES

A. INTRODUCTION

(1) Chapters 12, 13, 14, and 15 discuss the regulations under Section 1.168(i)-1, 1.168(i)-7 and 1.168(i)-8, collectively known as the disposition regulations. Chapter 12 provides the MACRS accounting rules, including the rules for placing assets in Single Asset Accounts ("SAAs"), Multiple Asset Accounts ("MAAs") and General Asset Accounts ("GAAs"). Chapter 13 contains general disposition rules. Chapter 14 covers disposition rules for SAAs and MAAs. Chapter 15 contains the GAA rules.

B. DISPOSITIONS OF MACRS PROPERTY IN GENERAL

(1) The disposition rules apply as a series of interrelated steps that use the MACRS accounting rules discussed in Chapter 12 as a starting point. A taxpayer without these records has a general recordkeeping issue that must be addressed before considering any of the disposition rules. The taxpayer's records are used to establish a disposition has occurred.

(2) The regulations contain a new partial disposition election to allow taxpayers to recognize a loss upon the disposition of a portion of an asset accounted for in an SAA or MAA, such as a structural component of a building. Prior to these regulations, taxpayers were generally prohibited from recognizing a loss on a

disposed structural component and were required to continue to depreciate the basis associated with the disposed component.

(3) The taxpayer must determine the asset disposed of before considering a disposition of a portion of that asset. Taxpayers were not previously required to maintain records on individual assets grouped in MAAs or portions of assets. In light of this, the regulations provide certain simplified methods that may be applied in limited circumstances to supplement a taxpayer's existing records.

(4) The rules discussed in this chapter also apply to a lessor and to a lessee of leased property when either the lessor or lessee has:

- Made an improvement to the property,
- Has a depreciable basis in the improvement, and
- Disposes of the improvement, or a portion of the improvement, before or upon the termination of the subject lease.

B.1. Identification of the Disposed Asset or Portion of an Asset

(1) The regulations contain rules to assist in determining the taxable year in which the asset disposed of was placed in service. In general, a taxpayer must use the specific identification method to determine the placed-in-service year of a disposed asset. Under this method, the taxpayer can determine the placed-in-service date of the disposed asset from its books and records.

(2) The regulations make an exception to the general rule where the asset disposed of is in an MAA or if a portion of an asset is disposed, and it is impracticable from the taxpayer's records to determine the particular taxable year in which the asset disposed of was placed in service. Although the regulations do not contain a definition, the term "impracticable" is interpreted in light of the recordkeeping rules contained in Chapter 12. Since taxpayers are not required to keep records on individual assets grouped in an MAA or portions of assets, the simplified methods are available when the asset disposed of is in an MAA or when disposing of a portion of an asset.

(3) When an asset disposed of is in an MAA, or if a portion of an asset is disposed, and it is impracticable from the taxpayer's records to determine the particular year in which the asset was placed in service, the regulations allow the taxpayer to supplement its existing records and identify the asset by using a permissible method as provided by the regulations. A taxpayer may use:

- A first-in, first-out (FIFO) method - FIFO may be used when the unadjusted depreciable basis of the asset disposed of cannot be readily determined from the taxpayer's records. Under this method, the taxpayer identifies the MAA or pool with the earliest placed-in-service year that has the same recovery period as the asset disposed of and that has assets at

the beginning of the taxpayer year of disposition. The taxpayer treats the asset disposed as being from that MAA or pool.

- A modified FIFO method - Modified FIFO may be used where the unadjusted depreciable basis of the asset disposed of can be readily determined from the taxpayer's records. The taxpayer identifies the MAA or pool with the earliest placed-in-service year that has the same recovery period as the asset disposed of and that has assets at the beginning of the year of disposition with the same unadjusted depreciable basis as the asset disposed of. The taxpayer treats the asset disposed as being from that MAA or pool.
- A mortality dispersion table if the asset disposed is a mass asset, or
- Any other method designated by the Secretary in published guidance to identify the asset disposed of. To date, no other method has been designated.

(4) A last-in, first-out (LIFO) method is expressly not permitted.

(5) For example, assume that a taxpayer owns a retail building. The original retail building, including its original structural components, is the asset for disposition purposes. Assume the taxpayer replaces 60% of the roof and makes a partial disposition election for the replaced portion (60%). The taxpayer capitalizes the 60% replacement under Section 263(a). As a result, the taxpayer has two assets related to the building and its structural components, the original building, and its original structural components (but only with 40% of the old roof) and the replacement roof (60%).

(6) Ten years after replacing the portion of the roof (60%), the same taxpayer replaces 55% of the roof of the building. The taxpayer makes the partial disposition election for the disposed portion and is required to capitalize the costs incurred for the replacement. However, the taxpayer cannot determine from its records whether the replaced 55% is part of the 60% replaced ten years ago or whether the replaced 55% includes part or all of the remaining 40% of the original roof. Under Section 1.168(i)-8(g)(3), the taxpayer is allowed to identify which asset it disposed of by using the first-in, first-out method of accounting. As a result, the remaining 40% of the original roof and 25% of the 10-year-old replacement roof are considered disposed (40% x 100% original roof + 25% x 60% ten-year-old roof = 55% total roof).

(7) Remember that the simplified methods are one of a series of steps contained in the disposition regulations. The simplified methods cannot be applied until the taxpayer has established that a disposition of an asset has occurred. A taxpayer cannot establish that an asset has been permanently withdrawn from use through sale, exchange, retirement, physical abandonment, or destruction without matching capitalized costs with tangible property those costs represent. The simplified methods also cannot be applied until the taxpayer has

established if the disposed item is an asset or a portion of an asset, and if the disposed asset is in an SAA or an MAA.

(8) Additionally, the simplified methods should not be used to identify an asset that does not contain the disposed part. For example, assume prior to the replacement of 55% of the roof in the above example, the taxpayer had three assets related to the building: the original building (with 40% of the old roof), the replacement roof, and a capitalized elevator replacement. Upon the disposition of 55% of the roof, the taxpayer would limit application of the simplified method to assets that contain a part of the roof, not to the elevator asset.

C. DISPOSITION OF A PORTION OF AN ASSET FROM AN SAA OR MAA

(1) The partial disposition rules are a key portion of both the tangible and disposition regulations. Two practice units are available on irs.gov that address the partial disposition of a building or its structural components.

(2) A disposition of an asset or portion of an asset may trigger capitalization of the replacement asset or portion. As a result, an examination of a disposition should include a consideration of the capitalization rules.

C.1. Interaction with Capitalization Rules

(1) In some cases, the disposition of an asset or portion of an asset will require capitalization of the replacement costs. Capitalization is generally required when a part or a combination of parts that comprise a major component or a substantial structural part of a unit of property ("UOP") is replaced. However, a replacement must be capitalized regardless of its size or importance if:

- A component of a UOP is replaced and the taxpayer has properly deducted a loss for that component,
- A component of a UOP is replaced 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, or
- A UOP is restored following a casualty loss or casualty event under Section 165.

(2) In these circumstances, the Section 263(a) rules look to dispositions as a requirement for capitalization.

(3) For example, assume that taxpayer D owns a retail building. Assume the building is a single asset for disposition purposes. D replaces the shingles on the roof of the building. The taxpayer is not required to capitalize the cost of replacing the shingles because the replacement of singles is not the replacement of a major component or substantial structural part of the UOP (the

building). The taxpayer may deduct the cost of the replacement shingles as a repair.

(4) However, capitalization of the replacement shingles would be required if the taxpayer made a partial disposition election for the shingles and deducted the adjusted basis of the shingles as a loss. Under Section 1.263(a)-3(k)(1)(i), amounts paid for the replacement of a component of a UOP for which the taxpayer has properly deducted a loss is an amount paid to restore the UOP and must be capitalized. Thus, D is required to capitalize the amounts paid for the replacement of the shingles as an improvement to the building under the restoration rules.

(5) This interaction between the Section 263(a) restoration rules and the Section168 disposition rules is a key concept contained in the final regulations. It is important to understand when a disposition is required due to a disposition's potential to trigger capitalization of a replacement.

C.2. Mandatory Partial Dispositions

(1) Certain partial dispositions are required. The partial disposition rule under Section 1.168(i)-8(d) will always apply when a portion of an asset is disposed as a result of:

- A casualty event described in Section 165,
- A disposition of a portion of an asset for which gain (determined without regard to
- Section 1245 or 1250) is not recognized in whole or in part under Section 1031 or 1033,
- Transfers of a portion of an asset in a "step-in-the-shoes" transaction described in
- Section 168(i)(7)(B), or
- Sales of a portion of an asset.

(2) A taxpayer cannot forego treating these events as a disposition under the partial disposition rule. The partial disposition is subject to the applicable rules for recognizing gain or loss upon the disposition of the property. The taxpayer must capitalize the cost to replace the disposed portion of the asset in these situations under Section 1.263(a)-3(k). The amounts may not be deducted as repairs.

C.3. The Partial Disposition Election

(1) Notwithstanding the mandatory partial dispositions, a taxpayer may elect to recognize a partial disposition for any disposition of less than an entire asset.

The ability to choose whether to make the partial disposition election provides the flexibility to either recognize a disposition loss for the old, replaced part or deduct the replacement costs of the new part as a repair. If the taxpayer chooses to recognize a disposition loss, replacement costs must be capitalized and not deducted as a repair.

(2) For example, assume the taxpayer acquires and places a building in service in Year 1. The original building and its original structural components are the asset for disposition purposes. In Year 5, the taxpayer replaces the roof membrane (not in a mandatory partial disposition transaction), which is part of the building asset. Since the disposition is not mandatory, the taxpayer can choose between deducting the adjusted basis of the old membrane and deducting the replacement cost of the new membrane as a repair (assuming the membrane is not a major component or a substantial structural part of the building UOP). If the taxpayer makes a partial disposition election and recognizes a loss for the old membrane, the taxpayer must capitalize the replacement membrane.

(3) A taxpayer can make a partial disposition election for the disposition of a portion of any type of MACRS property contained in an SAA or MAA. There is no partial disposition election under the GAA rules (Chapter 15). If the taxpayer makes a partial disposition election for an asset that is properly included in one of the asset classes 00.11 through 00.4 of Rev. Proc. 87-56, the taxpayer must classify the replacement portion of the asset under the same asset class as the disposed portion of the asset.

(4) A taxpayer makes the partial disposition election on its timely filed original tax return, including extensions, for the taxable year in which the portion of the asset is disposed. The taxpayer cannot make or revoke the election by filing an application for a change in method of accounting, Form 3115. A taxpayer may only revoke a partial disposition election by filing a request for a private letter ruling and obtaining the consent of the Commissioner.

(5) Three special rules apply to the partial disposition election. Revenue Procedures 2014-54, 2015-14, and 2016-29 allow taxpayers to make a late partial disposition election by filing a Form 3115 for automatic consent of the Commissioner. The late partial disposition election allows taxpayers to recognize gain or loss when they have disposed a portion of an asset in prior years. Taxpayers may make a late partial disposition election under the final disposition regulations for tax years beginning on or after January 1, 2012, and before January 1, 2015. See Chapter 18 for accounting method change rule requirements.

(6) Another special rule addresses Service adjustments capitalizing amounts that the taxpayer originally treated as repairs. When such an adjustment occurs, the taxpayer may make a partial disposition election for the disposition of the portion of the asset to which the Service’s adjustment pertains by filing an application for change in accounting method. The election may only be made if

the taxpayer still owns the asset of which the disposed portion was a part as of the beginning of the year of change (as defined for purposes of Section 446(e)).

(7) If a taxpayer chooses to make a partial disposition election for a taxable year beginning on or after January 1, 2012, and ending on or before September 19, 2013 (applicable taxable year), and the taxpayer did not make the partial disposition election on its timely filed original Federal tax return for the applicable taxable year, including extensions, the taxpayer must make the election by filing either:

- An amended Federal tax return for the applicable taxable year on or before 180 days from the due date including extensions of the taxpayer's Federal tax return for the applicable taxable year, or
- An application for change in accounting method with the taxpayer's timely filed original Federal tax return for the first or second taxable year succeeding the applicable taxable year.

D. GAIN OR LOSS ON DISPOSITIONS OF MACRS PROPERTY

(1) The recognition of gain or loss upon the disposition of the property applies to the disposition of an entire asset, mandatory partial dispositions of an asset, and partial dispositions of an asset that the taxpayer elects to recognize. The following rules apply:

- If an asset or portion of an asset is disposed of by sale, exchange, or involuntary conversion, gain or loss is recognized under the applicable Code provisions.
- If an asset or portion of an asset is disposed of by physical abandonment, loss is recognized in an amount equal to the adjusted depreciable basis at the time of abandonment. The taxpayer must intend to discard the asset irrevocably so that they will not use it again or retrieve it for sale, exchange, or other disposition in order to recognize a loss from physical abandonment. However, if the abandoned asset is subject to nonrecourse indebtedness, gain or loss is recognized under the applicable Code provisions.
- If a taxpayer disposes of an asset or portion of an asset other than by sale, exchange, involuntary conversion, physical abandonment, or conversion to personal use loss is recognized equal to the excess of the adjusted depreciable basis of the asset over the asset's fair market value at the time of the disposition. A gain is not recognized.

D.1. Determining the Adjusted Basis of a Disposed Asset or Portion of an Asset

(1) The taxpayer must determine the adjusted basis of the disposed asset or portion to calculate the gain or loss upon disposition. The starting point for determining the adjusted basis of a disposed asset is the unadjusted basis of the entire asset. The unadjusted basis is generally its cost, but exceptions or special rules may apply.

(2) The regulations allow a taxpayer to use reasonable methods to calculate unadjusted basis if:

- The asset is contained in an MAA, or
- The disposition is of a portion of an asset, and
- It is impracticable from the taxpayer's records to determine the unadjusted depreciable basis of the disposed asset or portion of asset.

(3) The regulations do not define impracticable, but impracticable should be interpreted in light of the recordkeeping requirements of Chapter 12. The taxpayer must first resort to existing records and supplement those records with the reasonable methods. Existing records may include source documents outside the taxpayer's electronic fixed asset system including capital project requests, asset sales agreements, cost segregation studies or capitalization-to-repair studies.

(4) Reasonable methods to determine unadjusted basis for assets contained in an MAA or for a portion of an asset include, but are not limited to:

- Discounting the cost of a replacement asset to its placed-in-service year cost using the Producer Price Index for Finished goods, the Producer Price Index (PPI) for Final Demand, or other index designated by guidance in the Internal Revenue Bulletin. This method can only be used if the replacement asset is a restoration as defined in Section 1.263(a)-3(k); it cannot be used if the replacement is a betterment as defined in Section 1.263(a)-3(j) or an adaption as defined in Section 1.263(a)-3(l),
- Pro rata allocation of the unadjusted depreciable basis of the MAA based on the replacement cost of the disposed asset and the replacement cost of all assets in the MAA (or pool); Similarly, if a portion of an asset is disposed of, a pro rata allocation of the unadjusted depreciable basis of the asset based on the replacement cost of the disposed portion of the asset and the replacement cost of the asset, and
- Study allocating the cost of the asset to its individual components.

(5) An examiner must apply the rules for determining unadjusted basis in the context of the steps of a disposition contained in the regulations. Determining unadjusted basis occurs after the taxpayer has:

- Established a disposition has occurred,

- Determined the disposed asset or portion of asset,
- Established the disposed asset is in an SAA or an MAA, and
- Identified the placed-in-service year of the disposed asset or portion of asset.

(6) As a result, the taxpayer will know the unadjusted basis of the entire MAA or asset before dividing that unadjusted basis into assets or parts. The unadjusted basis of an asset in an MAA or a portion of an asset may not exceed the unadjusted basis remaining in the MAA or asset.

(7) For example, assume the taxpayer owns a building. The taxpayer has two assets on its books related to that building. Asset 1 is the original building (and its remaining original structural components) with a remaining unadjusted basis of $3 million. Asset 2 is a replacement roof with an unadjusted basis of $2 million. The taxpayer renovates the interior of the building, incurring costs of $10 million. The taxpayer makes a partial disposition election.

(8) Before determining the unadjusted basis of the disposed parts, the taxpayer applies the steps contained in the regulations as follows:

- The taxpayer establishes, based on its existing records that the renovation resulted in a disposition of parts of the building.
- The records also reflect the taxpayer has two assets related to the building. The original building and its remaining original structural components are an asset for disposition purposes. The replacement roof is a separate asset since it is an improvement or addition placed in service after the original building.
- The taxpayer does not need to resort to the simplified methods to identify the placed- in-service year of the building asset. The disposed components are only contained in the original building since the renovation was of the building interior not the building roof.

(9) After applying these steps, the taxpayer knows the disposed parts are contained in the original building asset and that asset has a remaining unadjusted basis of $3 million. However, the taxpayer does not know how much of the $3 million should be allocated to the disposed parts.

(10) The taxpayer may use any reasonable method to determine how much of that $3 million unadjusted basis should be allocated to the disposed parts. However, the unadjusted basis allocated to the disposed parts cannot exceed the $3 million unadjusted basis of the original building. Although there is a second asset related to the building (the replacement roof), that asset does not contain the disposed parts. No part of the second asset's (replacement roof) unadjusted basis should be allocated to the disposed parts.

(11)Once a taxpayer uses a reasonable method to determine the unadjusted basis of an asset in an MAA, the reasonable method must be consistently applied to all assets in the same MAA for determining the unadjusted depreciable basis of disposed assets. Similarly, reasonable methods used to determine the unadjusted basis of the first disposed portion of an asset must be consistently applied to all portions of the same asset for purposes of determining the unadjusted depreciable basis of a disposed portion of the asset.

(12)From unadjusted basis, the taxpayer determines adjusted basis by decreasing unadjusted basis by the greater of the depreciation allowed or allowable. Depreciation allowed for disposition of an asset in an MAA is computed using the depreciation method, recovery period and convention applicable to the MAA and by including the additional first year depreciation claimed for the disposed asset. Similarly, for the disposition of a portion of an asset, the depreciation allowed is computed using the depreciation method, recovery period and convention applies to the asset in which the disposed portion is included and by including the portion of the additional first year depreciation deduction claimed for the asset that is attributable to the disposed portion.

E. STATISTICAL SAMPLING

(1) Taxpayers are permitted to use a statistical sampling methodology to apply the regulations to dispositions of assets or portions of assets in the current year, to disposition of assets or portions of assets in prior tax years other than the late partial disposition election under Section 1.168(i)-8(d), and to dispositions of portions of assets in prior tax years attributable to a late partial disposition election. A taxpayer changing its method of accounting for the disposition of a building or a portion of a building in a prior tax year, or for the disposition of an asset or portion of an asset other than a building in a prior tax year, may use statistical sampling to determine the Section 481(a) adjustment. The procedures provided in Rev. Proc. 2011-42 must be followed.

(2) A taxpayer changing its method of accounting under Rev. Proc. 2011-14, Rev. Proc. 2015-14, or Rev. Proc. 2016-29 for a late partial disposition election may use statistical sampling to determine the Section 481(a) adjustment, provided the statistical sampling method used is reasonable.

(3) While statistical sampling is allowed, taxpayers must maintain the records covered in Chapter 12 for assets and asset accounts. Taxpayers must be able to establish an ownership interest in disposed assets or disposed portions, establish that a disposition occurred, and identify a disposed asset or disposed portion. Examiners should ensure records support any statistical sampling method.

F. AUDIT PROCEDURES

(1) Examiners should consider the following steps when reviewing/examining an issue involving the disposition of MACRS property. The examiner should only

request documents that are pertinent to the facts and circumstances in each case.

F.1. Identify Potential Audit Issues

(1) Has the taxpayer determined dispositions in accordance with the final regulations?

(2) Review Annual Reports and Forms 10-K to identify any:

- Dispositions of property owned or leased,
- Replacement, betterment restoration, or adaptation of property owned or leased, or
- Casualty events.

(3) Consider the taxpayers line of business.

- Is the taxpayer an owner of property?
- Is the taxpayer a lessor of property?
- Is the taxpayer a lessee of property?

(4) Review the tax return.

- Consider assets sold or otherwise disposed of on Form 4797.
- Were any assets transferred in a Section 1031 exchange as reported on Form 8824?

F.2. Assess Audit Risk

(1) What impact if any, have the final regulations had on the taxpayer's definition of disposed property?

(2) Review the taxpayer's written policies regarding dispositions and partial dispositions of assets.

(3) Review the Schedule M for book-tax differences for fixed assets owned or leased.

(4) Review the Schedule M for book-tax depreciation differences.

(5) Did the taxpayer make a partial disposition election on its timely filed original tax return (including extensions)?

(6) Has the taxpayer filed Form(s) 3115 to change its method of accounting for dispositions?

- Consider whether the Form 3115 is the initial change or a change to “true up” or reverse any previous accounting method change(s).
- Determine specifically what accounting method changes the taxpayer is making.
- Consider whether the taxpayer is accounting for property previously disposed as part of any method change. Ensure that these assets are properly accounted for under the final regulations.
- Was a late partial disposition election made for tax years beginning after January 1, 2012, and before January 1, 2015?

F.3. Examination Considerations

(1) Identify the disposed asset. Was the asset:

- Sold, exchanged, retired, physically abandoned, or destroyed?
- Transferred to a supplies, scrap, or similar account (in whole or in part)?

(2) If a portion of an asset was disposed, was it as a result of:

- A casualty event described in Section 165?
- A transaction described in Section 1031 or 1033?
- A transfer as described in Section 168(i)(7)(B)?
- Was a portion of an asset sold? If so:
  - Is the cost of the replacement portion of the asset subject to capitalization under Section 263(a)?
  - Was the replacement portion of the asset classified under the same asset class as the disposed portion of the asset?

(3) Was gain or loss recognized on the disposition of property? If not, determine if the disposition was the result of:

- A sale, exchange, or involuntary conversion?
- A physical abandonment? If so, was the asset was subject to nonrecourse indebtedness?

(4) How was the adjusted basis of the disposed asset determined?

- From the taxpayer’s books and records, as generally required?
- If books and records were not used, why not?

- What method was used?
- Was the method consistently applied to all disposed portions of the same asset for purposes of determining the unadjusted depreciable basis of each disposed portion?
- Was the method appropriate to the disposed asset or disposed portions?
    - If the taxpayer used a discounting method applied to the replacement portion of an asset, was the replacement properly capitalized as a restoration, a betterment or adaptation?
- Was the unadjusted basis properly allocated?
- Ensure that the taxpayer is not using FIFO as a method to re-characterize a partially disposed asset such as a building and its subsequent improvements as a single asset to recover the unadjusted basis of the disposed portion.
- If a taxpayer establishes that it is impracticable to determine the unadjusted basis of the disposed portion of an asset using their records, is the method reasonable? How does it compare to the methods provided in the regulations?
    - If the taxpayer uses a method that discounts the cost of a replacement asset using a price index other than the Producer Price Index (PPI), the examiner should consider whether using the other index is more appropriate to their particular facts and circumstances.
    - If the taxpayer used a method specific to its industry, consider whether the method is comparable to the results obtained by applying information that is available to the public. For example, published guidance exists in the construction industry that provides the cost allocation percentages of both purchased and constructed buildings and their structural components. An examiner may use these allocation percentages to determine whether the unadjusted basis of the disposed portion of a building or its structural components is reasonable.

(5) Was the adjusted basis of the disposed asset (or portion of the asset) property accounted for? Consider:

- Whether the asset was fully depreciated or recovered prior to the disposition?
- Whether the effect of any cost segregation studies or C2R performed in prior years that were not recorded on the books and records?
- If a partial disposition occurred, was the unadjusted basis of the partially disposed asset properly reduced as of the first day of the taxable year in which the disposition occurred?

- If a late partial disposition election was made under Rev. Proc. 2014-54 for portions of an asset disposed of in a prior year, was the unadjusted basis of the partially disposed asset properly reduced as of the first day of the taxable year in which the disposition occurred?
- If a disposition was from an MAA, was the unadjusted basis of the MAA reduced as of the first day of the taxable year in which the disposition occurred?
- Was the disposition properly accounted for on an asset-by-asset basis in the taxpayer's books and records?

(6) Identify the partially disposed asset:

- How did the taxpayer identify the asset disposed?
- Consider all books and records including electronic fixed asset records. Also consider all underlying source documents related to the acquisition, construction, and maintenance of the asset.
- Consider all cost segregation studies and capitalization to repair studies, past and present.
- Can the specific asset disposed be determined based on the taxpayer's books and records?
    - If so, ensure that the disposed asset(s) is properly identified.
    - If not, determine which method permitted by the regulations was used:
    - FIFO
    - Modified FIFO
    - Mortality dispersion table (for mass assets)

(7) Consider how the capitalization rules under Section 1.263(a)-3(k) impact the treatment of the replacement of a component of a UOP:

- Has the taxpayer properly taken into account a loss on the disposition of the component?
- Has the taxpayer properly taken into account the adjusted basis of the component in realizing gain or loss on the sale or exchange of the component?
- If a casualty loss or event under Section 165 has occurred, has the restoration of the UOP been capitalized under Section 1.263(a)-3(k)(1)(ii)?

(8) Consider whether statistical sampling was used for dispositions.

- If so, was Rev. Proc. 2011-42 followed?
- Identify if statistical sampling was used for prior years, the current year, or both.
- Determine if statistical sampling was used to determine a Section 481(a) adjustment.
- Ensure that if statistical sampling was used for a late partial disposition election under Section 1.168(i)(8)(d), all adjustments to basis are properly accounted for on an asset-by-asset basis.

XV. CHAPTER 15 – GENERAL ASSET ACCOUNT RULES

A. INTRODUCTION

(1) Chapters 12, 13, 14, and 15 discuss the regulations under Section 1.168(i)-1, 1.168(i)-7, and 1.168(i)-8, collectively known as the final disposition regulations. Chapter 12 provides the MACRS accounting rules, including the rules for placing assets in Single Asset Accounts ("SAAs"), Multiple Asset Accounts ("MAAs") and General Asset Accounts ("GAAs"). Chapter 13 contains general disposition rules. Chapter 14 covers disposition rules for SAAs and MAAs. Chapter 15 contains the GAA rules.

(2) The Section 1.168(i)-1 regulations allow taxpayers to elect to maintain one or more GAA under Section 168(i)(4) of the Code. The rules discussed in this chapter apply to MACRS property for which a taxpayer elects GAA treatment. This chapter also discusses the rules related to dispositions of assets from a GAA.

B. ELECTION OF A GAA

(1) General Asset Accounting is available to simplify the accounting for taxpayers who own large numbers of assets of relatively small value in comparison to the entire group. A taxpayer may make a GAA election by checking the applicable box on Form 4562 of its tax return by the due date (including extensions) of the return for the year the MACRS property is placed in service. The election must be made by each member of a consolidated group. The election is made for partnerships and S corporations at the entity level and not by the partners or shareholders. With certain exceptions, a GAA election is irrevocable. The Section 1.168(i)-1 GAA regulations must be followed by the taxpayer in computing its taxable income for the election year and all subsequent tax years.

C. ESTABLISHING A GAA

(1) A GAA can be established with assets that are subject to either the MACRS general depreciation system under Section 168(a), or the MACRS alternative depreciation system under Section 168(g). Each GAA is effectively treated as the asset for tax accounting and depreciation purposes. Taxpayers can group

eligible assets into one or more GAA accounts and can place as few as a single asset or as many assets in each GAA account as their business needs require. An asset may not be included in a GAA if the asset is used both in a trade or business (or for the production of income) as well as in a personal activity at any time during the taxable year in which the asset is placed in service by the taxpayer. Further, an asset may not be included in a GAA if the asset is placed in service and disposed of during the same taxable year.

(2) In general, the assets in each GAA must be placed in service in the same taxable year, and have the same depreciation method, recovery period, and convention. The following additional rules apply:

- Assets subject to the mid-quarter convention may only be grouped into a GAA with assets placed in service in the same quarter of the taxable year,
- Assets subject to the mid-month convention may only be grouped into a GAA with assets placed in service in the same month of the taxable year,
- Passenger automobiles for which the depreciation allowance is limited under Section 280F(a) must be grouped into a separate GAA,
- Assets not eligible for additional first year depreciation (including assets for which the taxpayer elected not to deduct the additional first year-depreciation) must be grouped into a separate GAA,
- Assets eligible for additional first year depreciation may only be grouped into a GAA with assets for which the taxpayer claimed the same percentage of additional first year depreciation (e.g., 30 percent, 50 percent, or 100 percent),
- Except for passenger automobiles described in #3, listed property (as defined in Section 280F(d)(4)) must be grouped into a separate GAA,
- Assets for which the depreciation allowance for the placed-in-service year is not determined by using an optional depreciation table must be grouped into a separate GAA,
- Mass assets that are, or will be, identified by a mortality dispersion table upon disposition must be grouped into a separate GAA, and
- Assets for which a change in use results in a shorter recovery period or a more accelerated depreciation method and for which the depreciation allowance for the year of change in use, is not determined by using an optional depreciation table must be grouped into a separate GAA.

(3) An asset is included in a GAA to the extent of the asset's unadjusted depreciable basis. The unadjusted depreciable basis of the GAA is the sum of the unadjusted depreciable bases of all assets included in the GAA.

(4) Depreciation allowances are determined for each GAA using the depreciation method, recovery period, and convention applicable to the assets in the

account. Additional first-year depreciation is allowed for the GAA for the placed-in-service year, if applicable. Special rules are provided for the depreciation on passenger automobiles accounted for in a GAA.

D. DISPOSITIONS FROM A GAA IN GENERAL

(1) An asset is disposed from a GAA when ownership of the asset is transferred or when it is permanently withdrawn from use in a trade or business or in the production of income. Types of dispositions include the sale, exchange, retirement, physical abandonment, or destruction of an asset, and the transfer of an asset to a supply, scrap, or similar account. The manner of disposition (for example, abnormal or normal retirement, ordinary or extraordinary retirement), is not taken into account in determining whether a disposition occurs. Refer to Chapter 13 for more on dispositions in general.

D.1. Disposition of a Portion of an Asset from a GAA

(1) A disposition will always occur when a portion of an asset is disposed as a result of:

- A casualty event described in Section 165,
- A disposition of a portion of an asset for which gain (determined without regard to
- Section 1245 or 1250) is not recognized in whole or in part under Section 1031 or 1033,
- Transfers of a portion of an asset in a “step-in-the-shoes” transaction described in
- Section 168(i)(7)(B),
- Sales of a portion of an asset, or
- A disposition of a portion of an asset in a transaction described under the anti-abuse rules applicable to GAA.

(2) A taxpayer cannot forego treating the disposition of a portion of an asset in these transactions as a disposition. However, the partial disposition is subject to the GAA rules for recognizing gain or loss upon the disposition of the property. For other transactions, a taxpayer may treat the disposition of a portion of an asset as a disposition for tax purposes only if the taxpayer makes the election to terminate the GAA in which the disposed portion is the remaining portion of the last asset in that GAA or makes the qualifying disposition election for that disposed portion. Partial dispositions are subject to the GAA rules for recognizing gain or loss upon the disposition of the property.

E. GAIN OR LOSS ON DISPOSITIONS FROM A GAA

(1) When there is a disposition from a GAA, a determination must be made whether gain or loss must be recognized. This is true whether the disposition is of an entire asset or a portion thereof. In general, the disposition is disregarded, and depreciation continues. The disposed asset or portion thereof is treated as having an adjusted depreciable basis of zero immediately before the disposition. Therefore, no loss is realized upon the disposition.

(2) Any amount realized on disposition is recognized as ordinary income notwithstanding any other Code provision. Recognition is limited to the extent the sum of the unadjusted depreciable basis of the GAA and any expensed cost for assets in the account, exceeds any amounts previously recognized as ordinary income upon the disposition of other assets or portions of other assets in the account. The adjusted basis of the asset or portion of the asset disposed is not taken into account to compute a gain. Therefore, the unadjusted depreciable basis and depreciation reserve of the GAA are not affected by the disposition. Accordingly, a taxpayer continues to depreciate the GAA, including the disposed asset or portion of an asset, as though no disposition occurred.

(3) For example, assume that a taxpayer maintains one GAA for one office building. A leak in the roof of the building is discovered and the entire roof is replaced (not due to a mandatory partial disposition transaction). The roof is a structural component of the building. The original office building including its original structural components is the asset for disposition purposes under Section 1.168(i)-1(e)(2)(viii)(B)(1). The retirement of the replaced roof is not a disposition of a portion of an asset as described in Section 1.168(i)-1(e)(1)(ii). As a result, the taxpayer continues to depreciate the entire cost of the office building in the GAA. If the amount paid for the replacement roof results in an improvement to the building under Section 1.263(a)-3(d), the replacement roof is a separate asset for both disposition and depreciation purposes.

(4) Taxpayers who choose to place assets in a GAA rather than in an SAA or MAA, have less flexibility in recognizing the disposition of an asset or a portion of an asset. This is because recognition of gain or loss on a disposition from a GAA is allowed only in the narrow circumstances described below.

F. GAA TERMINATIONS

(1) Elective Terminations of GAA

- GAA treatment terminates if the taxpayer makes a qualifying disposition election for the disposed asset or portion of an asset, or elects to terminate the GAA upon the disposition of all of the assets, the last asset, or the remaining portion of the last asset in that GAA (the empty account election). If the qualifying disposition election is made, the taxpayer takes into account the remaining adjusted basis of the disposed assets or portion of assets in recognizing gain or loss under the normally applicable Code provisions. If the empty account election is made, the taxpayer takes

into account the remaining adjusted basis of that GAA in recognizing gain or loss under the normally applicable Code provisions.

- A taxpayer makes either election by reporting the gain, loss, or other deduction on its timely filed original Federal tax return, including extensions, for the taxable year in which the disposition occurs. The elections cannot be made through the filing of an application for change in accounting method. The elections are irrevocable, unless a taxpayer obtains the Commissioner's consent to revoke the election via a private letter ruling.

(2) Qualifying Disposition Election

- GAA treatment of an asset terminates if the taxpayer makes a qualifying disposition election for the disposed asset or portion of an asset.
- A qualifying disposition is a disposition that does not involve all the assets, the last asset, or the remaining portion of the last asset remaining in the account, that is:
  - A direct result of a fire, storm, shipwreck, or other casualty, or from theft,
  - A charitable contribution for which a deduction is allowable under Section 170,
  - A direct result of a cessation, termination, or disposition of a business, manufacturing or other income producing process, operation, facility, plant, or other unit, (other than by transfer to a supplies, scrap, or similar account), or
  - A transaction to which a non-recognition section of the Internal Revenue Code applies other than a transaction subject to Section 168(i)(7)(B), transactions subject to Section 1031 or Section 1033, transactions subject to technical terminations of partnerships, or transactions subject to the anti-abuse rule.
- The election is made on an asset-by-asset basis. The disposed asset (or portion thereof) is removed from the GAA and is accounted for in an SAA as of the first day of the taxable year in which the qualifying disposition occurs. The adjusted basis of the GAA is reduced by the adjusted basis of the disposed asset or portion of an asset.
- If the election is made, the taxpayer recovers the remaining adjusted basis of the disposed asset or portion of an asset and recognizes gain or loss under the normally applicable Code provisions, including Section 280B and the regulations thereunder. The character of the gain or loss is determined under other applicable Code provisions, subject to certain limitations for Section 1245 or Section 1250 property. Gain or loss is determined by taking into account the asset's adjusted depreciable basis

at the time of the disposition. The adjusted basis of the asset at the time of the disposition equals the unadjusted depreciable basis of the asset less the depreciation allowed or allowable (including any additional first year depreciation), for the asset computed by using the depreciation method, recovery period, and convention applicable to the GAA.

- The partial disposition rule under Section 1.168-8(d)(1) does not apply to MACRS assets accounted for in a GAA. That rule provides that a taxpayer may not forgo recognizing a loss if a disposition falls under any one of the four categories described therein. In other words, even if a disposition from a GAA falls into one of the categories described in Section 1.168-8(d)(1), the taxpayer can deduct a loss only if the disposition is a qualifying disposition under Section 1.168(i)-1(e)(3)(iii) and a qualifying disposition election is made, or the disposed asset or disposed portion is the last asset or the remaining portion of the last asset in the GAA and the taxpayer elects to terminated that GAA (see Empty Account Election later).
- If a building accounted for in a GAA is partially destroyed due to a casualty event a qualifying disposition election must be made to claim a casualty loss deduction. Failure to make the election would result in a disregarded partial disposition from a GAA. For example, assume a calendar year taxpayer maintains a GAA for one office building that it placed in service in July 2011. In May 2014, a tornado damages the roof of the building, and the entire roof is replaced. The roof is a structural component of the building. Because the roof was damaged as a result of a casualty event described in Section 165, the taxpayer may make a qualifying disposition election. Although the original office building, including its original structural components, is the asset for disposition purposes, the partial disposition rule provides that the retirement of the replaced roof is a disposition under Section 1.168(i)-1(e)(1). In addition, this is a qualifying disposition under Section 1.168(i)-1(e)(3)(iii)(B)(1) because it is the result of a storm. If that taxpayer makes a qualifying disposition election for the retirement of the damaged roof, the adjusted basis of the retired roof is taken into account at the time of the disposition in determining gain or loss under Section 165, and the adjusted basis of the roof as of the first day of 2014 is removed from the GAA. The amount paid for the replacement roof must be capitalized under Section1.263(a)-3(k)(1)(iii), and the replacement roof is accounted for as a separate asset for disposition purposes under Section 1.168(i)-1(e)(2)(viii)(B)(4) and for depreciation purposes pursuant to Section 168(i)(6).
- Alternatively, the taxpayer may choose to disregard the disposition and not make a qualifying disposition election for the retirement of the damaged roof. In this case, depreciation continues on the entire basis of the office building in the GAA. If the taxpayer must capitalize the amount paid for the replacement roof under Section 1.263(a)-3, the new roof is a

separate asset for disposition purposes under Section 1.168(i)-1(e)(2)(viii)(B)(4) or Section 1.168(i)-8(c)(4)(ii)(D), depending on whether the replacement roof is in a GAA, SAA, or MAA, and for depreciation purposes under Section 168(i)(6).

(3) GAA Termination Election (Empty Account Election)

- A taxpayer can elect to terminate a GAA if it disposes all of the assets, the last asset, or the remaining portion of the last asset in the account. If this election is made, the GAA terminates and the amount of gain or loss realized is determined by taking into account the adjusted depreciable basis of the GAA at the time of the disposition, as determined under the applicable method and convention(s) for the account. Whether and to what extent gain or loss is recognized is determined the applicable provisions of the Code, including Section 280B and Section 1.280B-1. Likewise, the character of the gain or loss is determined under the applicable provisions of the Code. The amount of gain is subject to Section 1245 and 1250 and certain other limitations.

(4) Mandatory Terminations of GAA

- If the disposition of an entire asset or portion thereof falls into one of the following categories, the GAA treatment terminates, and the disposition must be recognized.
    - Transactions subject to Section 168(i)(7)(B), pertaining to the treatment of transferees in certain non-recognition transactions,
    - Transactions subject to Section 1031 like-kind exchanges or Section 1033 involuntary conversions,
    - A technical termination of a partnership under Section 708(b)(1)(B), or
    - A transaction identified by the Service as abusive.
- The regulations provide rules for determining the adjusted basis allocable to the disposed asset or portion of an asset, the adjustment to the remaining adjusted basis of the GAA, whether and to what extent any gain or loss is recognized on the disposition, and whether and to what extent the transferee is bound by the transferor's GAA election.
- An asset in a GAA becomes ineligible for GAA treatment if a taxpayer uses the asset in any personal activity during a taxable year. See Section 1.168(i)-1(h). If the basis of an asset in a GAA is increased because of the recapture of an allowable credit or deduction, GAA treatment for the asset terminates. See Section 1.168(i)-1(g).

G. AUDIT PROCEDURES

(1) Examiners should consider the following steps when reviewing/examining a GAA issue. The examiner should only request documents that are pertinent to the facts and circumstances in each case.

G.1. Identify Potential Audit Issues

(1) Determine if the taxpayer accounts for property using a GAA.

(2) Review Annual Reports and Forms 10-K to identify any:

- Dispositions of property owned or leased, and
- Casualty events.

(3) Consider the taxpayers line of business.

- Does the taxpayer own many assets that are of relatively small value?

(4) Review the tax return.

- Consider assets sold or otherwise disposed of on Form 4797.
- Were any assets transferred in a Section 1031 exchange?
- Did the taxpayer make a GAA election for assets placed in service during the current tax year?
- Did the taxpayer make a Qualifying disposition election?
- Did the taxpayer elect to terminate a GAA?
  - If so, were all the assets, the last asset or the last portion of the asset removed from the account?
  - If not, were the general rules for dispositions followed?

G.2. Assess Audit Risk

(1) Determine if the taxpayer accounts for assets in one or more a GAA.

(2) Determine if the general rules for assets in a GAA were followed. See Section 1.168(i)-1(c)(2).

(3) What impact if any, have the final regulations had on the taxpayer's definition of GAA?

(4) Review taxpayer's written policies regarding dispositions and partial dispositions of assets.

(5) Review the Schedule M for book-tax differences for fixed assets owned or leased.

(6) Review the Schedule M for book-tax depreciation differences.

(7) Did the taxpayer make a partial disposition election on its timely filed original tax return (including extensions)? If yes, was the asset in a GAA?

(8) Has the taxpayer filed Form(s) 3115 to change its method of accounting for GAA?

- Consider whether the Form 3115 is the initial change or a change to "true up" or reverse any previous accounting method change(s).
- Determine specifically what accounting method changes the taxpayer is making.
- Consider whether the taxpayer accounted for property previously disposed as part of any method change. Ensure that these assets are properly accounted for under the final regulations. Taxpayers that make accounting method changes must be able to track the basis of the assets affected by each method change.
- Was a late partial disposition election made for tax years beginning after January 1, 2012, and before January 1, 2015?

G.3. Examination Considerations

(1) Determine if a disposition from a GAA occurred. If so, was the asset:

- Sold, exchanged, retired, physically abandoned, or destroyed?
- Transferred to a supplies, scrap, or similar account (in whole or in part)?

(2) If a portion of an asset was disposed, was it as a result of:

- A casualty event described in Section 165?
- A transaction described in Section 1031 or 1033?
- A transfer as described in Section 168(i)(7)(B)
- Was a portion of an asset sold? If so:
  - Is the cost of the replacement portion of the asset subject to capitalization under Section 1.263(a)-3(k)?
  - Was the replacement portion of the asset classified under the same asset class as the disposed portion of the asset?

(3) Determine how disposition from the GAA was accounted for.

- Was a loss recognized?
- Were proceeds from a sale received?

(4) Was the gain or loss recognized, or required to be recognized, on the disposition of property?

(5) If a qualifying disposition election was made:

- Was it made on an asset-by-asset basis?
- Was a gain or loss properly determined?
- Was the disposition due to a casualty event?
- Was the disposed property replaced? If so was Section 1.263(a)-3(k) properly applied?

(6) Did the disposition result in a termination of a GAA or of GAA treatment? If so, was it a:

- Mandatory Termination, or
- Elective Termination?

(7) If a portion of the GAA was disposed, did the taxpayer properly determine:

- The remaining basis of the GAA?
- Any gain or loss on disposition?

XVI. CHAPTER 16 – ACCOUNTING METHOD CHANGES

A. METHODS OF ACCOUNTING – IN GENERAL

(1) Section 446 governs the general rules for methods of accounting. The two basic concepts are timing and consistency. If the accounting practice does not permanently affect the taxpayer's lifetime taxable income, but changes or could change the taxable year in which taxable income is reported, it involves timing. Therefore, the practice is considered a method of accounting. Although a method of accounting may exist without a pattern of consistent treatment of an item, in most instances, a method of accounting is not adopted without consistent treatment.

(2) For a method of accounting to be adopted, the focus is on the actual treatment on the tax return. A taxpayer may adopt any permissible method of accounting for a material item by treating the item properly on the first return that reflects the item. To be considered as having adopted an impermissible method of accounting, the taxpayer must improperly treat the material item the same way

on two or more consecutively filed returns. Thus, a taxpayer adopts a permissible method by properly treating a material item on its first return, and may thereafter change its method only with permission from the Service. If the taxpayer reports the material item incorrectly only once, it may make the change as the correction of an error. If an impermissible method is reported on two or more consecutively filed returns, the taxpayer must seek permission from the Service to change its method of accounting.

(3) Once a method of accounting has been adopted, it may only be changed with the consent of the Commissioner. A change in method of accounting includes a change in an overall plan of accounting (e.g., cash to accrual), or a change in the treatment of any material item. For accounting method purposes, a "material item" is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. For example, the treatment of a capital expenditure, recovered through depreciation, versus a current repair expense is a material item.

(4) A taxpayer may voluntarily request consent to change a method of accounting by filing Form 3115. Rev. Proc. 2015-13, 2015-5 I.R.B. 419 provides the general procedures under Section 446 to obtain both non-automatic consent as well as automatic consent of the Commissioner to change a method of accounting.

(5) Under the non-automatic change procedures, a taxpayer is required to file Form 3115, Application for Change in Accounting Method, during the year of change. In general, the taxpayer must pay a user fee, receive a ruling letter consenting to the change, sign and return the consent agreement to the National Office prior to implementing the change, and implement the change within a specified period.

(6) Under the automatic change procedures, each automatic accounting method change is assigned a designated change number ("DCN"). These DCNs are provided in a revenue procedure that is generally updated each year, known as the List of Automatic Changes, which includes Rev. Proc. 2015-14, I.R.B. 450, Rev. Proc. 2016-29, 2016-21 I.R.B. 880, Rev. Proc. 2017-30, 2017-18 I.R.B. 1131, Rev. Proc. 2018-31, 2018-22 I.R.B. 637, Rev. Proc. 2019-43, 2019-48 I.R.B. 1107, and Rev. Proc. 2022-14, 2022-7 I.R.B. 502. Refer to the table below to determine the effective dates of each Rev. Proc.

(7) The following are the steps identified in the flow chart below:

(3)

List of Automatic Changes	When Form 3115 is Filed On or After:	For Year of Change Ending On or After:
Rev. Proc. 2022-14	1/31/2022	5/31/2021
Rev. Proc. 2019-43	11/8/2019	3/31/2019
Rev. Proc. 2018-31	5/9/2018	9/30/2017

Rev. Proc. 2017-30	4/19/2017	8/31/2016
Rev. Proc. 2016-29	5/5/2016	9/30/2015
Rev. Proc. 2015-14	1/16/2015	5/31/2014

(8) The List of Automatic Changes describes each method change and the manner of making the change. Under the automatic change procedures, the taxpayer may file Form 3115 no earlier than the first day of the year of change, and no later than the date the taxpayer files its original return including extensions. There is no user fee. If the taxpayer fully complies with the applicable provisions of Rev. Proc. 2015-13 and the applicable List of Automatic Changes, the taxpayer is "deemed" to have been granted consent. The Director (examination) will ascertain if the change in method of accounting was made in compliance with all the applicable provisions of Rev. Proc. 2015-13 and the applicable List of Automatic Changes, if and when the issue is examined.

(9) Most of the method changes made to comply with the final tangible property regulations ("final regulations") are automatic changes and are included in the List of Automatic Changes. Chapters 17 and 18 discuss these changes in more detail.

B. BACKGROUND

(1) Forms 3115 filed prior to August 27, 2009

- Taxpayers filing for an accounting method to change from capital/depreciable to current expense treatment for previously capitalized "repair costs" were required to file a Form 3115 using Rev. Proc. 97-27,1997-1 C.B. 680. Many taxpayers received consent to change their accounting methods for this issue under these advance consent request procedures. The consent ruling letters tended to be subject to significant caveats, effectively placing responsibility on the field to examine the facts and determine whether the new method implemented by the taxpayer was permissible.

(2) Forms 3115 filed on or after August 27, 2009, for tax years ending before January 1, 2012

- Taxpayers filing a Form 3115 for "repair costs" with a year of change ending on or after December 31, 2008, were generally required to use the automatic consent provisions contained in Rev. Proc. 2008-52, 2008-2 C.B. 587 (as modified by Rev. Proc. 2009-39, 2009-38 I.R.B. 371, and superseded by Rev. Proc. 2011-14, 2011-4 I.R.B. 330). Section 2.08 of Rev. Proc. 2009-39 added new Appendix section 3.06 to Rev. Proc. 2008-52, which applied to "Repair and Maintenance Costs." Appendix section 3.06 provided automatic consent for a taxpayer that changed its accounting method from capitalizing under Section 263(a) to deducting

repair and maintenance costs as ordinary and necessary business expenses under Section 162 and 1.162-4 in compliance with then current law. This change also applied to a taxpayer that wanted to change its unit of property ("UOP") determination for the deductibility of repair and maintenance costs under applicable legal authority. The DCN for this change was 144.

(3) Forms 3115 for tax years beginning on or after January 1, 2012, and before January 1, 2014, under the temporary tangible property regulations ("temporary regulations")

- The Treasury Department issued temporary regulations Section 1.162-3T, 1.162-4T, 1.263(a)-2T, 1.263(a)-3T, 1.167(a)-4T, 1.167(i)-1T, 1.168(i)-7T and 1.168(i)-8T (the temporary regulations) on December 27, 2011, effective for tax years beginning on or after January 1, 2012. The Service issued Rev. Proc. 2012-19, 2012-14 I.R.B. 689, and Rev. Proc. 2012-20, 2012-14 I.R.B. 700, shortly thereafter to provide guidance for method changes required to comply with the temporary regulations.
- Rev. Proc. 2012-19 applied to Forms 3115 filed before January 24, 2014. It modified Rev. Proc. 2011-14 and provided the procedures to change the tax treatment of the following items to comply with the temporary regulations for taxable years beginning on or after January 1, 2012:
  - Materials and supplies; repairs and maintenance (Section 1.162-3T & 4T),
  - Capital expenditures in general (Section 1.263(a)-1T),
  - Acquisition and transaction costs (Section 1.263(a)-2T), and
  - Improvements (Section 1.263(a)-3T).
- Rev. Proc. 2014-16, 2014-9 I.R.B. 606, modified and superseded Rev. Proc. 2012-19 for Forms 3115 filed on or after January 24, 2014. This revenue procedure applied to changes made under both the temporary regulations and under the final regulations that were issued on September 19, 2013. The date a taxpayer files its Form 3115 dictates the procedures governing its accounting method changes to comply with the temporary regulations. For example, a taxpayer who filed a Form 3115 for 2013 on March 1, 2014 to change from capitalizing to expensing a repair under the temporary regulations must have followed the procedures in Rev. Proc. 2014-16. Chapter 17 discusses method changes to comply with the regulations.
- The Service issued Rev. Proc. 2012-20 concurrently with Rev. Proc. 2012-19, to provide guidance for method changes relating to depreciation and dispositions to comply with the temporary depreciation and disposition regulations. Rev. Proc. 2012-20 applied to Forms 3115 filed before

February 28, 2014, and provided procedures for requesting a change for the following methods of accounting addressed in the temporary disposition regulations:

- Leased property (Section 1.167(a)-4T),
- General asset accounts (Section 1.168(i)-1T),
- Accounting for MACRS property (Section 1.168(i)-7T), and
- Dispositions of MACRS property (Section 1.168(i)-8T).

- Rev. Proc. 2014-17, 2014-12 I.R.B. 661, modified and superseded Rev. Proc. 2012-20 for method changes relating to depreciation and dispositions to comply with the temporary and proposed depreciation and disposition regulations, and the final depreciation and disposition regulations under Section 1.167(a)-4 and 1.168(i)-7. This revenue procedure provides guidance for Form(s) 3115 filed on or after February 28, 2014. The date that a taxpayer files its Form(s) 3115 determines which revenue procedures the taxpayer may use for accounting method changes to comply with the temporary depreciation or disposition regulations. For example, a taxpayer who filed a Form 3115 for 2013 on March 1, 2014, to change its method of accounting for dispositions of MACRS property under the temporary regulations must have followed the procedures in Rev. Proc. 2014-17. Chapter 18 discusses method change procedures to comply with the disposition regulations.

(4) Forms 3115 for tax years beginning on or after January 1, 2012, and before January 1, 2014, under the proposed disposition and final regulations.

- Proposed disposition regulations under Section 1.168(i)-1, 1.168(i)-7, and 1.168(i)-8, and final regulations under Section 1.162-3, 1.162-4, 1.263(a)-1, 1.263(a)-2 and 1.263(a)-3, 1.167(a)-4 and 1.168(i)-7 were issued on September 19, 2013. These regulations are effective for taxable years beginning on or after January 1, 2014, but taxpayers had the option to apply them to tax years beginning on or after January 1, 2012.
- In addition to describing the procedures to obtain automatic consent for changing to accounting methods under the temporary regulations, Rev. Proc. 2014-16 and Rev. Proc. 2014-17 provide the procedures for method changes to comply with the final regulations and the proposed depreciation and disposition regulations for tax years beginning on or after January 1, 2012, and before January 1, 2014. See Chapters 17 and 18 for additional information.

(5) Taxable years beginning on or after January 1, 2014

- The final regulations, published on September 19, 2013, are effective for taxable years beginning on or after January 1, 2014. Rev. Proc. 2014-16, issued January 24, 2014, modified Rev. Proc. 2011-14 to provide guidance for method changes to comply with both the temporary and the final regulations. Rev. Proc. 2014-16 specifically provided the procedures for requesting a change in the treatment of the following items addressed in the final regulations:
    - Materials and supplies, rotable and temporary spare parts (Section 1.162-3),
    - Repairs and maintenance (Section 1.162-4),
    - Certain costs to facilitate the sale of property (Section 1.263(a)-1),
    - Acquisition, production, investigatory costs (Section 1.263(a)-2, and
    - Improvements (Section 1.263(a)-3).
- The final regulations under Section 1.167(a)-4 and 1.168(i)-7 were published on September 19, 2013, and are effective for taxable years beginning on or after January 1, 2014. Taxpayers have the option to apply these regulations to years beginning on or after January 1, 2012. Rev. Proc. 2014-17 modified Rev. Proc. 2011-14 to provide the procedures for requesting a change in method of accounting for the following items under these two final regulations:
    - Leased property (Section 1.167(a)-4), and
    - Accounting for MACRS property (Section1.168(i)-7).
- The final disposition regulations, and modifications to Section 1.168(i)-7, were published on August 18, 2014, and are effective for taxable years beginning on or after January 1, 2014. Taxpayers have the option to apply these regulations to years beginning on or after January 1, 2012. Rev. Proc. 2014-54, 2012-14 I.R.B. 700, issued September 18, 2014, modified Rev. Proc. 2011-14 to provide the procedures for requesting a change in method of accounting for the following items under the final disposition regulations:
    - General asset accounts (Section 1.168(i)-1),
    - Accounting for MACRS property (Section 1.168(i)-7), and
    - Dispositions of MACRS property (Section 1.168(i)-8).

(6) Taxable years ending on or after May 31, 2014, and before September 30, 2015

- Rev. Proc. 2015-13 and Rev. Proc. 2015-14 supersede Rev. Proc. 2011-14 and Rev. Proc. 2014-16 for Forms 3115 filed on or after January 16, 2015, for a year of change ending on or after May 31, 2014. Rev. Proc.

2015-13 provides the procedures for non-automatic and automatic changes, and Rev. Proc. 2015-14 contains the List of Automatic Changes, which was previously contained in the Appendix of Rev. Proc. 2011-14. The automatic changes under the final regulations are in section 10.11 of Rev. Proc. 2015-14, and under the final depreciation and disposition regulations are in section 6 of Rev. Proc. 2015-14.

(7) Taxable years ending on or after September 30, 2015

- Rev. Proc. 2022-14 contains the current List of Automatic Changes to which Rev. Proc. 2015-13 applies. The automatic changes under the final regulations are in section 11.08 of Rev. Proc. 2022-14, and the final depreciation and disposition regulations are in section 6 of Rev. Proc. 2022-14.
- See Chapters 17 and 18 for a detailed discussion of the accounting method changes to comply with the final regulations and the final dispositions and depreciation regulations.

(8) Other Method Change Guidance

- Pursuant to the Industry Issue Resolution (IIR) process, the Service has issued several safe harbor revenue procedures for specific industry issues under the final regulations. This guidance provides procedures for taxpayers to change to the methods of accounting authorized under these rulings. See, for example:
  - Rev. Proc. 2001-46, 2001-2 I.R.B. 321, Track Maintenance Allowance Method for Class I Railroads. See Rev. Proc. 2015-14, section 10.12; or Rev. Proc. 2016-29, Rev. Proc. 2017-31, Rev. Proc. 2018-31, Rev. Proc. 2019-43, or Rev. Proc 2022-14, section 11.09; DCN 213
  - Rev. Proc. 2002-65, 2002-2 I.R.B. 700, Track Maintenance Allowance Method for Class II and III Railroads. See Rev. Proc. 2015-14, section 10.12; or Rev. Proc. 2016-29, Rev. Proc. 2017-31, Rev. Proc. 2018-31, Rev. Proc. 2019-43, or Rev. Proc 2022-14, section 11.09; DCN 213
  - Rev. Proc. 2011-27, 2011-18 I.R.B. 740, Wireline Network Asset Maintenance Allowance and Units of Property Accounting Method. See Rev. Proc. 2015-14, section 3.07; or Rev. Proc. 2016-29, Rev. Proc. 2017-31, Rev. Proc. 2018-31, Rev. Proc. 2019-43, or Rev. Proc 2022-14, section 3.07; DCN 158
  - Rev. Proc. 2011-28, 2011-18 I.R.B. 743, Wireless Network Asset Maintenance Allowance and Units of Property Accounting Method. See Rev. Proc. 2015-14, section 3.08; or Rev. Proc. 2016-29, Rev.

Proc. 2017-31, Rev. Proc. 2018-31, Rev. Proc. 2019-43, or Rev. Proc 2022-14, section 3.08; DCN 159

- Rev. Proc. 2011-43, 2011-37 I.R.B. 326, Transmission and Distribution of Electricity Accounting Method. See Rev. Proc. 2015-14, section 3.09; or Rev. Proc. 2016-29, Rev. Proc. 2017-31, Rev. Proc. 2018-31, Rev. Proc. 2019-43, or Rev. Proc 2022-14, section 3.09; DCN 160
- Rev. Proc. 2013-24, 2013-22 I.R.B. 1142, Steam or Electric Power Generation Units of Property and Accounting Method. See Rev. Proc. 2015-14, section 3.20; or, Rev. Proc. 2016-29, Rev. Proc. 2017-31, Rev. Proc. 2018-31, Rev. Proc. 2019-43, or Rev. Proc 2022-14, section 3.10; DCN 182
- Rev. Proc. 2015-12, 2015-2 I.R.B. 266, Cable Network Asset Capitalization Accounting Method. See Rev. Proc. 2015-14, section 3.21; or, Rev. Proc. 2016-29, Rev. Proc. 2017-31, Rev. Proc. 2018-31, Rev. Proc. 2019-43, or Rev. Proc 2022-14, section 3.11; DCN 208 or 209
- Rev. Proc. 2015-56, 2015-49 I.R.B. 827, Retail/Restaurant Remodel-Refresh Safe Harbor Accounting Method. Rev. Proc. 2015-56 modified Rev. Proc. 2015-14 to add sections 6.43 (DCN 221) and 10.13 (DCN 222). See also Rev. Proc. 2016-29, sec- tions 6.20 (DCN 221) and 11.10 (DCN 222), or, Rev. Proc. 2017-39, sections 6.18 (DCN 221) and 11.10 (DCN 222); and Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc 2022-14, section 11.10 (DCN 222). Proc. 2018-31 obsoleted section 6.18 of Rev. Proc. 2017-30 (DCN 221), relating to the revocation of the partial disposition election under the remodel-refresh safe harbor described in Rev. Proc. 2015-56.
- Note: This list is not all-inclusive, but rather provides examples of guidance issued as a result of the IIR program relating to tangible property issues. See Chapters 2 and 19.

C. IDENTIFYING POTENTIAL AUDIT ISSUES

C.1. Pre-Audit Considerations

(1) For tax years beginning before January 1, 2014, if the taxpayer did not file a Form 3115 to comply with the final regulations, the examiner should follow LB&I Directive 04-0313-001. For tax years beginning on or after January 1, 2014, the examiner should perform a risk assessment of the issue and proceed accordingly.

(2) Compliance responsibilities for accounting method changes filed under the automatic change procedures include the following considerations:

- Was the taxpayer within the scope of the applicable revenue procedure(s)?
- Was the change to a proper method filed as specified in the appropriate revenue procedures?
- Was the change implemented in compliance with all applicable provisions?
- Does the change lack audit protection?
- Was the Section 481(a) amount properly computed?

(3) Prior to the initial interview and/or the issuance of Information Document Requests ("IDRs"), the examiner should review Form 5346, Examination Information Report, if included in the case file, to gain an understanding of prior examination activity. For tax years beginning before January 1, 2012, examiners who stood down on the capital-to-repair issue were directed to complete a Form 5346 to assist in the future examination of the issue. In addition, copies of any pertinent work papers in the IMS file or other central location should be reviewed to determine what information has already been secured by exam.

(4) A taxpayer is required to attach Forms 3115, filed under the automatic change procedures, to the tax return for the year of change. The tax return should be reviewed to determine whether the taxpayer filed a Form 3115 to change its method of accounting pursuant to a specific revenue procedure to comply with the regulations. If a Form 3115 is not attached to the return, the examiner should consider the possibility that a Form 3115 was filed, but may no longer be attached to the paper return, or may not be included in LIN or the Employee User Portal as an attachment (e.g., due to scanning problems). The examiner should take additional steps to confirm whether a Form 3115 was filed.

(5) Schedule M-3, Part II, line 19, should reflect all Section 481(a) adjustments included on the tax return. Schedule M adjustments may also be reflected on various lines of the tax return including line 14, repairs and maintenance, or line 26, other deductions. These items should generally be questioned as the amount could be a result of netting two or more Section 481(a) adjustments. Each Section 481(a) adjustment should be risk-assessed and included as an examination item where appropriate.

C.2. Initial Interview

(1) During the initial interview, the examiner should ask the taxpayer whether it has filed any Forms 3115 with respect to items addressed in the final regulations and/or the final depreciation and disposition regulations for the year(s) under examination as well as prior and subsequent years. For prior years, this could include method changes for "capital to repair" (including DCN 144), materials

and supplies, or other items addressed in the final regulations. Preliminary information regarding each of the changes should be gathered and discussed to gain a basic understanding of any changes the taxpayer has made or requested. Forms 3115 filed for the year(s) under examination and prior and subsequent years will generally impact the examination of the issue. If the taxpayer has filed Form(s) 3115 for any of these changes, examiners should consider requesting an issue presentation or meeting to address the following:

- Discussion of Form(s) 3115 filed to date (prior, current, and subsequent to year of change),
- Consolidation/summary of all changes,
- General explanation of methodology for each change,
- General explanation of the computation of the Section 481(a) adjustment(s),
- Statistical sampling methodology used, whether any,
- Availability of documentation to support the changes.

C.3. Information and Documentation

(1) The examiner should issue IDRs related to accounting method changes as early as possible in the examination in accordance with LB&I Directive 04-0313-001.

(2) Examiners should determine whether additional accounting method changes have been made or requested for tax periods subsequent to the year(s) under examination. In such cases, examiners should consider obtaining copies of the respective Forms 3115. The taxpayer may have audit protection because of these filings, and it is beneficial to have this information up front prior to expending examination resources.

(3) The examiner should request information and documentation for voluntary method changes made under the non-automatic and automatic change procedures in Rev. Proc. 2015-13, and the applicable , List of Automatic Changes, and under prior accounting method change revenue procedures. This is particularly important with respect to capital-to-repair changes since both types of consent procedures have applied to such changes and/or the changes may affect a current-year change. There are four (4) basic steps in examining any method change issue:

(4) Determine whether the taxpayer is within the scope of the revenue procedure.

- The information needed to make this determination is generally found on the Form 3115 and by examining the proposed method.

(5) Understand the taxpayer's present method of accounting.

- For every method change, an examiner must understand what the tax treatment of the item was prior to the change. The accounting method that the taxpayer is changing from is the taxpayer's "present method" of accounting. In other words, what is the starting point for the change? To determine and understand the accounting method a taxpayer is changing from, examiners should consider requesting information and documentation for method changes for prior years, including previous changes for "capital to repair" and/or changes under DCN 144. Information for each current year change, and each entity requesting the change, should include, but is not limited to the following:
  - A detailed explanation of the taxpayer's present method of accounting for the items that are the subject of the current method change:
    - What is the taxpayer's present method of accounting?
    - What items or groups of items does the method apply to?
    - When was the present method adopted?
    - If the present method has been previously changed, when did the change occur?
    - What was the taxpayer's method before the change to the present method?
    - What was the amount of the Section 481(a) adjustment?
    - Analyses, assumptions, statistical samples, etc., used for the present method.
  - Copies of all Forms 3115 filed under non-automatic change procedures (see sections 3.10 and 3.11 of Rev. Proc. 2015-13) relating to the current change,
  - Copies of all ruling (consent) letters from National Office for requested method changes,
  - Correspondence between the taxpayer and National Office relating to the method change,
  - Copies of all Forms 3115 filed under automatic change procedures (see Rev. Proc. 2015-13 and the applicable List of Automatic Changes) relating to the current change,
  - Any information that may have been missing or omitted from any filed Forms 3115,
  - Other pertinent information relating to prior changes.

- The documentation will assist in making determinations regarding the taxpayer's present method of accounting and will provide the basis for computing the Section 481(a) adjustment. The Section 481(a) adjustment will be discussed in greater detail later in this chapter (see also Chapters 17 & 18).

(6) Examine the Taxpayer's Proposed Method

- In addition to understanding the taxpayer's present method of accounting, the examiner must determine whether the method to which the taxpayer is changing (the "proposed" method) is a permissible method and whether the method is implemented in accordance with the applicable revenue procedure(s). For each Form 3115 accounting method change request and each entity to which the change applies, the examiner should consider requesting:
  - A complete explanation of the proposed ("new") method of accounting.
    - What is the taxpayer's proposed method of accounting?
    - Is the method change within the scope of the applicable revenue procedure?
    - What items or groups of items does the method apply to?
    - Are items missing that should be included? Why are they missing?
    - Are items included that should not be? Why are they included?
  - Detailed work papers and/or schedules showing the computation of each current year adjustment.
    - Is the method a permissible method of accounting?
    - Did the taxpayer implement the method in accordance with the applicable revenue procedure?

(7) Determine Whether the Section 481(a) Adjustment is Computed Properly

- The propriety of the taxpayer's method(s) must be addressed to determine compliance with the final regulations (i.e., is the method permissible)? Once this determination is made, the examiner will be in a position to analyze the Section 481(a) adjustment.
- To determine the correctness of the Section 481(a) adjustment, the examiner should secure detailed work papers and/or schedules showing the computation of the Section 481(a) adjustment, which should address the following:
  - How was the Section 481(a) adjustment computed?

- Statistical sampling analyses, studies, or similar documentation,
- Cost segregation studies,
- Other computational tools used.

- Did the taxpayer consider, or true up, all prior method change Section 481(a) amounts?
- Did the taxpayer consider amounts from all years using the prior method (i.e., years between the prior year of change and the current year of change)?
- Where is the Section 481(a) amount included on the tax return (e.g., line 26, Schedule M, etc.)?
- What is the amount of the Section 481(a) adjustment?
- How is the Section 481(a) adjustment considered (i.e., what is the spread, if any)?
- Have all adjustments (e.g., depreciation, bonus depreciation, those relating to dispositions) necessary to prevent items from being duplicated or omitted been considered?
- Does the Section 481(a) adjustment include any correlative adjustments?

- Refer to Chapters 17 and 18 for information on Section 481(a) adjustments to comply with the final regulations and the final depreciation and disposition regulations.

D. AUDIT PROCEDURES

D.1. Determine Whether the Taxpayer is Within the Scope of the Revenue Procedure

(1) Different revenue procedures apply, depending on the date a Form 3115 is filed. The examiner must determine if the taxpayer complied with the filing provisions of the applicable revenue procedure and be aware that terms and conditions vary.

(2) Rev. Proc. 2015-13 generally provides the procedures for accounting method changes to comply with the final regulations for Forms 3115 filed on or after January 16, 2015. The List of Automatic Changes provides the list of automatic method changes to which the automatic change procedures in Rev. Proc. 2015-13 apply. Taxpayers under examination may file a Form 3115 at any time, but they will generally not have audit protection for the issue, and the spread of a positive Section 481(a) adjustment will be limited to two years. There are exceptions to the general rule (e.g., three-month window or 120-day window) that allow a four-year spread of a positive Section 481(a) adjustment and

provide audit protection. Newly published revenue procedures that contain additional automatic accounting method changes may modify The List of Automatic Changes to include these changes.

(3) Taxpayers generally filed Forms 3115, prior to January 16, 2015, to comply with the final regulations under the automatic change procedures found in Rev. Proc. 2011-14. Under this revenue procedure taxpayers under examination could not file a Form 3115 unless one of the exceptions applied (e.g., 90-day window, 120-day window, or Director Consent). However, the scope limitations in section 4.02 were generally waived for tax years ending before January 1, 2015.

(4) Note that while the scope limitations in section 4.02 of Rev. Proc. 2011-14 were waived for certain taxpayers under examination that allowed them to file a Form 3115, a taxpayer did not receive audit protection for prior years if an issue was "pending," or before Appeals or a Federal Court. An issue was pending if the taxpayer received written notification from the Service that an adjustment would be proposed with respect to the item.

D.2. Understand the Taxpayer's Present Method of Accounting

(1) The examiner must thoroughly understand what method the taxpayer is changing from to properly examine a method change issue. That is, what is the tax treatment of the item(s) before the change? This is particularly important because examiners were required to "stand down" under LB&I Directive 04-0313-001 on examinations involving capitalization-to-repair method changes and many of the prior methods were never reviewed or analyzed. The information provided with respect to the taxpayer's present method will also serve as a basis for the Section 481(a) adjustment. The examiner should issue follow-up requests for additional detail if the information is not sufficient to make the proper determinations.

D.3 Examine the Taxpayer's Proposed Method

(1) Neither an advance consent ruling nor deemed consent under the automatic method change procedures constitutes a determination by the Commissioner that the taxpayer has implemented an appropriate method of accounting to comply with the final regulations, and/or the final depreciation and disposition regulations. The determination as to the deductibility of repair and maintenance costs, for example, is made by examination. The examiner must determine if the taxpayer's new method is a permissible method. The method is permissible if it complies with the tax rules and regulations.

(2) The examiner must also determine if the method was implemented in accordance with the applicable revenue procedure. Each automatic accounting method change is assigned a DCN. The taxpayer should identify the DCN(s) included in the method change requests on Form 3115, page 1, Part I, line 1a.

Examiners should review the applicable accounting method change section identified by the DCN(s) to understand the specific provisions of that particular method change to ensure compliance.

D.4. Determine Whether the Section 481(a) Adjustment is Computed Properly

(1) The Section 481(a) adjustment is the cumulative difference between the present method and the proposed method as of the beginning of the year of change. This means the examiner will need to make sure the taxpayer has considered prior treatment of all items within the applicable method change and the calculations are mathematically correct. This includes previously filed Forms 3115, and any examination adjustments associated with the items included in the Section 481(a) adjustment in the current Form 3115. Example:

- The taxpayer's 2014 calendar year return is under examination. In 2009, the taxpayer filed a Form 3115 to deduct previously capitalized costs as repairs. The taxpayer deducted an $8,500,000, taxpayer-favorable (i.e., negative) Section 481(a) adjustment in 2009. This amount was equal to the remaining basis of a total of $10,000,000 of costs capitalized in 2007 and 2008 that were being depreciated over 10 years. The remaining basis was $4,000,000 (2007) and $4,500,000 (2008) as of the beginning of 2009. The taxpayer deducted $1,000,000, per year, from 2009 through 2013 as repairs under its 2009 method of accounting, deducting costs as repairs.
- The taxpayer filed a Form 3115 for 2014 to change its method of accounting for repairs that must be capitalized under the final regulations. The taxpayer's 2014 method change relates to all of the amounts deducted under its 2009 change. In other words, all of the previously deducted amounts are required to be capitalized under the taxpayer's 2014 method to comply with the final regulations. Since examiners were required to "stand down" on the examination of method changes relating to repairs and maintenance, the prior 2009 method change was never examined. The examiner should examine the propriety of the 2009 method change and the calculation of the Section 481(a) adjustments as part of the 2014 method change.
- Step 1: How were items treated under the taxpayer's 2009 method, described in the Form 3115 as the taxpayer's present method?
    - The starting point to compute the 2014 Section 481(a) adjustment, is to determine the cumulative effect of the tax treatment of the item(s) under the taxpayer's 2009, or present method as of the beginning of the year of change, 2014. This must take into account any prior Section 481(a) adjustments and deductions in each of the years prior to 2014, using the 2009 method. In the example, this will include the

2007 and 2008 amounts deducted under the pre-2009 method plus the 2009 Section 481(a) adjustment of $8,500,000 and the $1,000,000 repair deductions in each of the years 2009 - 2013.

(4)

Years	Amount	2007	2008	Total
2007	5,000,000	500,000	500,000	1,000,000
2008	5,000,000		500,000	500,000
Total	10,000,000	500,000	1,000,000	**1,500,000**

(5)

Years	Amount	2009	2010	2011	2012	2013	Total
2007	5,000,000	4,000,000					4,000,000
2008	5,000,000	4,500,000					4,500,000
2009	1,000,000	1,000,000					1,000,000
2010	1,000,000		1,000,000				1,000,000
2011	1,000,000			1,000,000			1,000,000
2012	1,000,000				1,000,000		1,000,000
2013	1,000,000					1,000,000	1,000,000
Total	15,000,000	9,500,000	1,000,000	1,000,000	1,000,000	1,000,000	**13,500,000**

- Step 2: What would the deductions have been using the 2014 proposed method (i.e., would the amounts have been deductible under the final regulations)?
    - For the purpose of this example, the final regulations require capitalization of all of the prior deductions. The examiner will need to determine what would have been the cumulative effect of the tax treatment under the 2014 proposed (new) method, as of the beginning of the year of change if the taxpayer had used the 2014 proposed method all along. The proposed method in this example is to capitalize and depreciate the items in question. The cumulative effect of the tax treatment under the 2014 proposed method is computed by capitalizing the deductions in each prior year, and allowing depreciation using the appropriate recovery period, as of the beginning of the year of change. For purposes of this example and simplicity, we are using straight-line depreciation over 10 years with a full-year convention and using no additional first-year depreciation deduction, for the proposed method. This example also assumes all of these properties are still owned by the taxpayer as of January 1, 2014, the first day of the year of change.

(6)

Year	Amount	Pre-2009	2009	2010	2011	2012	2013	Total
2007	5,000,000	1,000,000	500,000	500,000	500,000	500,000	500,000	3,500,000
2008	5,000,000	500,000	500,000	500,000	500,000	500,000	500,000	3,000,000
2009	1,000,000		100,000	100,000	100,000	100,000	100,000	500,000
2010	1,000,000			100,000	100,000	100,000	100,000	400,000
2011	1,000,000				100,000	100,000	100,000	300,000
2012	1,000,000					100,000	100,000	200,000
2013	1,000,000						100,000	100,000
Total	15,000,000	1,500,000	1,100,000	1,200,000	1,300,000	1,400,000	1,500,000	**8,000,000**

- Under the 2014 proposed method, the taxpayer would have been allowed a cumulative deduction of $8,000,000 as of the beginning of 2014 for all prior years had it used this method all along.

- Step 3: Compare the amounts determined in Steps 1 and 2.
  - The difference between the cumulative effect of the tax treatment under the 2009 (present) and 2014 (proposed) methods will be the Section 481(a) adjustment. In this case, the taxpayer deducted $7,000,000 more under its 2009 present method than it would have deducted under its 2014 proposed method as of the beginning of the year of change.
    - Cumulative effect – 2009 present method $ 15,000,000
    - Cumulative effect – 2014 proposed method $ (8,000,000)
    - Excess deductions under present method $ 7,000,000
  - The difference is the Section 481(a) adjustment. The Section 481(a) amount, $7,000,000, is the remaining basis in the capitalized costs, as of the beginning of 2014, and will be recovered through depreciation under the taxpayer's new method over the remaining recovery periods. For example, the remaining basis for the 2007 costs ($5,000,000) million is $1,500,000 as of the beginning of 2014. Using 10-year straight-line depreciation, the taxpayer will depreciate the remaining costs in 2014 (year 8), 2015 (year 9), and 2016 (year 10) at $500,000/year.

D.5. Consider Reviewing Studies

(1) Consider a review of any studies that formed the basis for increased "expense" treatment and any correlative depreciation adjustments resulting from prior

change in accounting methods, as well as current studies used to determine the current method changes.

(2) Many taxpayers previously changed their accounting methods for depreciation pursuant to a cost segregation study that separated components of an asset into separate tangible assets and/or reclassified separate assets into an asset class that qualified for a shorter recovery period. These taxpayers may have filed method change requests for these changes in conjunction with the “Repair and Maintenance Cost” method change. The examiner should review the assets identified in cost-segregation and/or asset-reclassification studies to determine whether the taxpayer is consistent in its classification of Section 1245 property (generally, personal property) and Section 1250 property (generally, real property). That is, the taxpayer must be consistent in its classifications for both (1) asset identification/classification; and (2) determining whether an expenditure relating to that asset should be capitalized or treated as a repair-expense deduction. If an item is identified as a tangible asset and treated as Section 1245 property for purposes of asset classification and/or depreciation, it cannot be treated as a structural component of a building and a replacement of a component of Section 1250 property to obtain repair-expense treatment.

(3) The examiner should determine whether the taxpayer is using the same definition for a UOP for purposes of both (1) asset depreciation/disposition, and (2) determination of whether an amount should be capitalized or treated as a repair-expense deduction. If the taxpayer is using different definitions for (1) and (2), then the examiner should verify whether the taxpayer’s new methods of determining repair expenses and claimed Section 481(a) adjustment are consistent with its claimed dispositions in earlier years. Previously, using the smaller separate asset as the UOP, the taxpayer treated the costs of replacing that asset as a capital expenditure and treated the adjusted basis of the original asset as a disposition. Having now changed the definition of the UOP to a larger asset, the taxpayer would like to treat the replacement of what is now a “component” as a qualifying repair expense. However, if the original smaller separate asset has been treated as a disposition, the taxpayer has a dilemma, because there is no “component” to be repaired or replaced, and therefore any expenditure to install a new “component” is a betterment that must be capitalized.

(4) For example, a taxpayer placed a building and its structural components in service in 2014 (year 1) and in 2019 (year 5) replaced the roof and windows of the building. In year 5, the taxpayer disposed of the original roof and windows. Taxpayer made a partial disposition election for these windows and roof on its timely filed year 5 federal tax return and, as a result, deducted the adjusted basis of these assets, while capitalizing the cost of the new roof and windows. Now, having identified the entire building as the UOP, the taxpayer has filed a Form 3115 to treat the adjusted basis of the costs that were capitalized in year 5 as deductible repair and maintenance costs. However, if the original roof and windows have been treated as disposed, there is neither a roof nor windows

available for “repair.” Unless and until the taxpayer receives a private letter ruling allowing the taxpayer to revoke the year 5 partial disposition election, there can be no consideration of whether the year 5 costs for the new roof and window are eligible for repair-expense treatment (refer to Chapter 18 for additional information on dispositions).

(5) These correlative changes should be addressed in the automatic consent method change request on Form 3115. Additional details regarding each of the method changes addressed in the various revenue procedures are found in Chapters 17 and 18.

XVII. CHAPTER 17 – ACCOUNTING METHOD CHANGES – CAPITALIZATION

A. APPLICABLE METHOD CHANGE PROCEDURES

(1) The final tangible property regulations (“final regulations”), published on September 19, 2013, are generally effective for taxable years beginning on or after January 1, 2014. Rev. Proc. 2014-16, 2014-9 I.R.B. 606, issued January 24, 2014, modified Rev. Proc. 2011-14, 2011-4 I.R.B. 330, to provide guidance for method changes to comply with the final regulations. Rev. Proc. 2014-16 specifically provided the procedures for requesting a change in the treatment of the following items addressed in the final regulations:

- Materials and supplies, certain rotable and temporary spare parts (Section 1.162-3),
- Repairs and maintenance (Section 1.162-4),
- Certain costs to facilitate the sale of property (Section 1.263(a)-1(e)),
- Acquisition, production, investigatory costs (Section 1.263(a)-2), and
- Improvements (Section 1.263(a)-3).

(2) Rev. Proc. 2014-16 also provided the method change procedures for taxpayers that chose to apply the final regulations for taxable years beginning on or after January 1, 2012, and for taxpayers that chose to change to a method in the temporary tangible property regulations (“temporary regulations”) for taxable years beginning on or after January 1, 2012 and before January 1, 2014.

(3) Rev. Proc. 2015-13, 2015-5 I.R.B. 419, and Rev. Proc. 2015-14, 2015-5 I.R.B. 450, superseded Rev. Proc. 2011-14 and Rev. Proc. 2014-16 for Forms 3115 filed on or after January 16, 2015, for a year of change ending on or after May 31, 2014. Rev. Proc. 2015-13 continues to provide the procedures for non-automatic and automatic changes. Rev. Proc. 2015-14, which was effective for Forms 3115 filed on or after January 16, 2015, and before May 5, 2016, for taxable years ending on or after May 31, 2014, and before September 30, 2015,

provided the List of Automatic Changes which were previously contained in the Appendix of Rev. Proc. 2011-14. The automatic change provisions for accounting methods under the final regulations are located in section 10.11 of Rev. Proc. 2015-14.

(4) Transition rules under Rev. Proc. 2015-13 provided additional time for taxpayers to file Forms 3115 for both automatic and non-automatic changes. For automatic changes, taxpayers were permitted to file a Form 3115 under either Rev. Proc. 2011-14 or Rev. Proc. 2015-13 for taxable years ending on or after May 31, 2014, and beginning before January 1, 2015, until the due date of the taxpayer's timely filed (including any extension) original federal tax return for the requested year of change.

(5) Rev. Proc. 2016-29, 2016-21 I.R.B. 880, amplifies, modifies, and supersedes, in part, Rev. Proc. 2015-14 for Forms 3115 filed on or after May 5, 2016, for a year of change ending on or after September 30, 2015. Rev. Proc. 2016-29 removes the procedures provided in section 10.11(3)(b) of Rev. Proc. 2015-14, which provided for changing to methods of accounting under the temporary tangible property regulations. This method of accounting is obsolete for taxable years of change beginning on or after January 1, 2014.

(6) Rev. Proc. 2017-30, 2017-18 I.R.B. 1131, amplifies, modifies, and supersedes, in part, Rev. Proc. 2016-29 for Forms 3115 filed on or after April 19, 2017, for a year of change ending on or after August 31, 2016.

(7) Rev. Proc. 2018-31, 2018-22 I.R.B. 637, amplifies, modifies, and supersedes, in part, Rev. Proc. 2017-30 for Forms 3115 filed on or after May 9, 2018, for a year of change ending on or after September 30, 2017.

(8) Rev. Proc. 2019-43, 2019-48 I.R.B. 1107, amplifies, modifies, and supersedes, in part, Rev. Proc. 2018-31 for Forms 3115 filed on or after November 8, 2019, for a year of change ending on or after March 31, 2019.

(9) Rev. Proc. 2022-14, 2022-7 I.R.B. 502, amplifies, modifies, and supersedes, in part, Rev. Proc. 2019-43 for Forms 3115 filed on or after January 31, 2022, for a year of change ending on or after May 31, 2021. Rev. Proc. 2022-14 contains the current List of Automatic Changes to which Rev. Proc. 2015-13 applies. The automatic changes under the final tangible regulations are located in section 11.08 of Rev. Proc. 2022-14.

(10) Thus, the date that a taxpayer files its Form(s) 3115 and its year of change determines which revenue procedure the taxpayer may use for making automatic accounting method changes to comply with the temporary regulations (if the taxpayer chose to do so) and to comply with the final regulations. The examiner should identify and confirm the revenue procedure a taxpayer used to file its change(s) to comply with the temporary or the final regulations as some procedures differ.

A.1. Scope Limitations and the "5-year rule"

(11)Rev. Proc. 2015-13 does not contain scope limitations for taxpayers under examination; Rev. Proc. 2015-13 permits a taxpayer under examination to file a Form 3115 at any time but modified the terms and conditions that apply. For example, a taxpayer under examination that files a Form 3115 does not generally get audit protection for the item that is the subject of the request.

(12)Section 10.11 of Rev. Proc. 2015-14 also waives the "5-year rule" in the automatic change procedures for a tangible property method change request for any taxable year beginning before January 1, 2015. This rule generally precludes taxpayers from using the automatic change procedures to change the treatment of an item more than once within a 5-year period, for changes in the revenue procedure. For example, a taxpayer that filed a method change from capitalizing to deducting certain repair costs in 2010 may use the automatic change procedures, rather than non-automatic change procedures, to make a change from deducting to capitalizing the same item in 2014.

(13)Section 11.08(2)(a) of Rev. Proc. 2016-29 continues to waive the "5-year rule" but extends this waiver another year to tangible property method change requests for any taxable year beginning before January 1, 2016. Section 11.08(2)(a) of Rev. Proc. 2017-30 and Rev. Proc. 2018-31 waive the "5-year rule" to tangible property method change requests for any taxable year beginning before January 1, 2017.

(14) Section 11.08(1)(b) of Rev. Proc. 2016-29, Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14 modify the inapplicability provisions of Rev. Proc. 2015-14 to provide additional type of tangible property change to which the automatic change provisions of Rev. Proc. 2015-13 do not apply. Specifically, section 11.08(1)(b)(viii) of Rev. Proc. 2016-29 provides that automatic changes for tangible property do not include amounts paid or incurred for repair and maintenance costs that the taxpayer is changing from capitalizing to deducting and for which the taxpayer has claimed a federal income tax credit or elected to apply Section 168(k)(4). Section 11.08(1)(b)(viii) of Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14 provides that automatic changes for tangible property do not include amounts paid or incurred for repair and maintenance costs that the taxpayer is changing from capitalizing to deducting and for which the taxpayer has (A) claimed a federal income tax credit, (B) elected to apply Section 168(k)(4), or (C) received a payment for specified energy property in lieu of tax credits under section 1603 of the American Recovery and Reinvestment Tax Act of 2009, Div. B of Pub. L. No. 111-5, 123 Stat. 115 (February 17, 2009), as amended by section 707 of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296 (December 17, 2010).

A.2.Accounting Method Change v. Election

(1) As discussed in previous Chapters, the final tangible regulations include certain safe harbor elections that the taxpayer may make in its timely filed original federal tax return for the taxable year in which the election applies. These elections include, but are not limited to, the de minimis safe harbor election under Section 1.263(a)-1(f), the safe harbor for small taxpayers under Section 1.263(a)-3(h), and the election to capitalize repair and maintenance costs under Section 1.263(a)-3(n). Each of these provisions requires an annual election by the taxpayer. The taxpayer does not file a Form 3115, Application for Change in Method of Accounting, to make these elections for a particular year, and the taxpayer does not file a Form 3115 to stop using these elections for a subsequent tax year.

A.3. Changes under Section 263A

(1) A taxpayer may file a change to comply with the final regulations under the applicable List of Automatic Changes and file a concurrent change on the same Form 3115 to comply with Section 263A. Taxpayers filing for concurrent method changes under the automatic method change procedures that are also under examination will not receive audit protection unless an exception applies. Taxpayers that are using an impermissible method of accounting for Section 263A are expected to comply with the uniform capitalization (UNICAP) rules, but a change to comply with the final regulations is not contingent on a concurrent change to a permissible UNICAP method.

(2) Section 11.09 of Rev. Proc. 2015-14 and section 12.08 of Rev. Proc. 2016-29, Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14 contain designated change number (“DCN”) 194 (formerly added to section 11.09 in the Appendix of Rev. Proc. 2011-14 by Rev. Proc. 2014-16). This section applies to a taxpayer that wants to change its method of allocating direct and indirect costs to a reasonable method that the regulations do not specifically describe. This change was previously a non-automatic change and required advance consent from the National Office.

A.4. Multiple Concurrent Changes under the Final Regulations

(1) Section 10.11(5) of Rev. Proc. 2015-14, section 11.08(5) of Rev. Proc. 2016-29, Rev. Proc. 2017-30 and Rev. Proc. 2018-31, and section 11.08(4) of Rev. Proc. 2019-43 and Rev. Proc. 2022-14 allow multiple changes under the final regulations for the same year of change to be included on a single Form 3115. The taxpayer must identify each DCN and compute a separate Section 481(a) adjustment for each change.

A.5. Reduced Filing Requirements for Small Taxpayers

(1) Section 10.11(4)(b) of Rev. Proc. 2015-14, section 11.08(4)(b) of Rev. Proc. 2016-29, Rev. Proc. 2017-30 and Rev. Proc. 2018-31, and section 11.08(3)(b)

of Rev. Proc. 2019-43 and Rev. Proc. 2022-14 provide reduced filing requirements for qualifying small taxpayers that file a Form 3115 to change to a method under the final regulations. A qualifying taxpayer, as defined in Section 1.263(a)-3(h)(3) is a taxpayer with average annual gross receipts of $10 million or less for the three preceding tax years, may provide less detailed information on Forms 3115 than other taxpayers.

A.6. Small Business Taxpayer Relief

(1) Rev. Proc. 2015-20, 2015-9 I.R.B. 694, permits a taxpayer with a qualifying small business to change certain methods of accounting under the final regulations by taking into account only amounts paid or incurred, and dispositions, in taxable years beginning on or after January 1, 2014. A taxpayer using this procedure would not have a Section 481(a) adjustment and was not required to file a Form 3115 for its first taxable year beginning on after January 1, 2014. In addition, the taxpayer would not receive audit protection for amounts paid or incurred in taxable years beginning before January 1, 2014. Thus, if a taxpayer uses this revenue procedure, and then decides to make a change by calculating a Section 481(a) adjustment and by filing a Form 3115 to use the final regulations in a later taxable year, it must calculate its Section 481(a) adjustment by taking into account only amounts paid or incurred, and dispositions, in taxable years beginning on or after January 1, 2014.

A.7. Section 481(a) Adjustment

(1) The requirements for Section 481(a) adjustments for each method change in section 10.11 of Rev. Proc. 2015-14 or section 11.08 of Rev. Proc. 2016-29, Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14, whichever is applicable, are not the same. Some changes under the final tangible property regulations require a full Section 481(a) adjustment, (i.e., the Section 481(a) adjustment can reach into prior open and closed years). A full Section 481(a) adjustment will take into account any Section 481(a) adjustments from previously filed Forms 3115 for the same item (“true up”). A Section 481(a) adjustment for a change to comply with Section 1.263(a)-3 may not include amounts attributable to property for which the taxpayer elected to apply the repair allowance under Section 1.167(a)-11(d)(2). This generally applies to pre-MACRS assets.

(2) Other changes under the final regulations require a “limited” Section 481(a) adjustment. For these changes, only amounts paid or incurred in taxable years beginning on or after January 1, 2014, are taken into account in the Section 481(a) adjustment. If a taxpayer elects to implement the final regulations in 2012 or 2013 (“early implementation”), the Section 481(a) adjustment takes into account amounts paid or incurred in taxable years beginning on or after January 1, 2012. Taxpayers must continue to account for amounts arising in tax

years beginning before January 1, 2014 (or January 1, 2012), under its prior method.

(3) For example, a taxpayer changing to a method of accounting under Section 1.162-3 (except Section 1.162-3(e), the optional method for rotable or temporary spare parts) is required to use a limited Section 481 adjustment. See section 10.11(6)(b) of Rev. Proc. 2015-14 or section 11.08(6)(b) of Rev. Proc. 2016-29, Rev. Proc. 2017-30 and Rev. Proc. 2018-31, or section 11.08(5)(b) of Rev. Proc. 2019-43 and Rev. Proc. 2022-14 for changes that require a limited adjustment.

A.8. Statistical Sampling

(1) Rev. Proc. 2015-14, Rev. Proc. 2016-29, Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14 permit the use of the statistical sampling methodology described in Rev. Proc. 2011-42, 2011-37 I.R.B. 318, to determine the Section 481(a) adjustment for all changes except changes that require a "limited" Section 481(a) adjustment. For example, statistical sampling is not permitted for a change to deducting non-incidental materials and supplies when used or consumed (DCN 186). Rev. Proc. 2011-42 does not allow extrapolation of results outside of the sampled population.

A.9. Audit Protection

(1) Section 8.01 of Rev. Proc. 2015-13, provides that, except as otherwise provided in section 8.02 of Rev. Proc. 2015-13 or under any guidance provided in the I.R.B., when a taxpayer timely files a Form 3115, the Service will not require the taxpayer to change its method of accounting for the same item for a taxable year prior to the requested year of change. Neither section 10.11 of Rev. Proc. 2015-14 nor section 11.08 of Rev. Proc. 2016-29, Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14 addressing automatic method changes under final tangible regulations, specifically address audit protection for taxpayers that file method changes under these sections' general provisions or under the provisions that require the taxpayer to compute more limited Section 481(a) adjustments. Therefore, the general rule under section 8.01 of Rev. Proc. 2015-13 applies to all of these changes. Thus, a taxpayer that timely and properly files a Form 3115 to change to a method of accounting under the final regulations pursuant to section 10.11 of Rev. Proc. 2015-14 or section 11.08 of Rev. Proc. 2016-29, Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14 receives audit protection for that item for taxable years prior to the year of change.

B. SPECIFIC METHOD CHANGES TO COMPLY WITH THE FINAL CAPITALIZATION REGULATIONS

(1) Section 10.11 of Rev. Proc. 2015-14 and section 11.08 of Rev. Proc. 2016-29, Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc.

2022-14 contain the method changes, including their DCNs, to comply with the final regulations. The following is a brief summary of each of the changes and applicable guidance. For a complete description of, and detailed guidance relating to each change, the examiner should review the applicable List of Automatic Changes.

B.1. Repairs and Maintenance

(1) DCN 184 replaces DCNs 162, 171 and 174 (changes made to comply with the temporary regulations) into a single DCN for implementing the final regulations. It applies to a taxpayer that wants to change to either deducting amounts paid or incurred for repairs and maintenance or that wants to change to capitalizing and, if depreciable, depreciating such property. The change includes a change, if any, in the method of identifying the unit of property ("UOP"), or in the case of a building, identifying the building structure or building systems for making the change.

(2) DCN 184 also includes a change to the safe-harbor method for routine maintenance of buildings or property other than buildings. This is a change to treating amounts paid or incurred for routine maintenance performed on a UOP as improvements to treating such amounts as not improving the UOP under the safe harbor.

(3) A taxpayer may not use this DCN to change a method of accounting for dispositions of depreciable property, including a change in the asset disposed of. Chapter 18 addresses these types of changes with its discussion of the depreciation and disposition revenue procedures.

(4) DCN 184 requires a full Section 481(a) adjustment. That is, the Section 481(a) calculation may reach into prior taxable years and include prior Section 481(a) adjustments for the same items. The revenue procedure expressly allows statistical sampling in determining the amount of the Section 481(a) adjustment for this change. A Section 481(a) adjustment for a change to comply with Section 1.263(a)-3 may not include amounts attributable to property for which the taxpayer elected to apply the repair allowance under Section 1.167(a)-11(d)(2). This generally applies to pre-MACRS assets.

(5) If a taxpayer files a 3115 to comply with the final regulations, and did not file a prior change for repairs, the change will generally result in a negative, or taxpayer-favorable, Section 481(a) adjustment. On the other hand, if a taxpayer previously deducted amounts that qualify as improvements under the final regulations or changed its method of accounting to expense repairs (Capitalization to Repairs or "C2R") in prior years, a Form 3115 to comply with the final regulations items would likely result in a positive, or government-favorable, Section 481(a) adjustment. In other words, a taxpayer may need to bring previously expensed amounts into income, or "true up" its tax treatment to comply with the final regulations.

(6) DCN 185 allows certain taxpayers to change to the regulatory method of accounting. The change does not apply to property subject to the repair allowance under Section 1.167(a)-11(d)(2), and the taxpayer must apply the change to all other property subject to regulatory accounting rules. The Section 481(a) adjustment is limited to amounts incurred in tax years beginning on or after January 1, 2014, or January 1, 2012, if the taxpayer has implemented the final regulations early. This is a "limited" Section 481(a) adjustment. Statistical sampling is not allowed for this change.

B.2. Materials and Supplies

(1) DCN 186 allows a taxpayer to change its method of accounting for non-incidental materials and supplies to deducting such amounts in the taxable year the taxpayer uses or consumes them. The Section 481(a) adjustment is limited to amounts incurred in tax years beginning on or after January 1, 2014, or January 1, 2012, if the taxpayer has implemented the final regulations early. This is a "limited" Section 481(a) adjustment. Statistical sampling is not allowed for this change.

(2) Example of a limited Section 481(a) adjustment for DCN 186:

(3) Prior method: Non-incidental materials and supplies deducted when purchased.

(4) New method: Non-incidental materials and supplies deducted when used or consumed.

(5) Purchases of non-incidental materials and supplies (assume the taxpayer has not used these items as of the end of the tax year):

- 12-15-2013 $ 10,000
- 01-15-2014 $ 5,000
- 07-15-2014 $ 7,000

(6) Example 1: 2014-12 year of change. Limited Section 481(a) adjustment = $ 0

- In this example, the taxpayer makes the method change as of the beginning of the year of change, January 1, 2014. A limited Section 481(a) adjustment does not include amounts paid or incurred in tax years beginning before January 1, 2014. Therefore, there is no Section 481(a) adjustment for a change implemented as of January 1, 2014, for a calendar-year taxpayer. In other words, the Section 481(a) adjustment is zero.
- Under the new method, which begins on January 1, 2014, the taxpayer expenses supplies purchased in January ($5,000) and in July ($7,000) when used or consumed. The taxpayer deducted the non-incidental

supplies purchased on December 15, 2013, when it purchased them under the prior method of accounting. The 2014 method change does not affect the treatment of these supplies.

(7) Example 2: 2015-06 year of change. Limited Section 481(a) adjustment = $ 5,000

- In this example, the beginning of the taxable year of change is July 1, 2014. The taxpayer deducted $5,000 of non-incidental supplies purchased in a taxable year beginning on or after January 1, 2014. This is the amount of the limited Section 481(a) adjustment. Under the new method, the taxpayer will deduct amounts paid or incurred for the non-incidental supplies on January 15 and July 15, 2014, when the taxpayer uses or consumes them. Like Example 1, the method change does not affect the non-incidental supplies purchased on December 15, 2013.

(8) DCN 187 allows a method change in the method of accounting for incidental materials and supplies to deducting the amounts as paid or incurred under Section 1.162-3(a)(2). The Section 481(a) adjustment is limited to amounts incurred in tax years beginning on or after January 1, 2014, or January 1, 2012, if the taxpayer has implemented the final regulations early. This is a “limited” Section 481(a) adjustment. Statistical sampling is not allowed for this change.

(9) DCN 188 allows a method change for non-incidental rotable and temporary spare parts to deducting when the item is disposed of under Section 1.162-3(a)(1). The Section 481(a) adjustment is limited to amounts incurred in tax years beginning on or after January 1, 2014, or January 1, 2012, if the taxpayer has implemented the final regulations early. This adjustment is a “limited” Section 481(a) adjustment. Statistical sampling is not allowed for this change.

(10) DCN 189 provides for a change to the “optional method” for rotable and temporary spare parts. The optional method is described in Section 1.162-3(e) of the final regulations. This change is made with a full Section 481(a) adjustment (i.e., the calculation can reach into prior taxable years), and statistical sampling is allowed for its computation.

B.3. Facilitative Expenses

(1) DCN 190 applies to a dealer in property that wants to change its method for expenses that facilitate the sale of property, including commissions, to deducting such costs under Section 1.263(a)-1(e)(2). This change is made with a full Section 481(a) adjustment, (i.e., the calculation can reach into prior taxable years), and statistical sampling is allowed for its computation.

(2) CN 191 applies to a non-dealer in property to change its method for expenses to facilitate the sale of property to capitalizing and depreciating such costs under Section 1.263(a)-1(e)(1). This change is made with a full Section 481(a)

adjustment, (i.e., the calculation can reach into prior taxable years), and statistical sampling is allowed for its computation.

B.4. Acquire or Produce Method Changes

(1) DCN 192 allows a taxpayer to change its method of accounting to capitalize amounts paid to acquire or produce property under Section 1.263(a)-2 and, if depreciable, depreciate such amounts. This change is made with a full Section 481(a) adjustment, (i.e., can reach into prior taxable years), and statistical sampling is allowed for its computation.

(2) DCN 193 allows changes from capitalizing to deducting certain amounts paid in the process of investigating or otherwise pursuing the acquisition of property, including employee compensation and overhead. The Section 481(a) adjustment is limited to amounts incurred in tax years beginning on or after January 1, 2014, or January 1, 2012, if the taxpayer has implemented the final regulations early. This is a “limited” Section 481(a) adjustment. Statistical sampling is not allowed for this change.

XVIII. CHAPTER 18 – ACCOUNTING METHOD CHANGES – DEPRECIATION AND DISPOSITIONS

A. AUTOMATIC METHOD CHANGES & DESIGNATED CHANGE NUMBERS

(1) The following are the steps identified in the flow chart below:

DESCRIPTION OF CHANGE	REV. PROC. sections[2]	DCN	Section 481(a)	Adjust-ment
			FULL	LIMITED[3]
Change to deducting repair and maintenance costs, or to capitalizing improvements and depreciating them. Includes a change in UOP, building structure or building systems for the purpose of making this change. Section 1.162-4, 1.263(a)-3	10.11/11.08	184	X	
Change to regulatory accounting method. No statistical sampling. Section 1.263(a)-3(m)	10.11/11.08	185		X
Change to deducting non-incidental materials and supplies when used or consumed. No statistical sampling. Section 1.162-3(a)(1), (c)(1)	10.11/11.08	186		X
Change to deducting incidental materials and supplies when paid or incurred. No statistical sampling. Section 1.162-3(a)(2), (c)(1)	10.11/11.08	187		X
Change to deducting non-incidental rotable and temporary spare parts when disposed of. No statistical sampling. Section 1.162-3(a)(3), (c)(2)	10.11/11.08	188		X
Change to the optional method for rotable and temporary spare parts. Section 1.162-3(e)	10.11/11.08	189	X	
Change by a dealer in property to deduct commissions and other costs that facilitate sales. Section 1.263(a)-1(e)(2)	10.11/11.08	190	X	
Change by non-dealer in property to capitalizing commissions and other costs that facilitate sale. Section 1.263(a)-1(e)(1)	10.11/11.08	191	X	
Change to capitalizing acquisition or production costs and, if depreciable, to depreciating under Section 167 or 168. Section 1.263(a)-2	10.11/11.08	192	X	
Change to deducting certain costs for investigating or pursuing the acquisition of real property. No stat. sampling. Section 1.263(a)-2(f)(2)(iii)	10.11/11.08	193		X

[2] Rev. Proc. 2015-14, Rev. Proc. 2016-29, Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, Rev. Proc. 2022-14.

[3] Takes into account only amounts paid or incurred in taxable years beginning on or after January 1, 2014. Note: If the final regulations are implemented "early" the limited Section 481(a) adjustment takes into account amounts paid or incurred in taxable years beginning on or after January 1, 2012.

(2) Takes into account only amounts paid or incurred in taxable years beginning on or after January 1, 2014. Note: If the final regulations are implemented "early" the limited Section 481(a) adjustment takes into account amounts paid or incurred in taxable years beginning on or after January 1, 2012.

B. APPLICABLE METHOD CHANGE PROCEDURES

(1) Rev. Proc. 2014-17, 2014-12 I.R.B. 661, released February 28, 2014, and Rev. Proc. 2014-54, 2014-41 I.R.B. 675, released September 18, 2014, modified Rev. Proc. 2011-14, 2011-4, I.R.B. 330, to add and revise Appendix sections that contain the automatic change in accounting method procedures to comply with the final depreciation and dispositions regulations. Rev. Proc. 2014-17 included the automatic consent procedures for a taxpayer to change to a method of accounting to comply with Section 1.167(a)-4, depreciation of leasehold improvements, and certain changes from one permissible depreciation method to another permissible depreciation method under Section 1.168(i)-8. All other method change provisions in Rev. Proc. 2014-17 applied to the temporary and proposed depreciation and disposition regulations. Rev. Proc. 2014-54 modified certain procedures added by Rev. Proc. 2014-17 to include, in part, application to the final regulations. Rev. Proc. 2014-54 also added the procedures for three new automatic changes. The method change procedures in Rev. Proc. 2014-54 applied to changes to methods of accounting in the following sections of the regulations:

- Section 1.168(i)-1 – Rules for general asset accounts (“GAA”),
- Section 1.168(i)-7 – Rules for accounting for property depreciated under Section 168 (MACRS property), and
- Section 1.168(i)-8 – Dispositions of MACRS property

(2) Rev. Proc. 2014-54 also contained procedures for making late GAA elections, revoking GAA elections, and making late partial disposition elections. While an election is generally made on a filed return, and may not be changed using method change procedures, due to changes made to the regulations, the IRS treated these specific items as changes in method of accounting for a limited period of time.

(3) Rev. Proc. 2015-13, 2015-5 I.R.B. 419, and Rev. Proc. 2015-14, 2015-5 I.R.B. 450, superseded Rev. Proc. 2011-14 for Forms 3115 filed on or after January 16, 2015. Rev. Proc. 2015-13 provides the procedures for voluntary method changes, both automatic and non-automatic. Rev. Proc. 2015-14, which is effective for Forms 3115 filed on or after January 16, 2015, and before May 5, 2016, set out the List of Automatic Changes, which were previously contained in the Appendix of Rev. Proc. 2011-14. Section 6.32 through 6.40 of Rev. Proc. 2015-14 contained the automatic method changes to comply with the final depreciation and disposition regulations. Transition rules generally allowed taxpayers the option of filing automatic method changes to comply with the final

regulations under either Rev. Proc. 2011-14 or Rev. Proc. 2015-13 for tax years ending on or after May 31, 2014, and beginning before January 1, 2015, until the due date of the taxpayer's timely filed (including extensions) original federal income tax return for the requested year of change.

(4) Rev. Proc. 2016-29, 2016-21 I.R.B. 880, amplifies, modifies, and supersedes, in part, Rev. Proc. 2015-14 for Forms 3115 filed on or after May 5, 2016, for a year of change ending on or after September 30, 2015. List of Automatic Changes Sections 6.10 through 6.17 of Rev. Proc. 2016-29 contain automatic changes under the disposition and depreciation final regulations. Rev. Proc. 2016-29 also removes the automatic changes provided in sections 6.27 through 6.32 of Rev. Proc. 2015-14, which provided for automatic changes under the temporary and proposed depreciation and disposition regulations. These methods of accounting are obsolete for a year of change beginning on or after January 1, 2014.

(5) Rev. Proc. 2017-30, 2017-18 I.R.B. 1131, amplifies, modifies, and supersedes, in part, Rev. Proc. 2016-29 for Forms 3115 filed on or after April 19, 2017, for a year of change ending on or after August 31, 2016.

(6) Rev. Proc. 2018-31, 2018-22 I.R.B. 637, amplifies, modifies, and supersedes, in part, Rev. Proc. 2017-30 for Forms 3115 filed on or after May 9, 2018, for a year of change ending on or after September 30, 2017.

(7) Rev. Proc. 2019-43, 2019-48 I.R.B. 1107, amplifies, modifies, and supersedes, in part, Rev. Proc. 2018-31 for Forms 3115 filed on or after November 8, 2019, for a year of change ending on or after March 31, 2019.

(8) Rev. Proc. 2022-14, 2022-7 I.R.B. 502, amplifies, modifies, and supersedes, in part, Rev. Proc. 2019-43 for Forms 3115 filed on or after January 31, 2022, for a year of change ending on or after May 31, 2021. Rev. Proc. 2022-14 contains the most recent List of Automatic Changes to which Rev. Proc. 2015-13 applies.

(9) Thus, the date that a taxpayer files its Form(s) 3115, the type of change, and the year of change determines which revenue procedure the taxpayer may use for making automatic accounting method changes under the proposed, temporary, or final depreciation and disposition regulations. The examiner should identify and confirm the revenue procedure a taxpayer used to file its change(s) to comply with the regulations as some procedures differ.

(10) A comprehensive chart, summarizing the method changes that may be made for depreciation and dispositions of MACRS property under Section 1.167(a)-4, 1.168(i)-1, 1.168(i)-7, and 1.168(i)-8 is found on at the end of this chapter. The chart includes a brief description of each change, the applicable final regulation section, the voluntary method change revenue procedure section, the designated change number ("DCN"), Section 481(a) information, and applicable references to any other revenue procedure that contains full information on the change.

B.1. Scope Limitations and the “5-year rule”

(1) Rev. Proc. 2014-17 and 2014-54 waived the scope limitations in sections 4.02 of Rev. Proc. 2011-14 for any taxable year beginning on or after January 1, 2012, and before January 1, 2015, for most changes, or before January 1, 2014, for specified changes to comply with the final regulations. This means that a taxpayer, even under examination, may file a Form 3115 for tax years beginning before January 1, 2015 (or January 1, 2014) for these changes without regard for the 90-day and the 120-day windows in Rev. Proc. 2011-14 or Director Consent.

(2) Rev. Proc. 2015-13 does not contain scope limitations, as described above, for taxpayers under examination. A taxpayer under examination may file a Form 3115 at any time, but modified terms and conditions generally apply. For example, a taxpayer under examination who files a Form 3115 may not get audit protection for the item that is the subject of the request.

(3) The so-called “5-year rule,” which precludes taxpayers from using the automatic change procedures more than once within a 5-year period, did not apply to changes included in Rev. Proc. 2014-17 and Rev. Proc. 2014-54. However, Rev. Proc. 2015-14 limited this waiver to taxpayers making certain depreciation and disposition changes for taxable years beginning on or after January 1, 2012, and beginning before January 1, 2015. Rev. Proc. 2016-29 continues to waive the “5-year rule” for taxpayers making these depreciation and disposition changes but extends this waiver another year to making these method changes for any taxable year beginning before January 1, 2016. Rev. Proc. 2017-30 waives the “5-year rule” for certain depreciation and disposition changes for any taxable year beginning before January 1, 2017.

(4) An additional provision in Rev. Proc. 2014-17 also waived the prior five-year item change rule for changes described in Appendix section 6.01(2) of Rev. Proc. 2011-14. This waiver was also included in section 6.01(2) of Rev. Proc. 2015-14, and section 6.01(2) of Rev. Proc. 2016-29, Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14. These provisions allow certain impermissible to permissible accounting method changes for depreciation or amortization. If a taxpayer requested or made a change in method of accounting during the prior five-year period from expensing to capitalizing (or vice versa) the cost or other basis of an asset, the “5-year rule” does not apply to a change under section 6.01 for the same asset.

B.2. Audit Protection

(1) A taxpayer generally receives audit protection with the filing of a Form 3115 for the item(s) that is the subject of the method change. This means the Service will not change the method for the same item for years prior to the year of change. A taxpayer under examination, who is eligible to file a change in accounting method under Rev. Proc. 2011-14, as modified by Rev. Proc. 2014-

17 or Rev. Proc. 2014-54, generally receives audit protection for the item if the issue is not "pending" before Appeals, or before a Federal court. An issue is pending if the Service has given the taxpayer written notification indicating Examination will make or propose an adjustment with respect to the taxpayer's method of accounting. Written notification may be but is not required to be on a Form 5701 or 886-A, and the amount of the adjustment does not need to be determined at the time of notification.

(2) A taxpayer under examination, who requests a method change under Rev. Proc. 2015-13, does not receive audit protection, unless an exception applies.

B.3. Multiple Concurrent Changes and Reduced Filing Requirements for Small Taxpayers

(1) Rev. Proc. 2014-17 and 2014-54, and subsequently, the applicable provisions of Rev. Proc. 2015-14, Rev. Proc. 2016-29, Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14 allow for multiple changes. It should be noted however, that while concurrent depreciation method changes under section 6.01 can be made with disposition changes, concurrent UNICAP changes cannot be made with disposition changes. Concurrent UNICAP changes under section 12.01, 12.02, 12.08, or 12.12 in the List of Automatic Changes can be made with depreciation changes under certain sections in the List of Automatic Changes. (See, e.g., section 6.01(8)(b) and section 6.11(4)(b) of Rev. Proc. 2022-14). Concurrent UNICAP changes can be made with capitalization changes as discussed in Chapter 17. The taxpayer must identify each DCN and compute a separate Section 481(a) adjustment for each change.

(2) The revenue procedures also contain reduced filing requirements for qualifying taxpayers. A qualifying taxpayer, defined as one whose average annual gross receipts for the three preceding tax years is less than or equal to $10 million, is only required to complete select lines on Form 3115. This equates to providing substantially less detailed information on Forms 3115 than other taxpayers provide.

B.4. Small Business Taxpayers' Administrative Burden Relief

(1) Rev. Proc. 2015-20 permits qualifying small business taxpayers to make certain tangible property and disposition changes in methods of accounting with a Section 481(a) adjustment that takes into account only amounts paid or incurred, and dispositions that occur, in taxable years beginning on or after January 1, 2014. For example, a change to deducting amounts paid or incurred for repair and maintenance in accordance with Section 1.162-4 may take into account only amounts paid or incurred in taxable years beginning on or after January 1, 2014, if the taxpayer qualifies and used the small business exception. In addition, for its first taxable year that begins on or after January 1,

2014, the revenue procedures permit qualified small business taxpayers to make certain tangible property and disposition changes prospectively without filing a Form 3115. These include changes in methods of determining the asset disposed of or determining the unadjusted depreciable basis of a disposed asset.

B.5. Statistical Sampling

(1) The use of a statistical sampling methodology described in Rev. Proc. 2011-42 is limited to specific changes. Rev. Proc. 2014-17 and 2014-54 and subsequently, the applicable provisions of Rev. Proc. 2015-14, Rev. Proc. 2016-29, Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14, do not expressly allow other sampling methodologies. See table below.

B.7. IRC Section 481(a) Adjustment

(1) Section 481(a) adjustments for changes to comply with the final regulations vary, depending on the change. Some changes require a full Section 481(a) adjustment that reaches into prior open and closed years and takes into account any Section 481(a) adjustments from previously filed Forms 3115 for the same item (i.e., a true up). A full Section 481(a) adjustment puts the taxpayer in the same position as if it had used the new method in all years preceding the year of change. The new method is applied to all items beginning with the year of change.

(2) Some changes use a “limited cut-off.” Under a limited cut-off, the adjusted, or remaining, depreciable basis is recovered using the new method of accounting. The accumulated depreciation or depreciation reserve of the asset as of the beginning of the year of change carries over. In other words, a limited cut-off does not consider prior year deductions by computing a Section 481(a) adjustment. Rather, the taxpayer applies the method on a “go forward” basis using amounts as of the beginning of the year of change. For example, if a $100 asset has a $40 adjusted basis as of the beginning of the year, the taxpayer applies the new method to the $40 adjusted basis going forward.

(3) Still other changes require a change using “cut-off.” These changes also do not generally have a Section 481(a) adjustment. The new method applies to dispositions occurring on or after the beginning of the year of change and to depreciation on assets placed in service on or after the beginning of the year of change. The taxpayer continues to account for assets disposed of, or placed in service, as applicable, before the year of change under the taxpayer’s prior method of accounting. For example, a change from one permissible method to another permissible method of identifying which assets have been disposed uses a cut-off method.

(4) The List of Automatic Changes dictates how each specific change is made, including whether the change is made with a Section 481(a) adjustment, or on a limited cut-off or a cut-off basis. See discussion of each DCN.

(5) Method changes to comply with the final disposition regulations generally apply on an asset-by-asset basis. The method may be applied to one, some, or all applicable assets. The taxpayer may compute a net Section 481(a) adjustment, or, if the Section 481(a) is comprised of both positive and negative adjustments, may be presented as a single positive, and single negative Section 481(a) adjustment.

(6) A negative Section 481(a) is taken into account entirely in the year of change. The spread period of a positive Section 481(a) adjustment depends on which voluntary change revenue procedure and DCN a taxpayer uses to request its change(s). It is important to identify and confirm the revenue procedure and DCN a taxpayer is using to file its change(s) to determine how the taxpayer's Section 481(a) adjustment is taken into account.

B.8. Non-Accounting Method Changes

(1) At its option, a taxpayer may treat certain changes to comply with these regulations to assets placed in service prior to 2003 as a non-change in method of accounting. Rather, a taxpayer may file amended returns for such assets, limited to the taxable years open by statute. See Chief Counsel Notice 2004-007 for additional information.

B.9. Other

(1) Section 10.11(1)(b)(ii) of Rev. Proc. 2015-14 and section 11.08(1)(b)(ii) of Rev. Proc. 2016-29, Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14 specify that changes in section 10.11 of Rev. Proc. 2015-14 and section 11.08 of Rev. Proc. 2016-29, Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14 do not apply to amounts paid or incurred for certain materials and supplies that the taxpayer has elected to capitalize and depreciate under Section 1.162-3(d).

(2) Special rules apply to changes affecting public utility assets. A taxpayer making changes to public utility property must agree to: (1) a normalization method of accounting for the property; (2) provide the completed Form 3115 to any regulatory body having jurisdiction over the property; and (3) adjust its deferred tax reserve account by the amount of the deferral of federal income tax liability associated with the Section 481(a) adjustment.

(3) Finally, Rev. Proc. 2011-14, and the applicable provisions of Rev. Proc. 2015-14, Rev. Proc. 2016-29, Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14, provide transition rules that may apply to

taxpayers that requested method changes shortly before the effective date of each procedure.

C. SPECIFIC METHOD CHANGES TO COMPLY WITH THE FINAL DEPRECIATION AND DISPOSITION REGULATIONS

(1) Rev. Proc. 2014-17 added two sections to the Appendix of Rev. Proc. 2011-14, superseded by Rev. Proc. 2015-14 and superseded again by Rev. Proc. 2016-29, Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14, for automatic changes to comply with the final regulations. It also added several new Appendix sections for automatic method changes to comply with the temporary and proposed disposition regulations. Rev. Proc. 2014-54 modified the language in these Appendix sections to include, in part, applicability to the final regulations. Rev. Proc. 2014-54 also added three (3) sections to the Appendix of Rev. Proc. 2011-14, superseded by Rev. Proc. 2015-14 and superseded again by Rev. Proc. 2016-29, Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14, for additional changes to methods in the final disposition regulations, and assigned DCNs to each new automatic change. For a complete description of, and guidance relating to, each change, the examiner should review the full text of the applicable revenue procedure.

(2) The following is a brief description of the automatic method changes and procedures contained in Rev. Proc. 2014-17 and Rev. Proc. 2014-54 related to methods in the final depreciation and disposition regulations, as provided in Rev. Proc. 2015-14, Rev. Proc. 2016-29, Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14, as applicable:

C.1. Late GAA Elections – Section 6.32 of Rev. Proc. 2015-14

(1) DCN 180 allows a taxpayer to:

- Make a late GAA election for one or more MACRS assets placed in service in a taxable year beginning before January 1, 2012, and owned by the taxpayer as of the beginning of the year of change,
- Make a late election to recognize gain/loss on a disposition of all or the last asset in a GAA, and
- Make a late election to recognize gain or loss upon disposition in a qualifying disposition of an asset in a GAA.

(2) This may affect whether a taxpayer must capitalize amounts to restore a unit of property.

(3) A taxpayer may only use the method change procedures for these late elections for taxable years beginning on or after January 1, 2012, and before January 1, 2014. This opportunity is not available after this period has past and so is not

included in Rev. Proc. 2016-29. The election is generally irrevocable and binding on the taxpayer for the year of change and all subsequent tax years for the applicable GAA assets.

(4) A taxpayer makes a late GAA election on a limited cut-off basis. That is, the "new" method applies to the unadjusted basis and accumulated depreciation as of the beginning of the year of change. However, there is a full Section 481(a) adjustment for a late election to recognize gain or loss on disposition for all assets, the last asset, or the remaining portion of the last asset in a GAA, and for a late election to recognize gain or loss upon disposition of an asset in a qualifying disposition.

(5) The taxpayer making a late GAA election must provide a statement with a description of the assets to which the GAA election applies. The taxpayer must also state that it consents to and agrees to apply all of the provisions of Section 1.168(i)-1 to the assets that are subject to the election.

(6) Rev. Proc. 2014-17 initially added Appendix section 6.32 to Rev. Proc. 2011-14 to apply under the temporary and proposed regulations. Rev. Proc. 2014-54 modified the language to allow the late GAA election under the final regulations for taxpayers who implement these regulations prior to January 1, 2014 (i.e., early implementation). The late GAA election is not available for tax years beginning on or after January 1, 2014.

C.2. Late Partial Disposition Election – Section 6.33 of Rev. Proc. 2015-14 or Section 6.10 of Rev. Proc. 2016-29

(1) DCN 196 applies to a taxpayer that wants to make a late partial disposition election for the disposition of a portion of an asset not in a GAA and owned by the taxpayer as of the beginning of the year of change. This change may affect whether the taxpayer must capitalize amounts paid to restore a unit of property. It is made with a full Section 481(a) adjustment.

(2) As with a late GAA election, a late partial disposition election may only use the CAM procedures during the limited time specified in Rev. Proc. 2014-54. A late partial disposition election under the final regulations must be made for a taxable year beginning on or after January 1, 2012, and before January 1, 2015.

(3) Special rules apply to taxable years beginning on or after January 1, 2012, and ending on or before September 19, 2013, the effective date of the proposed regulations that added this election. If a taxpayer did not make the partial disposition election on its timely filed original return, but later wants to apply the provisions, Section 1.168(i)-8(d)(2)(iv) gives the taxpayer two options:

- The taxpayer may file an amended return within 180 days from the extended due date of the applicable tax year, or

- The taxpayer may file a Form 3115 to make the election with its timely filed tax return for the 1st or 2nd tax year succeeding the applicable year.

(4) A taxpayer may not revoke a partial disposition election by filing a Form 3115. Rather, a taxpayer must request a private letter ruling and receive the consent of the Commissioner to revoke an election.

C.3. Revocation of a GAA Election – Section 6.34 of Rev. Proc. 2015-14 or Section 6.11 of Rev. Proc. 2016-29

(1) Section 1.168(i)-1(l)(1) provides that GAA elections are irrevocable. However, because of changes contained in the final regulations, section 6.34 of Rev. Proc. 2015-14 or section 6.11 of Rev. Proc. 2016-29 provides a window of opportunity for a taxpayer to revoke its GAA election for an item or items of MACRS property included in a GAA account. The GAA election may be either a late GAA election made under Rev. Proc. 2011-14, Appendix section 6.32, or a GAA election made on the federal income tax return for MACRS property placed in service in a tax year beginning on or after January 1, 2012, and beginning before January 1, 2014. The final (and proposed) regulations allow a taxpayer to make an election for a partial disposition of an asset not in a GAA. This option was not available in the temporary regulations. After filing a late GAA election under the temporary regulations, taxpayers may decide they do not want to account for assets in a GAA. The method change procedures and DCN 197 allow a taxpayer to revoke, or undo, such GAA election(s) for any tax year beginning on or after January 1, 2012 and beginning before January 1, 2015. This change is made with a Section 481(a) adjustment, and the entire amount is taken into account in the year of change (i.e., no spread for a positive Section 481(a) adjustment).

C.4. Partial Dispositions of Tangible Depreciable Assets to which the IRS's Adjustment Pertains – Section 6.35 of Rev. Proc. 2015-14, Section 6.12 of Rev. Proc. 2016-29, or Section of 6.10 of Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14

(1) DCN 198 applies to changes to make a late, partial disposition election to the disposition of a portion of an asset, owned by the taxpayer as of the beginning of the year of change, related to an IRS adjustment. The change is made with a full Section 481(a) adjustment.

C.5. Depreciation of Leasehold Improvements – Section 6.36 of Rev. Proc. 2015-14, Section 6.13 of Rev. Proc. 2016-29, or Section of 6.11 of Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14

(2) DCN 199, added by Rev. Proc. 2014-17, applies to a taxpayer that wants to change its method of accounting to comply with Section 1.167(a)-4 for leasehold improvements in which the taxpayer has a depreciable interest at the beginning of the year of change. This includes a change:

- From improperly depreciating leasehold improvements to which Section 168 applies over the term of the lease to properly depreciating under Section 168,
- From improperly amortizing leasehold improvements to which Section 197 applies over the term of the lease to properly amortizing under Section 197, or
- From improperly amortizing leasehold improvements to which Section 167(f)(1) applies over the term of the lease to properly amortizing under Section 167(f)(1).

(3) This change is made with a full Section 481(a) adjustment.

C.6. Permissible to Permissible Method of Accounting for Depreciation of MACRS Property – Section 6.37 of Rev. Proc. 2015-14, Section 6.14 of Rev. Proc. 2016-29, or Section 6.12 of Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14

(1) DCN 200 applies to certain permissible to permissible methods of accounting for depreciation of MACRS property owned by the taxpayer as of the beginning of the year of change and accounted for in an single asset account (SAA), an multiple asset account (MAA) or a general asset account (GAA). Section 6.37 of Rev. Proc. 2015-14, section 6.14 of Rev. Proc. 2016-29, or section 6.12 of Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14 applies to the following:

- Change from SAAs (or item accounts) for specific items of MACRS property to MAAs (or pools) for the same assets, or vice versa,
- Change from grouping specific items of MACRS property in MAAs or GAAs to a different grouping of the same assets in MAAs or GAAs,
- Change in the method of identifying which assets in an MAA or GAA, or portions of assets have been disposed of (e.g., a change from the specific identification method to the first-in, first-out (FIFO) method), and
- Change in determining the unadjusted depreciable basis of a disposed asset in an MAA or GAA or disposed portion of an asset from one reasonable method to another when it is impracticable to use taxpayer records to do so.

(2) The character of the Section 481(a) adjustment varies depending on the specific change. For example, a change from SAAs to MAAs for the same assets uses a limited cut-off basis. Certain changes in the method of identifying which assets in an MAA or portions of assets have been disposed, are made on a cut-off basis, while others are made with a full Section 481(a) adjustment. The examiner should carefully review the changes covered within section 6.37 of Rev. Proc. 2015-14, section 6.14 of Rev. Proc. 2016-29, or section of 6.12 of Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14 to determine the proper manner of making the change.

D. AUTOMATIC METHOD CHANGES – MANNER OF MAKING CHANGE

(3)

Rev. Proc. Sections 6.37(3)(a)/6.14(3)(a)/6.12(3)(a)[4]	Manner of making change	Rev. Proc. Sections 6.37(3)(b)/6.14(3)(b)/6.12(3)(b)
MACRS property not subject to GAA election		**MACRS property subject to GAA election**
i. Single asset/item to multiple asset or pool for the same assets, and vice versa	Limited Cut-off	
ii. Multiple asset grouping "A" to grouping "B"	Limited Cut-off	i. General asset grouping "A" to grouping "B"
iii. MAA identification of dispositions from specific ID to FIFO or to modified FIFO	Cut-off	ii. GAA identification of dispositions from specific ID to FIFO or to modified FIFO
iv. MAA identification of dispositions from FIFO or modified FIFO to specific ID	Full 481(a)	iii. GAA identification of dispositions from FIFO or modified FIFO to specific ID
v. MAA identification of dispositions from FIFO to modified FIFO & vice versa	Full 481(a)	iv. GAA identification of dispositions from FIFO to modified FIFO & vice versa
vi. MAA identification of mass asset dispositions from specific ID to mortality dispersion table	Cut-off	v. Mass assets in separate GAAs identification of dispositions from specific ID to mortality dispersion table
vii. MAA identification of mass asset dispositions from FIFO or modified FIFO to mortality dispersion table	Full 481(a)	vi. Mass assets in separate GAAs identification of dispositions from FIFO or modified FIFO to mortality dispersion table
viii. MAA identification of mass asset dispositions from mortality dispersion table to specific ID, FIFO, or modified FIFO	Full 481(a)	vii. Mass assets in separate GAAs – identification of dispositions from mortality dispersion table to specific ID, FIFO, or modified FIFO

[4] Rev. Proc. 2015-14, Section 6.37; Rev. Proc. 2016-29, Section 6.14; Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14, Section 6.12.

Rev. Proc. Sections 6.37(3)(a)/6.14(3)(a)/6.12(3)(a)[4]	Manner of making change	Rev. Proc. Sections 6.37(3)(b)/6.14(3)(b)/6.12(3)(b)
ix. Method of determining unadjusted basis of disposed assets in an MAA from one reasonable method to another when it is impracticable to use taxpayer's records to determine unadjusted basis	Cut-off	viii. Method of determining unadjusted basis of a disposed asset or a disposed portion of an asset in a GAA from one reasonable method to another when it is impracticable to use taxpayer's records to determine unadjusted basis
x. Method of determining unadjusted basis of disposed portions of assets from one reasonable method to another when it is impracticable to use taxpayer's records to determine unadjusted basis	Cut-off	

(1) Disposition of a Building or Structural Component – Section 6.38 of Rev. Proc. 2015-14, Section 6.15 of Rev. Proc. 2016-29, or Section 6.13 of Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14

(2) Disposition of Tangible Assets, other than a Building or its Structural Components – Section 6.39 of Rev. Proc. 2015-14, Section 6.16 of Rev. Proc. 2016-29, or Section 6.14 of Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14

(3) The rules for changes regarding the disposition of a building or structural component, DCN 205, and the rules for changes for disposition of other tangible assets, DCN 206, differ only with respect to the types of property affected. These method changes may affect the determination of gain or loss from dispositions and may affect whether the taxpayer must capitalize amounts to restore a unit of property.

(4) Sections 6.38 and 6.39 of Rev. Proc. 2015-14, or sections 6.15 and 6.16 of Rev. Proc. 2016-29, or sections of 6.13 and 6.14 of Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14, if applicable, each include the procedures for five basic method changes for dispositions of MACRS property that is not in a GAA:

- Change in determining the asset disposed of,
- Change from depreciating a disposed asset or portion of an asset to recognizing gain or loss on disposition,
- Change in the method of identifying which assets in an MAA or portions of assets have been disposed of when the present method is not permitted under Section 1.168(i)-8(g) (e.g., from LIFO to FIFO),

- Change from not using to using taxpayer records to determine the unadjusted depreciable basis of a disposed asset in an MAA or portion of a disposed asset when it is practicable to use taxpayer's records, and
- Change in determining the unadjusted depreciable basis of disposed assets in an MAA or disposed portion of an asset from an unreasonable method to a reasonable method when taxpayer records cannot be used.

(5) Each change is made with a full Section 481(a) adjustment. Under certain circumstances the Section 481(a) amount is taken into account entirely in one year, whether positive or negative.

(6) Statistical sampling, as provided by Rev. Proc. 2011-42, 2011-37 I.R.B. 318, is expressly allowed to determine the Section 481(a) adjustment for the changes in sections 6.38 and 6.39 of Rev. Proc. 2015-14, or sections 6.15 and 6.16 of Rev. Proc. 2016-29, or sections 6.13 and 6.14 of Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14, if applicable. These are the only changes for which statistical sampling is expressly allowed for changes to the final disposition regulations.

(7) Dispositions of Tangible Depreciable Assets in a GAA – Section 6.40 of Rev. Proc. 2015-14, Section 6.17 of Rev. Proc. 2016-29, or Section 6.15 of Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14

(8) DCN 207 provides the procedures regarding disposition of assets in a GAA. These procedures are included in section 6.40 of Rev. Proc. 2015-14, section 6.17 of Rev. Proc. 2016-29, or section 6.15 of Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14, as applicable. These changes mirror the changes for disposition of buildings (DCN 205) and non-building tangible assets (DCN 206) discussed in the previous paragraphs with the exception of a change from depreciating a disposed asset or portion of an asset to recognizing gain or loss on disposition as this is not applicable to assets in a GAA.

(9) All changes require a full Section 481(a) adjustment. There are special rules for determining the spread of the Section 481(a) adjustment for changes in determining the asset disposed of.

E. AUTOMATIC METHOD CHANGES – DESIGNATED CHANGE NUMBER

(4)

DESCRIPTION OF CHANGE	REG Section	REV. PROC. 2015-14, 2016-29, 2017-30, 2018-31, 2019-43, and 2022-14[5]	DCN	MANNER OF MAKING CHANGE	ORIGINAL REV. PROC. REFERENCE
Late Elections or Revocation of GAA Election (sections 6.32 , 6.34, and 6.11)					
GAAs					
Late GAA election - Tax years beginning on or after 1/01/2012 and beginning before 1/01/2014	1.168(i)-1	6.32(1)(a)(i)[6]	180	Limited cut-off	2014-17, section 3.02(9), modified by 2014-54, section 3.02(3)
Late election to recognize gain/loss upon disposition of all assets, the last asset, or the remaining portion of the last asset in a GAA – Tax years beginning on or after 1/01/2012 and beginning before 1/1/2014	1.168(i)-1(e)(3)(ii)	6.32(1)(a)(iii)		Section 481(a)	
Late election to recognize gain/loss upon disposition of an asset in a qualifying disposition, tax years beginning on or after 1/01/2012 and beginning before 1/1/2014	1.168(i)-1(e)(3)(iii)	6.32(1)(a)(v)			
Revocation of GAA election made under section 6.32(1) or Section 1.168(i)(1), Prop. Reg. 1.168(i)(1), or 1.168(i)-1T. Tax years beginning on or after 1/1/2012 and before 1/1/2015	1.168(i)-1	6.34/6.11	197	Section 481(a) No spread	2014-17, section 3.03(2), modified by 2014-54, section 3.02(5)
Late Partial Disposition Election (sections 6.33 and 6.35/6.10 and 6.12/6.10)					
Late partial disposition election – CAM for tax years beginning on or after 1/1/2012 and beginning before 1/1/2015	1.168(i)-8(d)(2)(i)	6.33/6.10	196	Section 481(a)	2014-54, section 3.02(4)
Late partial disposition election – CAM for 1st or 2nd tax year succeeding the applicable year per 1.168(i)-8(d)(2)(iv)	1.168(i)-8(d)(2)(iv)(B)				

[5] Rev. Proc. 2015-14, Sections 6.32 – 6.40 (Previously Rev. Proc. 2011-14 Appendix); Rev. Proc. 2016-29, Sections 6.10 – 6.17; Rev. Proc. 2017-30, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14, Sections 6.10 – 6.15.

[6] Rev. Proc. 2016-29 removed section 6.32 of Rev. Proc. 2015-14 because these provisions were obsolete.

DESCRIPTION OF CHANGE	REG Section	REV. PROC. 2015-14, 2016-29, 2017-30, 2018-31, 2019-43, and 2022-14[5]	DCN	MANNER OF MAKING CHANGE	ORIGINAL REV. PROC. REFERENCE
Partial dispositions of tangible depreciable assets to which the IRS adjustment pertains	1.168(i)-8(d)(2)(iii)	6.35/6.12/6.10	198	Section 481(a)	2014-54, section 3.02(6)
Depreciation Changes (section 6.36/6.13/6.11)					
Depreciation of leasehold improvements	1.167(a)-4	6.36/6.13/6.11	199	Section 481(a)	2014-17, section 3.03(4)
Permissible to Permissible Method of Accounting for Depreciation of MACRS Property (section 6.37/6.14/6.12)					
SAAs or MAAs for MACRS Property					
Change from single assets accounts to MAAs, or vice versa	1.168(i)-7	6.37(3)(a)(i)/ 6.14(3)(a)(i)/ 6.12(3)(a)(i)	200	Limited cut-off	2014-17, section 3.03(5), Modified by 2014-54, section 3.02(7)
Change in grouping assets in MAAs	1.168(i)-7(c)	6.37(3)(a)(ii)/ 6.14(3)(a)(ii)/ 6.12(3)(a)(ii)			
Change in method of identifying which MAA assets or portions of assets have been disposed from one method to another method specified in Section 1.168(i)-8(g)	1.168(i)-8(g)	6.37(3)(a)(iii) and (vi)/ 6.14(3)(a)(iii) and (vi)/ 6.12(3)(a)(iii) and (vi)	200	Cut-off	2014-54, section 3.02(7)
Change in method of identifying which MAA assets or portions of assets have been disposed from one method to another method specified in Section 1.168(i)-8(g)	1.168(i)-8(g)	6.37(3)(a)(iv), (v), (vii), (viii)/ 6.14(3)(a)(iv), (v), (vii), (viii)/ 6.12(3)(a)(iv), (v), (vi), (viii)		Section 481(a)	
Change in determining unadjusted depreciable basis of disposed asset in an MAA or disposed portion of an asset from one reasonable method to another when impracticable to use taxpayer records	1.168(i)-8(f)(2) or (3)	6.37(3)(a)(ix) and (x)/ 6.14(3)(a)(ix) and (x)/ 6.12(3)(a)(ix) and (x)		Cut-off	
GAAs					

DESCRIPTION OF CHANGE	REG Section	REV. PROC. 2015-14, 2016-29, 2017-30, 2018-31, 2019-43, and 2022-14[5]	DCN	MANNER OF MAKING CHANGE	ORIGINAL REV. PROC. REFERENCE
Change in grouping assets of MACRS property in a GAA	1.168(i)-1(c)	6.37(3)(b)(i)/ 6.14(3)(b)(i)/ 6.12(3)(b)(i)	200	Limited Cut-off	2014-54, section 3.02(7)
Change in method of identifying which assets or portions of assets have been disposed from one method to another method specified in Section 1.168(i)-1(j)	1.168(i)-1(j)(2)(i)	6.37(3)(b) (ii) and (v)/ 6.14(3)(b) (ii) and (v)/ 6.12(3)(b)(ii) and (v)		Cut-off	
Change in method of identifying which assets or portions of assets have been disposed from one method to another method specified in Section 1.168(i)-1(j)	1.168(i)-1(j)(2)	6.37(3)(b)(iii), (iv), (vi), (vii)/ 6.14(3)(b)(iii), (iv),(vi), (vii)/ 6.12(3)(b)(iii),(iv), (vi), (vii)		Section 481(a)	2014-54, section 3.02(7)
Change in determining unadjusted depreciable basis of all assets in the same GAA from one reasonable method to another when impracticable to use taxpayer records	1.168(i)-1(j)(3)	6.37(3)(b) (viii)/ 6.14(3)(b)(viii)/ 6.12(3)(b)(viii)	200	Cut-off	
Dispositions of a Building or Structural Component not in a GAA (section 6.38/6.15/6.13)					
Change in determining the asset disposed of	1.168(i)-8(c)(4)	6.38(3)(a)/ 6.15(3)(a)/ 6.13(3)(a)			
Change in method of identifying which assets in an MAA or portion of an asset that have been disposed of from a method not specified in Section 1.168(i)-8(g) to a method that is	1.168(i)-8(g)	6.38(3)(d)/ 6.15(3)(f)/ 6.13(3)(f)			

[7] Special rules apply – Section 481(a) adjustment (positive or negative) must be taken into account entirely in one year under certain circumstances.
[8] Special rules apply – Section 481(a) adjustment (positive or negative) must be taken into account entirely in one year under certain circumstances.
[9] Special rules apply – Section 481(a) adjustment (positive or negative) must be taken into account entirely in one year under certain circumstances.

DESCRIPTION OF CHANGE	REG Section	REV. PROC. 2015-14, 2016-29, 2017-30, 2018-31, 2019-43, and 2022-14[5]	DCN	MANNER OF MAKING CHANGE	ORIGINAL REV. PROC. REFERENCE
Change from depreciating a disposed asset or disposed portion of an asset to recognizing gain/loss upon disposition	1.168(i)-8(h)(1)	6.38(3)(b), (c)/ 6.15(3)(b), (c), (d), (e)/ 6.13(3)(b), (c), (d), (e)	205	Section 481(a)[10] Statistical sampling allowed to determine Section 481(a) under Rev. Proc. 2011-42	2014-54, section 3.03(1)
Change to using TP records to determine the unadjusted basis of a disposed (or portion of a disposed asset) in an MAA, when practicable to use TP records	1.168(i)-8(f)(2) or (3)	6.38(3)(e), (g)/ 6.15(3)(g), (i)/ 6.13(3)(g), (i)			
Change in determining unadjusted depreciable basis of a disposed asset in an MAA or portion of an asset from unreasonable to a reasonable method when impracticable to use taxpayer records.	1.168(i)-8(f)(2) or (3)	6.38(3)(f), (h)/ 6.15(3)(h), (j)/ 6.13(3)(h), (j)			
Dispositions of Tangible Depreciable Assets, other than a Building or its Structural Components not in a GAA (section 6.39/6.16/6.14)					
Change in determining the asset disposed of	1.168(i)-8(c)(4)	6.39(3)(a)/ 6.16(3)(a)/ 6.14(3)(a)			
Change in method of identifying which MAA assets or portion of an asset was disposed of from a method	1.168(i)-8(g)	6.39(3)(d)/ 6.16(3)(f)/			

[10] Special rules apply – Section 481(a) adjustment (positive or negative) must be taken into account entirely in one year under certain circumstances.

[11] Special rules apply – Section 481(a) adjustment (positive or negative) must be taken into account entirely in one year under certain circumstances.

[12] Special rules apply – Section 481(a) adjustment (positive or negative) must be taken into account entirely in one year under certain circumstances.

DESCRIPTION OF CHANGE	REG Section	REV. PROC. 2015-14, 2016-29, 2017-30, 2018-31, 2019-43, and 2022-14[5]	DCN	MANNER OF MAKING CHANGE	ORIGINAL REV. PROC. REFERENCE
not specified in Section 1.168(i)-8(g) to a method that is		6.14(3)(f)			
Change from depreciating a disposed asset/portion of an asset to recognizing gain or loss upon disposition	1.168(i)-8(h)(1)	6.39(3)(b), (c)/ 6.16(3)(b), (c), (d), (e)/ 6.14(3)(b), (c), (d), (e)	206	Statistical sampling allowed to determine Section 481(a) under Rev. Proc. 2011-42	2014-54, section 3.03(2)
Change to using TP records to determine the unadjusted basis of a disposed (or portion of a disposed asset) in an MAA, when practicable to use TP records	1.168(i)-8(f)(2) or (3)	6.39(3)(e), (g)/ 6.16(3)(g), (i)/ 6.14(3)(g), (i)			
Change in determining unadjusted depreciable basis of a disposed asset in an MAA or portion of an asset from unreasonable to a reasonable method when impracticable to use TP records	1.168(i)-8(f)(2) or (3)	6.39(3)(f), (h)/ 6.16(3)(h), (j)/ 6.14(3)(h), (j)			
Dispositions of Tangible Depreciable Assets in a GAA (section 6.40/6.17/6.15)					
Change in determining the asset disposed of	1.168(i)-1(e)(2)(viii)	6.40(3)(a)/ 6.17(3)(a)/ 6.15(3)(a)	207	Section 481(a)	2014-54, section 3.03(3)
Change in method of identifying which assets or portions of assets have been disposed of from a method not specified in Section 1.168(i)-1(j) to a method that is	1.168-1(j)(2)	6.40(3)(b)/ 6.17(3)(b)/ 6.15(3)(b)			
Change from not using to using TP records to determine the unadjusted depreciable basis of disposed asset (or portion of an asset) when it is practicable to use TP records	1.168(i)-1(j)(3)	6.40(3)(c)/ 6.17(3)(c)/ 6.15(3)(c)			
Change in determining unadjusted depreciable basis of disposed asset (or portion of) from an unreasonable	1.168(i)-1(j)(3)	6.40(3)(d)/ 6.17(3)(d)/			

DESCRIPTION OF CHANGE	REG Section	REV. PROC. 2015-14, 2016-29, 2017-30, 2018-31, 2019-43, and 2022-14[5]	DCN	MANNER OF MAKING CHANGE	ORIGINAL REV. PROC. REFERENCE
to a reasonable method when impracticable to use TP records		6.15(3)(d)			

XIX. CHAPTER 19 – LB&I TANGIBLE PROPERTY DIRECTIVES

A. STAND DOWN DIRECTIVE

(1) As addressed in Chapter 2 of this Audit Technique Guide, on March 15, 2012, Large Business and International (LB&I) published Directive 04-312-004. Examiners were required to "stand down" or stop all examination activity for tax positions taken on original tax returns for costs incurred to maintain, replace, or improve tangible property and any correlative issues involving the disposition of those assets. The LB&I Division took this action to conserve exam resources and permit taxpayers time to comply with the final regulations.

(2) This original "stand down" Directive 04-0312-004 later was superseded by the "modified stand down" Directive 04-0313-001 published March 22, 2013. This directive provides examination instructions for three specific tax periods. Examination of tax years beginning before January 1, 2012; tax years beginning on or after January 1, 2012, but before January 1, 2014; and years beginning on or after January 1, 2014. This directive remains in effect for those tax periods.

B. INDUSTRY DIRECTIVES

(1) The preamble to the tangible property regulations states that, "to the extent the rules in the final regulations present situations that might be addressed through the IIR program, taxpayers may pursue additional guidance through the IIR process," and that "specific industry guidance is better addressed through the IIR program." Industry groups submitted requests for guidance under Rev. Proc. 2003-36 as addressed in IRM 7.40.1, to resolve the question of which costs are deductible repairs under Section 162 and which costs are capitalized under Section 263(a).

(2) Chapter 2 of this Audit Technique Guide addresses industry specific revenue procedures issued as a result of the Industry Issue Resolution (IIR) process. As a companion to many of these revenue procedures, LB&I issued a directive to instruct examiners on the proper application of each revenue procedure for qualified taxpayers. This chapter contains those directives.

(3) Note: There is no revenue procedure for the Mining Industry. The Mining Industry Directive was issued outside of the IIR process, but with the participation of Mining Industry Groups.

C. SUPERSEDED DIRECTIVES

(1) Additional tangible property directives issued and later superseded are not included in this Chapter.

D. INSTRUCTIONS TO STAFF

(1) On July 29, 2020, the Commissioner of LB&I announced a change in the industry directive format. IRM 4.51.2.6, Developing Administrative Guidance – LMSB (LB&I) Directives will no longer be used. Going forward, any instructions to staff will be in the IRM. All existing directives are to be evaluated and either incorporated into the IRM or revoked.

E. CURRENT TANGIBLE PROPERTY DIRECTIVES

(1) Tangible Property – Unit of Property Guidance

(2) The following are the steps identified in the flow chart below:

(5)

Industry	Directive	Directive #	Date Published
All	Modified Stand Down	04-0313-001	3-22-2013
Utilities	Transmission & Distribution #1	04-1111-019	11-25-2011
Utilities	Transmission & Distribution #3	04-0814-006	9-3-2014
Utilities	Steam or Electric Generation	04-0713-005	6-10-2013
Utilities	Substantially All	04-0315-002	7-6-2015
Telecom	Wireline and Wireless	03-1111-021	1-23-2012
Telecom	Cable	04-0415-003	4-16-2015
Railroad	Railroad	04-1212-013	12-7-2012
Mining	Subsurface, Surface, Processing Plant	04-0917-004	9-11-2017

F. MODIFIED STAND DOWN DIRECTIVE

(1) The following are the steps identified in the directive below:

(2) LB&I Control No: LB&I-04-0313-001, Impacted IRM 4.51.5, March 22, 2013

(3) MEMORANDUM FOR: ALL LARGE BUSINESS AND INTERNATIONAL DIVISION EMPLOYEES

(4) FROM: Heather C. Maloy /s/ Heather C. Maloy, Commissioner, Large Business & International Division

(5) SUBJECT: UPDATED LB&I DIRECTIVE for Large Business & International Division for Taxpayers who Adopted a Method of Accounting Relating to the Conversion of Capitalized Assets to Repair Expense under I.R.C. Section 263(a)

(6) This memorandum replaces LB&I Directive No. LB&I-4-0312-004, dated March 15, 2012, and provides direction to the field in examinations of the repair versus capitalization issue. The effective date of the tangible property temporary regulations, in amendments published December 17, 2012, in T.D. 9564, has been extended to taxable years beginning on or after January 1, 2014. Accordingly, this memorandum provides modified examination instructions for taxable years beginning on or after January 1, 2012, and before January 1, 2014, and restates prior examination instructions for taxable years beginning before January 1, 2012 and on or after January 1, 2014.

(7) Background

- On December 27, 2011, the Service published temporary regulations (T.D. 9564) to clarify and expand the standards in the current regulations under sections 162(a) and 263(a) and provide some bright-line tests (for example, a de minimis rule for certain acquisitions) for applying these standards. The temporary regulations also amend the general asset account regulations and provide guidance regarding the accounting for, and dispositions of, property subject to section 168. The temporary regulations affect all taxpayers that acquire, produce, or improve tangible property, and are applicable to taxable years (or costs incurred in taxable years, as appropriate) beginning on or after January 1, 2014 (per amendments effective Dec. 17, 2012). For taxable years beginning on or after January 1, 2012, and before the applicability dates provided in forthcoming final regulations (hereinafter the “Option Period”), taxpayers may choose to apply the temporary regulations (as contained in 26 CFR part 1 edition revised as of April 1, 2012).
- As provided in Notice 2012-73, I.R.B. 2012-51, 713, the IRS and the Treasury Department expect to publish final tangible property regulations in 2013 that may include changes to the rules provided in the temporary regulations. The IRS and the Treasury Department expect the final regulations to apply to taxable years beginning on or after January 1,

2014, and to permit taxpayers to apply the provisions of the final regulations for taxable years beginning during the Option Period.

- Taxpayers choosing to apply the provisions of the temporary regulations to taxable years beginning on or after January 1, 2012, may continue to rely on the procedures by which a taxpayer may obtain the automatic consent of the Commissioner of Internal Revenue to change its methods of accounting provided in Revenue Procedures 2012-19, 2012-14 I.R.B. 689, and 2012-20, 2012-14 I.R.B. 700. For taxpayers choosing to apply the provisions of the final regulations to taxable years beginning on or after January 1, 2012, the IRS and the Treasury Department expect to publish procedures for obtaining automatic consent to change a method of accounting when the final regulations are published. (Hereinafter in total "Applicable Procedures").
- Revenue Procedure 2012-19 provides the procedures for requesting a change for the following methods of accounting addressed in the temporary regulations:
  - Materials and supplies (Section 1.162-3T & 4T),
  - Capital expenditures in general (Section 1.263(a)-1T),
  - Transaction costs (Section 1.263(a)-2T), and
  - Improvements (Section 1.263(a)-3T).
- Revenue Procedure 2012-20 provides the procedures for requesting a change for the following methods of accounting addressed in the temporary regulations:
  - Leased property (Section 1.167(a)-4T),
  - General asset accounts (Section 1.168(i)-1T),
  - MACRS property (Section 1.168(i)-7T), and
  - Dispositions of MACRS property (Section 1.168(i)-8T).

(8) Scope of this Directive

- This directive applies to the exam activity relating to positions taken on original returns relating to the following issues (hereinafter "Issues").
  - Whether costs incurred to maintain, replace, or improve tangible property must be capitalized under section 263(a), (see, e.g., Rev. Proc. 2011-14, Appendix section 3.06, repair, and maintenance costs (designated change number 144)), and,
  - Any correlative Issues involving the disposition of structural components of a building or dispositions of tangible depreciable assets (other than a building or its structural components), (see, e.g.,

Rev. Proc. 2011-14, Appendix sections 6.24 and 6.25 (designated change number 146 and 147, respectively)).

- This directive does not apply to current examination activity relating to (1) costs for which the IRS provides specific guidance, separate from the temporary regulations, for determining whether expenditures incurred to maintain, replace or improve tangible property must be capitalized under section 263(a), or (2) issues that do not pertain to whether costs incurred to maintain, replace, or improve tangible property must be capitalized under section 263(a). See, for example:
  - Rev. Proc. 2001-46 and Rev. Proc. 2002-65, Track maintenance allowance for certain railroads,
  - Rev. Proc. 2011-14, Appendix section 3.07, Wireline network asset maintenance allowance and units of property methods of accounting under Rev. Proc. 2011-27 (designated change number 158),
  - Rev. Proc. 2011-14, Appendix section 3.08, Wireless network asset maintenance allowance and units of property methods of accounting under Rev. Proc. 2011-28 (designated change number 159),
  - Rev. Proc. 2011-14, Appendix section 3.09, Method of accounting under Rev. Proc. 2011-43 for taxpayers in the business of transporting, delivering, or selling electricity (designated change number 160),
  - Rev. Proc. 2011-14, Appendix section 6.01, A change from an impermissible to a permissible method of accounting for depreciation or amortization (depreciation) (designated change number 7), or
  - Rev. Proc. 2011-14, Appendix section 3.05, Materials and Supplies (designated change number 143).

(9) Examination of Tax Years Beginning Before January 1, 2012

- You should discontinue current exam activity with regard to the Issues.
- You should not begin any new exam activity with regard to the Issues.
- If, however, a taxpayer files a Form 3115 with regard to the Issues on or after December 27, 2011 (the date the temporary regulations were published) for a tax year not included in the Option Period, you should risk assess the Form 3115 and determine, in consultation with the Methods of Accounting & Timing or the Deductible and Capital Expenditures Issue Practice Groups, whether to examine the Form 3115.
- You should take the following steps to discontinue the exam activity with regard to the Issues:

- Withdraw Forms 4564, Information Document Request, or portions thereof, relating to the development of this issue for amounts paid to maintain, replace, or improve tangible property, and any correlative Issues involving the disposition of associated assets.
- Withdraw all Forms 5701, Notice of Proposed Adjustment, which propose an adjustment to repair expenses related to whether costs incurred to maintain, replace, or improve tangible property must be capitalized under section 263(a), and any correlative adjustments involving the disposition of associated assets.
- Develop and issue a Form 5701 with a Form 886-A, Explanation of Adjustments, containing the following language: The Service neither accepts nor rejects the position taken in the tax return related to the method to determine the proper treatment of amounts incurred to repair tangible property. [Insert taxpayer name] will be allowed a two-year period to adopt the appropriate methods of accounting provided in Rev. Procs. 2012-19 and 2012-20 and any other Applicable Procedures issued in the future. If an appropriate method is adopted, a change in method of accounting can be made in accordance with Section 4 or 5 of the Applicable Procedure for all assets. If [Insert taxpayer name] has not changed its accounting method consistent with the Applicable Procedures, then the repair expense will be subject to risk assessment and possible examination for tax years beginning on or after January 1, 2014.
- After the taxpayer has signed the Form 5701 with the 886-A, Explanation of Adjustments, upload the documents into the Information Management System (IMS) to substantiate for the subsequent examination team that the taxpayer was notified that Service has discontinued examination of the issue. Input into IMS as follows: UIL 263.14-01, and Issue Tracking Attribute Code 1400.
- Retain copies of pertinent workpapers in the IMS file or other central location permitted by IRM 4.46.7.2.3(3)(c) &(d).
- Complete the Form 5346, Examination Information Report, in accordance with the specific instructions provided for this issue located on the Deductible and Capital Expenditures Issue Practice Group website.

(10) Examination of Tax Years Beginning on or after January 1, 2012, but before January 1, 2014

- When you begin examining a return for a taxable year beginning on or after January 1, 2012, but before January 1, 2014, you should determine:

- If the taxpayer has changed its method of accounting with respect to the Issues, with or without filing a Form 3115, Application for Change in Accounting Method,
- If yes, perform a risk assessment regarding the method change,
- If no, the Option Period is still open. Do not examine the issue.

(11) Examination of Tax Years Beginning on or after January 1, 2014

- You should apply the regulations in effect and follow normal exam procedures.

(12)Section 481(a) Adjustment

- When performing a risk assessment of the section 481(a) adjustment for the Issues, you should:
  - Consider if the adjustment properly accounts for amounts paid to acquire, produce, or improve tangible property that were computed under the taxpayer's prior method and previously deducted under section 162,
  - Determine if the section 481(a) adjustment(s) resulting from any prior year change was taken into account, and
  - Consider the accuracy of the section 481(a) adjustment.

(13)Contacts

- For further guidance regarding this directive, please contact a member of the LB&I Issue Practice Groups for Deductible and Capital Expenditures or Methods of Accounting & Timing.

(14)This Directive is not an official pronouncement of law, and cannot be used, cited, or relied upon as such.

(15)cc: Division Counsel, LB&I, Chief, Appeals

G. ELECTRIC T&D PROPERTY DIRECTIVE #1

(1) The following are the steps identified in the directive below:

(2) LB&I Control No: LB&I 04-1111-019, Impacted IRM 4.51.5, November 25, 2011

(3) MEMORANDUM FOR: INDUSTRY DIRECTORS, DIRECTOR, FIELD SPECIALISTS, DIRECTOR, PREFILING AND TECHNICAL GUIDANCE

(4) DIRECTOR, INTERNATIONAL BUSINESS COMPLIANCE

(5) FROM: Cheryl P. Claybough /s/ Cheryl P. Claybough, Acting Industry Director, Natural Resources and Construction

(6) SUBJECT: Large Business & International Directive, Transition Rules for Taxpayers Adopting the Safe Harbor Method of Accounting for Electric Transmission and Distribution Property

(7) This memorandum provides direction to the field in the examination of a taxpayer eligible to change to the transmission and distribution property safe harbor method described in Rev. Proc. 2011-43. Rev. Proc. 2011-43 provides a method for taxpayers to determine whether expenditures to maintain, replace, or improve electric transmission and distribution property must be capitalized under I.R.C. Section 263(a) or are deductible under I.R.C. Section 162. This directive applies to taxpayers who are eligible to use the Rev. Proc. 2011-43 safe harbor, whether or not a change to the safe harbor method of accounting has been filed.

(8) The use of the safe harbor included in this Revenue Procedure is only permitted under the terms and conditions contained therein and should not be considered for purposes of resolving capitalization issues in prior open exam years under any circumstances. This directive provides the guidance for addressing prior open exam years.

(9) Taxpayers that transmit and distribute electricity incur significant expenditures to maintain, replace, and improve transmission and distribution property. For those taxpayers eligible to adopt the unit of property definitions and safe harbor provisions provided in Rev. Proc. 2011-43, this directive sets forth guidance to the field related to closing current examination activity relating to capital versus repair treatment for expenditures on utility electric transmission and distribution property.

(10) Planning and Examination Guidance - Tax Years Ending Before December 31, 2010

- For taxable years ending before December 31, 2010, examiners should discontinue current examination activity involving whether costs incurred to maintain, replace, or improve electric transmission and distribution property must be capitalized under I.R.C. Section 263(a). This discontinuation only applies to positions taken on original returns filed for the years ending before December 31, 2010. Please contact Douglas E. Toney, Utilities Technical Specialist at (972) 308-1166 for guidance on claims.
- Revenue Procedure 2011-43 waives the scope limitations for a request to change a method of accounting, which normally apply to a taxpayer under examination, for the taxpayer’s first and second taxable year ending after December 30, 2010. If a taxpayer with applicable asset expenditures has not adopted the safe harbor method pursuant to Rev. Proc. 2011-43 for its first or second taxable year ending after December 30, 2010, the examiner should follow the guidance under Planning and Examination Guidance –

Tax Years Ending On or After December 31, 2010 as provided in the next section.

- Discontinuing the examination of the capital versus repair expense issue should include the following steps:
  - Withdraw Forms 4564, Information Document Request, or portions thereof, relating to the development of this issue for transmission and distribution property.
  - Withdraw all outstanding Forms 5701, Notice of Proposed Adjustment, which propose an adjustment to repair expenses related to whether costs incurred to maintain, replace, or improve electric transmission and distribution property must be capitalized under I.R.C. Section 263(a).
  - Develop and issue a Form 5701 with a Form 886-A, Explanation of Adjustments, containing the following language:
    - The Service neither accepts nor rejects the position stated in the tax return related to the method to determine the proper repair expense with respect to electric transmission and distribution property. [Insert taxpayer name] will be allowed a two-year period to adopt the safe harbor method provided in Rev. Proc. 2011-43. If the safe harbor method is adopted, a change in method of accounting can be made in accordance with Section 7 of the applicable revenue procedure for all of the transmission and distribution property. If [Insert taxpayer name] has not adopted the safe harbor method in its first or second taxable year ending after December 30, 2010, the repair expense will be subject to risk assessment and possible examination for tax years ending on or after December 31, 2010.
- After the taxpayer has signed the Form 5701 with the 886-A, Explanation of Adjustments, upload the documents into the Information Management System (IMS) to substantiate for the subsequent examination team that the taxpayer was notified of the Service's position to discontinue the issue.
- Complete the Form 5346, Examination Information Report, in accordance with the specific instructions provided for this issue located on the Deductible and Capital Expenditures Issue Practice Group (IPG) website.
- Confirm the issue was input into IMS as follows: UIL 263.14-01, and Issue Tracking Attribute Code 1400.

(11) Planning and Examination Guidance – Tax Years Ending On or After December 31, 2010

- When examining returns of utility companies for taxable years ending on or after December 31, 2010, examiners should determine if the taxpayer

filed a Form 3115, Application for Change in Accounting Method, to adopt the safe harbor method provided in Rev. Proc. 2011-43.

- If the taxpayer adopted the safe harbor method, then examiner should determine if the adoption is consistent with the Rev. Proc. 2011-43. If the adoption is not consistent, then a determination needs to be made whether the taxpayer correctly adopted the method, and the examiner should consult with the Deductible and Capital Expenditures Issue Practice Group for further guidance.
- Rev. Proc. 2011-43 section 5.03(3) provides a transition rule for the first three taxable years ending on or after December 31, 2010, permitting taxpayers to determine the percentage of a unit of linear property replaced based on average circuit length within a county or geographic area similar to a county, such as a parish, borough, or other similar geographic division. Examiners should not challenge a taxpayer's ability to use the transition rule for tax years ending before January 1, 2014.

(12) True-up Requirement. When performing the risk assessment, the examiner should also consider the accuracy of the I.R.C. Section 481(a) adjustment. If prior to the issuance of Rev. Proc. 2011-43 the taxpayer filed a Form 3115 to change the treatment of expenditures for transmission or distribution property, then the I.R.C. Section 481(a) adjustment resulting from a change to the Rev. Proc. 2011-43 safe harbor method ("new I.R.C. Section 481(a) adjustment") should account for any previous I.R.C. Section 481(a) adjustment ("old I.R.C. Section 481(a) adjustment"). The taxpayer should also ensure that the new I.R.C. Section 481(a) adjustment properly accounts for electric transmission and distribution property repair expenses that were computed under the taxpayer's prior method and deducted under I.R.C. Section 162 in the interim years between the old and new I.R.C. Section 481 adjustments. When changing to the Rev. Proc. 2011-43 safe harbor, a taxpayer must take the entire net Section 481(a) adjustment into account (whether positive or negative) in computing taxable income in the year of change.

(13) If the taxpayer did not adopt the safe harbor method, then the agent should perform a risk assessment to determine the materiality of the repair deduction claimed with respect to the electric transmission and distribution property. If the result of the risk assessment is deemed to be material, the examiner should examine the deduction utilizing I.R.C. Section 263(a) and the Treasury Regulations thereunder.

(14) Contacts

- If you have any questions, please contact the Deductible and Capital Expenditures IPG.

(15) This Directive is not an official pronouncement of law and cannot be used, cited, or relied upon as such.

(16) cc: Commissioner, LB&I, Deputy Commissioner, Operations, Deputy Commissioner, International, Division Counsel, LB&I, Chief, Appeals, Directors, Field Operations, Director, Pre-filing and Technical Guidance

H. ELECTRIC T&D PROPERTY DIRECTIVE #3

(1) The following are the steps identified in the directive below:

(2) LB&I Control No: LB&I 04-0814-006, Impacted IRM 4.51.2, September 3, 2014

(3) MEMORANDUM FOR: ALL LARGE BUSINESS AND INTERNATIONAL DIVISION EMPLOYEES

(4) FROM: Heather C. Maloy /s/ Heather C. Maloy, Commissioner, Large Business & International Division

(5) SUBJECT: Large Business & International Directive Extending Transition Rules and the Scope Limitation Waiver for Taxpayers Adopting the Safe Harbor Method of Accounting for Electric Transmissions and Distribution Property – LBI Directive #3

(6) INTRODUCTION

- This memorandum provides direction to the field in the examination of a taxpayer eligible to change to the transmission and distribution property safe harbor method described in Rev. Proc. 2011-43, 2011-37 I.R.B. 326. Rev. Proc. 2011-43 provides a method for taxpayers to determine whether expenditures to maintain, replace, or improve electric transmission and distribution property must be capitalized under I.R.C. section 263(a) or are deductible under I.R.C. section 162.
- This memorandum provides additional direction to the field regarding the transition rules for determining the percentage of a unit of property replaced set forth in Rev. Proc. 2011-43. section 5.03(3). The Service is aware that some companies that own electric transmission and distribution property have not been able to timely revise their accounting systems to determine the percentage of a unit of linear property replaced and require additional time to revise these accounting systems.
- In addition, this directive modifies LB&I Directive 4-1111-019 to conform to the scope limitation waiver set forth in Rev. Proc. 2014-16, 2014-9 I.R.B. 606. This directive also supersedes LB&I Directive 04-0513-003.

(7) PLANNING AND EXAMINATION GUIDANCE

- Section 5.03(3) of Rev. Proc. 2011-43 provides that for the first three taxable years ending on or after December 31, 2010, a taxpayer using the transmission and distribution property safe harbor method provided by this

revenue procedure may determine the percentage of a unit of linear property replaced on the basis of an average circuit within a county.

- This memorandum directs agents not to challenge a taxpayer's use of the above-stated transition rule for the first six taxable years ending on or after December 31, 2010 (i.e., for a calendar-year taxpayer with no intervening short years, taxable years ending 12/31/2010-12/31/2015).
- For a request to change to the transmission and distribution property safe harbor method, section 7.03 of Rev. Proc. 2011-43 waives for the taxpayer's first and second taxable year ending after December 30, 2010, the scope limitations in Rev. Proc. 2011-14, 2011-4 I.R.B., 330, that normally apply to a taxpayer under examination. Rev. Proc. 2012-39, 2012-41 I.R.B., 470, section 3.01(3) extends this scope limitation waiver to the third taxable year ending after December 30, 2010. Rev. Proc. 2014-16, section 3.01(2), further extends this scope limitation waiver to the fourth taxable year ending after December 30, 2010.
- This directive modifies the planning and examination guidance set forth in LB&I Directive 4-1111-019. Specifically, if a taxpayer with applicable asset expenditures has not adopted the safe harbor method pursuant to Rev. Proc. 2011-43 for its first, second, third, or fourth taxable year ending after December 30, 2010, the examiner should follow the guidance under Planning and Examination Guidance -- Tax Years Ending On or After December 31, 2010, as provided in that section of LB&I Directive 4-1111-019.
- Correspondingly, if an examiner needs to develop and issue a Form 5701 with a Form 886-A, Explanation of Adjustments, the required language provided in LB&I Directive 4-1111-019 should be modified to reflect that a four-year period has been provided in which taxpayers may adopt the safe harbor method of accounting provided in Rev. Proc. 2011-43:
    - The Service neither accepts nor rejects the position stated in the tax return related to the method to determine the proper repair expense with respect to electric transmission and distribution property. [Insert taxpayer name] will be allowed a four-year period to adopt the safe harbor method provided in Rev. Proc. 2011-43. If the safe harbor method is adopted, a change in method of accounting can be made in accordance with Section 7 of the applicable revenue procedure for all of the transmission and distribution property. If [Insert taxpayer name] has not adopted the safe harbor method in its first, second, third, or fourth taxable year ending after December 30, 2010, the repair expense will be subject to risk assessment and possible examination for tax years ending on or after December 31, 2010.
- All planning and examination guidance provided in LB&I Directive 4-1111-019 remains in effect, subject to the modifications provided above.

(8) CONTACTS

- If you have any questions, please contact the Deductible and Capital Expenditures IPG.

(9) This Directive is not an official pronouncement of law and cannot be used, cited, or relied upon as such.

(10) cc: Division Counsel, LB&I

(11) Chief, Appeals

I. STEAM & ELECTRIC GENERATION PROPERTY DIRECTIVE

(1) The following are the steps identified in the directive below:

(2) LB&I Control No: LB&I-04-0713-005, Impacted IRM 4.51.5, June 10, 2013

(3) MEMORANDUM FOR: ALL LARGE BUSINESS & INTERNATIONAL EMPLOYEES

(4) FROM: Paul D. DeNard

(5) SUBJECT: Large Business & International Directive for Taxpayers Changing to the Method of Accounting Provided in Rev. Proc. 2013-24 for Steam and Electric Generation Property

(6) Introduction

- This memorandum provides direction to the field in the examination of a taxpayer eligible to change to the method of accounting provided in Rev. Proc. 2013-24 for steam or electric generation property. The revenue procedure provides definitions of units of property and major components taxpayers may use to determine whether expenditures to maintain, replace, or improve steam or electric generation property must be capitalized under I.R.C. Section 263(a) of the Internal Revenue Code.
- LB&I Directive No. 04-0313-001 (issued March 22, 2013) which replaced Directive 04-0312-004 (issued March 15, 2012) (hereinafter "Stand Down Directive") requires agents to stand down or suspend current examination activity on certain issues involving:
  - Whether costs incurred to maintain, replace, or improve tangible property must be capitalized under I.R.C. Section 263(a), and
  - Any correlative issues involving the disposition of structural components of a building or dispositions of tangible depreciable assets.
- The Stand Down Directive continues to apply to whether costs incurred to maintain, replace, or improve steam or electric generation property must be capitalized under I.R.C. Section 263(a) and any correlative issues

involving the disposition of structural components of a building or dispositions of tangible depreciable assets.

- The use of the definitions of units of property and major components provided in Rev. Proc. 2013-24 is only permitted under the terms and conditions contained therein and should not be considered for purposes of resolving capitalization issues in prior open exam years under any circumstances. This steam or electric generation property directive provides the guidance for addressing prior open exam years. This directive applies to taxpayers who are eligible to use the Rev. Proc. 2013-24, whether or not a request to change to the definitions of units of property and major components has been filed.

(7) Background

- Taxpayers that generate steam or electric power incur significant expenditures to maintain, replace, and improve generation property. Whether these expenditures are deductible as repairs under I.R.C. Section 162 or must be capitalized as improvements under Section 263(a) depends on whether the expenditures materially increase the value of the property or appreciably prolong its life. In general, under I.R.C. Section 263(a) the cost of replacing a unit of property or major component must be capitalized.
- A generation plant is composed of numerous functionally interdependent items of machinery and equipment, and it can be difficult to identify which items constitute discrete units of property, major components, or something else. As a consequence, taxpayers and the Internal Revenue Service often disagree about whether the cost to replace a particular item is a capital or deductible expense.
- A taxpayer's method for determining whether an expenditure is deducted or is capitalized, including unit of property and major component definitions, is a method of accounting under I.R.C. Section 446, I.R.C. Section 446(e) and Income Tax Regulation Section 1.446-1(e) require taxpayers to secure the consent of the Commissioner before changing a method of accounting for Federal income tax purposes. Regulation Section 1.446-1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions necessary to permit a taxpayer to obtain consent to change a method of accounting.
- Rev. Proc. 2013-24 provides definitions of units of property and major components for steam or electric generation property to which taxpayers may apply I.R.C. Section 263(a) to determine whether expenditures to maintain, replace, and improve steam or electric generation property are required to be capitalized. For those taxpayers eligible to change to using the unit of property and major component definitions provided in Rev.

Proc. 2013-24, this directive sets forth guidance to the field related to examination activity relating to capital versus repair treatment for expenditures on utility steam or electric generation property.

(8) Planning and Examination Guidance - Tax Years Ending Before December 31, 2012

- For taxable years ending before December 31, 2012, examiners should discontinue current examination activity involving whether costs incurred to maintain, replace, or improve steam or electric generation property must be capitalized under I.R.C. Section 263(a). This discontinuation only applies to positions taken on original returns filed for the years ending before December 31, 2012. Please contact the LB&I Issue Practice Group (IPG) for Deductible and Capital Expenditures for guidance on claims.
- Revenue Procedure 2013-24 waives the scope limitations for a request to change a method of accounting that normally apply to a taxpayer under examination, for the taxpayer's first, second and third taxable year ending after December 30, 2012. If a taxpayer with applicable asset expenditures has not changed to using the definitions of units of property and major components provided in Rev. Proc. 2013-24 for its first, second or third taxable year ending after December 30, 2012, the examiner should follow the guidance under Planning and Examination Guidance – Tax Years Ending On or After December 31, 2012 as provided in the next section.
- Discontinuing the examination of the capital versus repair expense issue should include the following steps:
  - Withdraw Forms 4564, Information Document Request, or portions thereof, relating to the development of this issue for steam or electric generation property.
  - Withdraw all outstanding Forms 5701, Notice of Proposed Adjustment, which propose an adjustment to repair expenses related to whether costs incurred to maintain, replace, or improve steam or electric generation property must be capitalized under I.R.C. Section 263(a).
  - Develop and issue a Form 5701 with a Form 886-A, Explanation of Adjustments, containing the following language:
    - The Service neither accepts nor rejects the position stated in the tax return related to the method to determine the proper repair expense with respect to steam or electric generation property. [Insert taxpayer name] will be allowed a three-year period to change to all, or some, of the definitions of units of property and major components provided in Rev. Proc. 2013-24. If all, or some, of the definitions are adopted, a change in method of accounting can be made in accordance with Section 6 of Rev. Proc. 2013-24 for all of the steam or electric generation property. If [Insert

taxpayer name] has not changed to using the unit of property and major component definitions provided in Rev. Proc. 2013-24 in its first, second or third taxable year ending after December 30, 2012, and the repair expense will be subject to risk assessment and possible examination for taxable years ending on or after December 31, 2014.

- After the taxpayer has signed the Form 5701 with the 886-A, Explanation of Adjustments, upload the documents into the Information Management System (IMS) to substantiate for the subsequent examination team that the taxpayer was notified of the Service's position to discontinue the issue.
- Retain copies of pertinent workpapers in the IMS file or other central location permitted by I.R.M. 4.46.7.2.3(c) & (d).
- Complete the Form 5346, Examination Information Report, in accordance with the specific instructions provided for this issue located on the IPG for Deductible and Capital Expenditures website.
- Confirm the issue was input into IMS as follows: UIL 263.14-01, and Issue Tracking Attribute Code 1400.

(9) Planning and Examination Guidance – Tax Years Ending On or After December 31, 2012

- When examining returns of utility companies for taxable years ending on or after December 31, 2012, examiners should determine if the taxpayer filed a Form 3115, Application for Change in Accounting Method, to change to using the definitions of units of property and major components provided in Rev. Proc. 2013-24.
  - If the taxpayer changes to all, or some, of the definitions of units of property and major components, then the examiner should determine if the change is consistent with Rev. Proc. 2013-24 (including whether the I.R.C. Section 481(a) adjustment was accurately computed). If the change is not consistent, then a determination needs to be made whether the taxpayer correctly changed to the method and the examiner, if needed, may consult with the IPG for Deductible and Capital Expenditures for further guidance.
  - Section 481(a) adjustment
    - When changing under the Rev. Proc. 2013-24, a taxpayer must take the entire net I.R.C. Section 481(a) adjustment into account (whether positive or negative) in computing taxable income in the year of change.
    - If, prior to the issuance of Rev. Proc. 2013-24, the taxpayer filed a Form 3115 to change the treatment of expenditures for steam or

electric generation property, then the I.R.C. Section 481(a) adjustment resulting from a change under Rev. Proc. 2013-24 ("new I.R.C. Section 481(a) adjustment") should account for any previous I.R.C. Section 481(a) adjustment ("old I.R.C. Section 481(a) adjustment").

- The new I.R.C. Section 481(a) adjustment must properly account for steam or electric generation property repair expenses that were computed under the taxpayer's prior method and deducted under I.R.C. Section 162 in the interim years between the old and new I.R.C. Section 481(a) adjustments.

- If the taxpayer does not change to all, or some, of the definitions of units of property and major components provided in Rev. Proc. 2013-24 for the first or second taxable year ending after December 30, 2012, then the examiner should not commence any examination activity involving the repair deduction claimed with respect to steam or electric generation property since the taxpayer could still change to the method for third taxable year ending after December 30, 2012.
- If the taxpayer does not change to all, or some, of the definitions of units of property and major components provided in Rev. Proc. 2013-24 for the first, second or third taxable year ending after December 30, 2012, then the agent should perform a risk assessment to determine the materiality of the repair deduction claimed with respect to the steam or electric generation property. If the result of the risk assessment is deemed to be material, the examiner should examine the deduction utilizing I.R.C. Section 263(a) and the Treasury Regulations under Section 263(a).

(10)Contacts

- If you have any questions, please contact the IPG for Deductible and Capital Expenditures.

(11)This Directive is not an official pronouncement of law and cannot be used, cited, or relied upon as such.

(12) Division Counsel, LB&I, Chief, Appeals

J. "SUBSTANTIALLY ALL" DIRECTIVE

(1) The following are the steps identified in the directive below:

(2) LB&I Control No: LB&I-04-0325-002, Impacted IRM 4.51.2, July 6, 2015

(3) MEMORANDUM FOR: ALL LARGE BUSINESS AND INTERNATIONAL EMPLOYEES

(4) FROM: Heather C. Maloy /s/ Heather C. Maloy, Commissioner, Large Business & International Division

(5) SUBJECT: Large Business & International Directive for Determining When "Substantially All" of a Major Component (as Defined in Revenue Procedure 2013-24) has been Replaced under I.R.C. Section 263(a)

(6) Introduction

- This memorandum provides direction to the field in the examination of a taxpayer that has properly changed to the method of accounting provided in Rev. Proc. 2013-24, 2013-22 I.R.B. 1142, for steam or electric generation property. The revenue procedure provides definitions of units of property and major components that taxpayers may use to determine whether expenditures to maintain, replace, or improve steam or electric power generation property must be capitalized under I.R.C. Section 263(a).
- This directive provides instructions to the field on determining whether a major component pertaining to steam or electric generation property is replaced under Treas. Reg. Section 1.263(a)-3(k). Specifically, this directive provides that a major component Is replaced if "substantially all" of the major component is replaced.

(7) Background

- Taxpayers that generate steam or electric power incur significant expenditures to maintain, replace, and improve generation property. Whether these expenditures are deductible as repairs under I.R.C. Section 162 or must be capitalized as improvements under I.R.C. Section 263(a) depends on whether the expenditures improve a unit of property. The regulations under I.R.C. Section 263(a) generally require taxpayers to capitalize as improvements expenditures that constitute a betterment to a unit of property, restore a unit of property, or adapt a unit of property to a new or different use. In general, under I.R.C. Section 263(a) the cost of replacing a unit of property or major component must be capitalized. Treas. Reg. Section 1.263(a)-2, Treas. Reg. Section.1.263(a)-3(d).
- A generation plant is composed of numerous functionally interdependent items of machinery and equipment, and it can be difficult to identify which items constitute discrete units of property, major components, or something else. As a consequence, taxpayers and the Internal Revenue Service often disagree about whether the cost to replace a particular item is a capital or deductible expense.
- Rev. Proc. 2013-24 provides definitions of units of property and major components for steam or electric generation property that, if used in accordance with the requirements set forth in Rev. Proc. 2013-24, will not

be challenged by the IRS underSection 263(a) and the regulations thereunder. This directive sets forth instructions to the field related to examination activity of taxpayers that have changed their method of accounting to use the unit of property and major component definitions provided in Rev. Proc. 2013-24.

- Specifically, this directive provides direction to the field in examinations when "substantially all" of a major component has been replaced for purposes of determining whether the expenditure is for the replacement of a part or combination of parts that comprise a major component or a substantial structural part of a unit of property. See Treas. Reg. Section1.263(a)-3(k)(1)(vi). Similar direction is provided where a unit of property that has not structural components has been replaced. This directive only applies to major components, or units of property that have no major components, specifically identified in Rev. Proc. 2013-24.

(8) Planning and Examination Guidance - Tax Years Ending On or After December 31, 2012

- When examining returns of utility companies that generate steam or electric power for taxable years ending on or after December 31, 2012, examiners should not challenge the following "substantially all" determination for taxpayers adopting the method of accounting set forth in Rev. Proc. 2013-24.
  - Agents should not challenge a taxpayer's treatment of its expenditures when substantially all of a major component (or of a unit of property that has no major components) has been replaced and properly capitalized. For this purpose, the term "substantially all" means 80 percent or more.
  - Agents generally should not challenge a taxpayer's treatment of its expenditures to replace a major component (or unit of property that has no major components) as not required to be capitalized if "less than substantially all" of the major component (or unit or property that has no major components) has been replaced. For this purpose, the term "less than substantially all" means less than 80 percent. If Agents believe that such expenditures should be capitalized as an improvement (e.g., a betterment, an adaptation to a new and different use, etc.), Agents may challenge the taxpayer's treatment of the expenditures but only after consultation and concurrence by their assigned Counsel, and their Director of Field Operations.
  - Agents should not challenge the use of either of the following measurement methodologies to substantiate that less than substantially all of a major component (or a unit of property that has no major components) has been replaced---

- Comparing the actual replacement cost recorded on the taxpayer's financial statements to the undepreciated financial statement cost of the major component (or the unit of property has no major components), or
- Comparing the actual replacement cost recorded on the taxpayer's financial statements to the estimated replacement cost of the entire major component (or the entire unit of property that has no major components).

- Agents should not treat as a method of accounting a measurement methodology used by a taxpayer to substantiate that less that substantially all of a major component has been replaced. Therefore, a change in measurement methodology should not be challenged as an unauthorized change in method of accounting.
- This directive only clarifies when a major component (or a unit of property that has not major components) is replaced. The ultimate determination of whether an expenditure involving the replacement of "less than substantially all" of a major component (or a unit of property that has no major components) is deductible is based on application of the regulations. As noted above, however, challenges to the deduction of an expenditure involving replacement of less than substantially all of a major component (or a unit of property that has no major components) must be coordinated with Counsel and approved by the Agent's Director of Field Operations.

(9) If you have any questions, please contact the IPG for Deductible and Capital Expenditures.

(10) This Directive is not an official pronouncement of law and cannot be used, cited, or relied upon as such. In addition, nothing in this Directive should be construed as affecting the operation of any other provision of the Internal Revenue Code, Treasury Regulations, or guidance thereunder.

(11) cc: Division Counsel, LB&I, Chief, Appeals

K. TELECOMMUNICATIONS WIRELESS/WIRELINE DIRECTIVE

(1) The following are the steps identified in the directive below:

(2) LB&I Control No: LB&I-04-1111-021, Impacted IRM 4.51.5, January 23, 2012

(3) MEMORANDOM FOR: DIRECTOR, FIELD SPECIALISTS DIRECTOR, PREFILING AND TECHNICAL GUIDANCE, DIRECTOR, INTERNATIONAL BUSINESS COMPLIANCE

(4) FROM: Patricia C. Chaback /s/ Patricia C. Chaback, Large Business & International Division, Industry Director, Communications, Technology, and Media Industry

(5) SUBJECT: Large Business & International Directive, Telecommunication Carriers Change in Method of Accounting Relating to Conversion of Capitalized Assets to Repair Expense Under I.R.C. section 263(a)

(6) This memorandum provides direction to the field in the examination of an issue arising from the conversion of previously capitalized assets to a deduction for repair expense claimed by a taxpayer that provides telecommunications services. This directive is intended to provide a uniform format and approach for examiners to evaluate potential compliance risk related to this issue.

(7) Background

- Taxpayers that provide telecommunications services incur significant expenditures to maintain, replace, and improve network property. Whether these expenditures are deductible as repairs under IRC Section 162 or must be capitalized as improvements under IRC Section 263(a) depends on whether the expenditures materially increase the value of the property or substantially prolong its useful life. See Treasury Regulation Section 1.162-4. Applying capitalization principles to telecommunications network assets can be particularly difficult, largely because the property consists of a network of interconnected items such as mobile telephone switching offices and property located at cell sites for wireless telecommunications services, or central office equipment, poles, copper wire, fiber optic cable and remote and network terminals for wireline telecommunications services.
- To resolve this issue in a manner that conserves resources of both the Internal Revenue Service (Service) and taxpayers, the Service issued Revenue Procedure 2011-27, 2011-18 I.R.B. 1, which sets forth two alternative safe harbor approaches for taxpayers who provide wireline telecommunications services to use when determining whether expenditures to maintain, replace, or improve wireline network assets must be capitalized. The two alternative safe harbor methods involve a network asset maintenance allowance method or a “units of property” method. The Service also issued Revenue Procedure 2011-28, 2011-18 I.R.B. 1, which provides similar safe harbor approaches for taxpayers who provide wireless telecommunication services. Both Revenue Procedure 2011-27 and Revenue Procedure 2011-28 are effective prospectively, for taxable years ending on or after December 31, 2010.
- The use the safe harbor approaches included in these Revenue Procedures is only permitted under the terms and conditions contained therein and should not be considered for purposes of resolving capitalization issues in prior open exam years. This directive provides the guidance for addressing prior open exam years.

(8) Planning and Examination Guidance - Tax Years Ending Before December 31, 2010

- For the tax years ending before December 31, 2010, examiners should discontinue any current examination of the conversion of previously capitalized assets to a deduction for repair expense issue. This examination discontinuation only applies to positions taken on original returns filed for tax years ending before December 31, 2010. Please contact the LB&I Issue Practice Group for Deductible and Capital Expenditures for guidance on claims.
- The taxpayer will be allowed a two-year period to adopt one of the safe harbor methods discussed in either Revenue Procedure 2011-27 for wireline carriers or Revenue Procedure 2011-28 for wireless carriers. If the taxpayer has not adopted a safe harbor method for its first or second taxable year ending on or after December 31, 2010, the examiner should follow the guidance under Planning and Examination Guidance – Tax Years Ending On or After December 31, 2010, as provided in the next section.
- Discontinuing the examination of the repair expense should include the following steps:
    - Revoke any outstanding Form 4564, Information Document Request, relating to the development of the issue.
    - Revoke any outstanding Form 5701, Notice of Proposed Adjustment, which proposed an adjustment to repair expense related to a capital conversion.
    - Develop and issue a Form 886-A, Explanation of Adjustments, with the following language:
        - The Service neither accepts nor rejects the position stated in the tax return related to the method to determine the proper repair expense with respect to telecommunication network assets. [Insert taxpayer name] will be allowed a two-year period to adopt a safe harbor method as discussed in Revenue Procedure 2011-27 for a wireline carrier or Revenue Procedure 2011-28 for a wireless carrier. If the safe harbor for units of property is adopted, a change in method of accounting can be made in accordance with Section 7 of the applicable revenue procedure for all of the assets, or for one or some of the assets listed in Section 6 of that revenue procedure. For those asset descriptions that the safe harbor for units of property is elected, the taxpayer's method of accounting will be accepted without performing further examination procedures. If a change in method of accounting is made to adopt the Network Asset Maintenance Allowance method consistent with Section 5 of the applicable revenue procedure, and the computation method so described is properly applied, then the examiner should accept the reported repair expense as filed without performing further examination procedures. If the

[Insert taxpayer name] has not adopted a safe harbor method in its first or second taxable year ending on or after December 31, 2010, the repair expense will be subject to risk assessment and possible examination.

- If the taxpayer filed a Form 3115, Change in Method of Accounting, in the year under examination, then include a statement that the Service neither accepts nor rejects the method described in the Form 3115. In the year the taxpayer adopts the safe harbor method of accounting the IRC Section 481(a) adjustment will be subject to risk assessment and possible examination. The Form 886-A should also include a statement that if the taxpayer has not adopted one of the safe harbor methods within the two-year adoption period, the taxpayer's accounting method and determination of the proper IRC Section 481(a) adjustment will be subject to risk assessment and possible examination.
- After the taxpayer has signed the Form 886-A, Explanation of Adjustments, upload the document into the Information Management System (IMS) to substantiate for the subsequent examination team that the taxpayer was notified of the Service's position to discontinue the examination of the issue.
- Complete a Form 5346, Examination Information Report, in accordance with the specific instructions provided for this issue, located on the LB&I Issue Practice Group website for Deductible and Capital Expenditures.
- Confirm the issue was input into IMS as follows: UIL 263.14-01, and Issue Tracking Attribute Code 1400.

(9) Planning and Examination Guidance – Tax Years Ending On or After December 31, 2010

- For tax years ending on or after December 31, 2010, when examining returns of telecommunication carriers, examiners should determine if a change in method of accounting was made to adopt a safe harbor method described in either Revenue Procedure 2011-27 for wireline carriers or Revenue Procedure 2011-28 for wireless carriers.
- The taxpayer may change its method of accounting to adopt the safe harbor for unit of property with respect to all of its assets or with respect to one or some of its assets. If all of the taxpayer's units of property are consistent with those found in Section 6 of the applicable revenue procedure, then the examiner should accept the repair expense as filed. If only some, but not all, of the taxpayer's units of property are consistent with those found in Section 6 of the applicable revenue procedure, then the examiner should perform a risk assessment to determine the

materiality of the repair deduction claimed with respect to the network assets. If the results of the risk assessment are deemed to be material, the examiner should examine the deduction.

- If the taxpayer adopted the Network Asset Maintenance Allowance method, the examiner should request that the taxpayer provide a breakdown of the computation that is required to be filed with the tax return, by legal entity in order to conduct a risk analysis. Once the examiner ascertains that the taxpayer computed the network asset additions in accordance with Section 5 of either Revenue Procedure 2011-27 for wireline carriers or Revenue Procedure 2011-28 for wireless carriers, the examiner should accept the additional repair expense as filed.

(10) True-up Requirement. When performing the risk assessment, the examiner should also consider if the IRC Section 481(a) adjustment was computed accurately. If prior to the issuance of Revenue Procedure 2011-27 and Revenue Procedure 2011-28 the taxpayer had filed a Form 3115, Change in Accounting Method, to change the treatment of expenditures for network assets, then the I.R.C. Section 481(a) adjustment resulting from a change to the Rev. Proc. 2011-27 or Rev. Proc. 2011-28 safe harbor method ("new I.R.C. Section 481(a) adjustment") should account for any previous I.R.C. Section 481(a) adjustment ("old I.R.C. Section 481(a) adjustment"). The taxpayer should also ensure that the new I.R.C. Section 481(a) adjustment properly accounts for network assets that were computed under the taxpayer's prior method, in the interim years between the old and new I.R.C. Section 481(a) adjustments.

(11) If the taxpayer did not adopt a safe harbor method, then the agent should perform a risk assessment to determine the materiality of the repair deduction claimed with respect to the network assets. If the result of the risk assessment is deemed to be material, the examiner should examine the deduction utilizing IRC Section 263(a) and the Treasury Regulations thereunder.

(12) Contacts

- If you have any questions, please contact the LB&I Issue Practice Group for Deductible and Capital Expenditures.

(13) This Directive is not an official pronouncement of law, and cannot be used, cited, or relied upon as such.

(14) cc: Commissioner, LB&I Deputy Commissioner, Operation Deputy Commissioner, International Division Counsel, LB&I Chief, Appeals Directors, Field Operations Director, Pre-filing and Technical Guidance

L. TELECOMMUNICATIONS CABLE NETWORK ASSETS DIRECTIVE

(1) The following are the steps identified in the directive below:

(2) LB&I Control No: LB&I-04-0415-003, Impacted IRM 4.51.2, April 16, 2015

(3) MEMORANDUM FOR: ALL LARGE BUSINESS AND INTERNATIONAL DIVISION EMPLOYEES

(4) FROM: Heather C. Maloy /s/ Heather C. Maloy, Commissioner, Large Business & International Division Technology, and Media Industry

(5) SUBJECT: LB&I Directive on the Examination of Taxpayers using the Safe Harbor Methods of Accounting for Cable Network Assets

(6) This memorandum provides direction to the field in the examination of taxpayers using the safe harbor methods of accounting for cable network assets described in Rev. Proc. 2015-12, 2015-2 I.R.B. 266 (Rev. Proc. 2015-12). Rev. Proc. 2015-12 provides safe harbor approaches to determine:

- Whether expenditures to maintain, replace, or improve cable network assets may be deducted or must be capitalized,
- Whether the costs of customer drops and customer premise equipment (CPE) may be deducted or must be capitalized,
- Treatment of the asset and placed in service date of a node and fiber optic cable for depreciation purposes, and
- Whether for depreciation purposes cable distribution network assets are primarily used for providing one-way or two-way communication services.

(7) I. Methods for Deductible or Capital Expenditures for Network Assets and Customer Drops

- Background
  - Cable system operators and their affiliates that provide video, high-speed internet, and voice-over-internet-protocol (VOIP) telephone services incur significant expenditures to maintain, replace, and improve network property. Whether these costs may be deducted as repairs under I.R.C. section 162 or must be capitalized as improvements under section 263(a) depends on whether the costs are for a betterment to the unit of property, restore the unit of property, or adapt the unit of property to a new or different use. See Treas. Reg. Section 1.162-4 and 1.263(a)-3(d). Cable network assets include property consisting of operating plant and equipment that receive signals and convey signals between the headend and customer premises, including signal-receiving equipment, encoding, and decoding devices, cables, connectors, switches, amplifiers, and distribution equipment at or near customer locations. Capitalization principles can be particularly difficult to apply to cable network assets because determining the units of property that comprise the network assets is difficult. As a result, taxpayers, and the Internal Revenue

Service (“Service”) have often disagreed whether the replacement of a particular item is an improvement that must be capitalized.

- To resolve this issue in a manner that conserves the resources of both the Service and taxpayers, the Treasury Department and the Service issued Rev. Proc. 2015-12. Revenue Procedure 2015-12 provides two alternative safe harbor approaches to determine whether expenditures to maintain, replace, or improve cable network assets may be deducted as repairs under section 162 or must be capitalized as improvements under section 263(a) or as property produced by the taxpayer under section 263A: (1) a “network asset maintenance allowance” method and (2) a “units of property” method.
- Revenue Procedure 2015-12 also provides two alternative methods for determining whether the costs of customer drops may be deducted as repairs under section 162 or must be capitalized as improvements under section 263(a) or as property produced by the taxpayer under section 263A: (1) a “specific identification” method, and (2) a safe harbor allocation method.
- Revenue Procedure 2015-12 is effective for taxable years ending after December 31, 2013. The eligibility rules in section 5.01(1)(d) and (f) of Rev. Proc. 2015-13, 2015-5 I.R.B. 419, do not apply to a cable system operator that changes to a method of accounting provided in section 5, section 6, or section 7 of Rev. Proc. 2015-12 for its first or second taxable year ending after December 31, 2013.
- The use of the safe harbor methods of accounting under section 263(a) provided by Rev. Proc. 2015-12 are only permitted under the terms and conditions contained therein and should not be considered for purposes of resolving capitalization issues in prior open exam years. This directive provides instruction for addressing open exam years.

- Application
  - This directive applies to the examination activity of positions taken on original returns relating to the following issues (hereinafter “Issues”).
    - Whether costs incurred to maintain, replace, or improve cable network assets may be deducted under section 162 or must be capitalized under section 263(a) or section 263A, see designated change number 208.
    - Whether costs incurred for customer drops and CPE installations may be deducted under section 162 or must be capitalized under section 263(a) or section 263A, see designated change number 209. and

- Any correlative issues involving the disposition of structural components of a building or dispositions of cable network assets (other than a building or its structural components), see designated change numbers 205 and 206, respectively.

- Examination of Tax Years Ending Before January 1, 2014
  - You should discontinue current exam activity with regard to the Issues.
  - You should not begin any new exam activity with regard to the Issues.
  - You should take the following steps to discontinue the exam activity with regard to the Issues.
    - Withdraw Forms 4564, Information Document Request, or portions thereof, relating to the development of these Issues.
    - Withdraw all currently issued Forms 5701, Notice of Proposed Adjustment, which propose an adjustment to these Issues.
    - Develop and issue a new Form 5701 with a Form 886-A, Explanation of Adjustments, containing the following language:
    - The Service neither accepts nor rejects the position taken in the tax return related to the method to determine the proper treatment of amounts incurred to repair tangible property. [Insert taxpayer name] will be allowed a two-year period to adopt the appropriate method of accounting provided in Rev. Proc. 2015-12. If an appropriate method is adopted, a change in method of accounting can be made in accordance with section 5, 6, or 7 of the applicable Rev. Proc. for all property (designated change numbers 208 and 209). If [Insert taxpayer name] has not changed its accounting method consistent with Rev. Proc. 2015-12 in its first or second taxable year ending after December 31, 2013, then the repair expense will be subject to risk assessment and possible examination for tax years ending on or after December 31, 2015.
  - After the taxpayer has signed the Form 5701 with the Form 886-A, Explanation of Adjustments, upload the documents into the Information Management System (IMS) to substantiate for the subsequent examination team that the taxpayer was notified that the Service has discontinued examination of the Issues. Input into IMS as follows: UIL 263.14-01; and Issue Tracking Attribute Code 1400.
  - Retain copies of pertinent workpapers in the IMS file or other central location permitted by IRM 4.46.7.2.3(3)(c) and (d).
  - Complete the Form 5346, Examination Information Report, in accordance with the specific instructions provided for this issue

located on the Deductible and Capital Expenditures Issue Practice Group (DCE IPG) website.

- Examination of Tax Years Ending After December 31, 2013
  - When examining returns of cable companies for taxable years ending after December 31, 2013, examiners should determine if the taxpayer filed a Form 3115, Application for Change in Accounting Method, to change to any of the methods provided in sections 5 (Network Asset Maintenance Allowance Method for Cable Network Assets), 6 (Units of Property for Cable Network Assets), or 7 (Customer Drop and CPE Installation Costs) of Rev. Proc. 2015-12.
    - If the taxpayer changes to any of the methods provided in sections 5, 6, or 7, then the examiner should determine if the change is consistent with Rev. Proc. 2015-12 (including whether the section 481(a) adjustment was accurately computed). If the change is not consistent, then a determination needs to be made whether the taxpayer correctly changed to the method, and the examiner, if needed, may consult with the Deductible and Capital Expenditure IPG for further assistance.
    - Section 481(a) adjustment
      - A change in method of accounting under Rev. Proc. 2015-12 requires a Section 481(a) adjustment. It does not include any amount for any taxable year attributable to property for which the taxpayer elected to apply the repair allowance.
      - If, prior to the issuance of Rev. Proc. 2015-12, the taxpayer filed a Form 3115 to change the treatment of expenditures for cable property, then the section 481(a) adjustment resulting from a change under Rev. Proc. 2015-12 (“new section 481(a) adjustment”) should account for any previous section 481(a) adjustment (“old section 481(a) adjustment”).
      - The new section 481(a) adjustment must properly account for cable property repair expenses that were computed under the taxpayer’s prior method and deducted under section 162 in the interim years between the old and new section 481(a) adjustments.
    - If the taxpayer does not change to either safe harbor method provided in sections 5 or 6 or one of the safe harbors in section 7 of Rev. Proc. 2015-12 for the first taxable year ending after December 31, 2013, then the examiner should not commence any examination activity with respect to the Issues since the taxpayer

could still change to the method for the second taxable year ending after December 31, 2013.

- If the taxpayer does not change to either safe harbor method provided in sections 5 and 6 or one of the safe harbors in section 7 of Rev. Proc. 2015-12 for the first or second taxable year ending after December 31, 2013, then the agent should perform a risk assessment to determine the materiality of the repair deduction claimed with respect to the cable property. If the result of the risk assessment is deemed to be material, the examiner should examine the deduction under section 263(a) and the Treasury Regulations thereunder.

(8) II. Prior Guidance Clarified and Expanded

- Two other areas covered in Rev. Proc. 2015-12 involve treatment of the asset and placed in service date of a node and fiber optic cable for depreciation purposes and whether cable distribution network assets are primarily used for providing one-way or two-way communication services for depreciation purposes. Both of these areas were previously discussed in Rev. Proc. 2003-63, 2003-2 C.B. 304, and are either clarified or expanded upon in Rev. Proc. 2015-12. Revenue Procedure 2003-63 was superseded by Rev. Proc. 2015-12.
- Examination of Tax Years Ending Before January 1, 2014
  - For taxable years ending on or before December 31, 2013, the examiner should make sure the taxpayer followed the guidance described in Rev. Proc. 2003-63. See Rev. Proc. 2015-14 section 6.08(1).
- Examination of Tax Years Ending After December 31, 2013
  - Section 8 of Rev. Proc. 2015-12 provides the same safe harbor method provided in Rev. Proc. 2003-63 under which a fiber optic transfer node and trunk line consisting of fiber optic cable used in a cable distribution system are treated as the asset for depreciation purposes. Section 8, however, clarified the definitions in that section and they apply only for purposes of Section 167 and 168.
  - For tax years ending after December 31, 2013, as under sections 5, 6, and 7, the taxpayer under section 8 can change to the safe harbor in the first or second taxable year ending after December 31, 2013. The examiner should make sure the taxpayer followed the correct methods to change under Rev. Proc. 2015-12 and Rev. Proc. 2015-14 section 6.42.
- Section 9 of Rev. Proc. 2015-12 - Primary Use Determination

- In determining whether a tested asset is primarily used for providing one-way or two-way communication services to subscribers, a cable system operator must determine primary use by using any reasonable manner that is consistently applied to the tested asset. Revenue Procedure 2003-63 first addressed methods in determining primary use. Section 9 of Rev. Proc. 2015-12 further clarifies that determining primary use solely by bandwidth is not reasonable and provides that a reasonable manner includes, but is not limited to, determining primary use by gross receipts or by subscriber count for each service within the applicable cable system. In addition, section 9 provides a safe harbor manner for determining whether a tested asset is primarily used for providing one-way (7-year property) or two-way (15-year) communication services to subscribers. The safe harbor manner for making the determination, if properly applied, will not be challenged by the Service. A taxpayer may use different reasonable manners to determine primary use from taxable year to taxable year.
- Under section 9 of Rev. Proc. 2015-12, if there is a change in the classification of the asset, taxpayers are to follow the change in use guidelines under Treasury Regulation section 1.168(i)-4. Examiners will determine if the safe harbor was applied properly and, if applicable, whether the application of the regulations for change in use was done correctly.

(9) Contacts

- For further guidance regarding this directive, please contact the Deductible and Capital Expenditures Issue Practice Group or the Methods of Accounting & Timing Issue Practice Group.

(10) This Directive is not an official pronouncement of law and cannot be used, cited, or relied upon as such.

(11) cc: Division Counsel, LB&I, Chief, Appeals

M. RAILROAD DIRECTIVE

(1) The following are the steps identified in the directive below:

(2) LB&I Control No: LB&I-04-1212-013, Impacted IRM 4.51.5, December 7, 2012

(3) MEMORANDUM FOR: ALL LARGE BUSINESS & INTERNATIONAL EMPLOYEES

(4) FROM: Heather C. Maloy /s/ Heather C. Maloy Commissioner, Large Business & International Division

(5) SUBJECT: Railroad Industry Capitalization Issues Impacted by the March 15, 2012, Stand Down Directive (LB&I-4-0312-004) Released after the Temporary Tangible Regulations were Issued December 23, 2011

(6) This memorandum provides direction to the field for the examination of railroad industry taxpayers.

(7) Background

- Temporary Tangible Regulations (issued on December 23, 2011) provide examples that illustrate routine maintenance rules and betterments rules for locomotives and freight cars. LB&I issued a directive to the field (LB&I-4-0312-004; March 15, 2012) (hereinafter referred to as the "stand down directive") requiring agents to stand down or suspend current examination activity on certain issues involving:
  - Whether costs incurred to maintain, replace, or improve tangible property must be capitalized under I.R.C. Section 263(a); and
  - Any correlative issues involving the disposition of structural components of a building or dispositions of tangible depreciable assets.
- Questions have been raised concerning the application of the stand down directive to issues addressed in two previous LB&I Field Guidance Directives for the examination of railroad industry taxpayers. These two Directives were issued on March 4, 2005, and concern cyclical overhauls, betterments and rebuilds of locomotives and freight cars for Class I railroads.

(8) Scope of this Directive

- This directive applies to current examination activity that includes Railroad Industry issues concerning the cyclical overhauls, betterments and rebuilds of locomotives and freight cars for Class I railroads.

(9) Planning and Examination Guidance

- The Temporary Tangible Regulations apply to the issues pertaining to the cyclical overhauls, betterments and rebuilds of locomotives and freight cars for Class I railroads. Therefore, the stand down directive is applicable and examiners should follow the steps as outlined in the directive.

(10) Field Guidance Directives Withdrawn

- The following directives are withdrawn and are no longer effective:
  - 1. 03-04-05 Field Guidance on the Planning and Examination of the Cyclical Overhauls, Betterments, and Rebuilds of Locomotives for Class I Railroads

- 2. 03-04-05 Field Guidance on the Planning and Examination of the Cyclical Overhauls, Betterments, and Rebuilds of Freight Cars for Class I Railroads

(11)Previously Published Guidance

- The Temporary Tangible Regulations do not alter or invalidate previously published guidance addressing the treatment of network assets for particular industries, such as the track maintenance allowance method for Class I, II or III railroads. Therefore, the stand down directive is not applicable and examiners should not follow the stand down directive for these issues (see Rev. Proc. 2002-65 (2002-2 CB 700) and Rev. Proc. 2001-46 (2001-2 CB 263)).

(12)Contacts

- For further guidance regarding this directive, please contact a member of either the Deductible and Capital Expenditures or the Methods of Accounting and Timing Issue Practice Groups.

(13)This Directive is not an official pronouncement of law, and cannot be used, cited, or relied upon as such.

(14)cc: Division Counsel, LB&I, Chief, Appeals

N. MINING UNITS OF PROPERTY AND MAJOR COMPONENTS DIRECTIVE

(1) The following are the steps identified in the directive below:

(2) LB&I Control No: LB&I-04-0917-004, Impacted IRM 4.51.2, September 11, 2017

(3) MEMORANDUM FOR: ALL LARGE BUSINESS & INTERNATIONAL EMPLOYEES

(4) FROM: Doug W. O'Donnell Commissioner, Large Business & International Division

(5) SUBJECT: Large Business & International Directive for Determining Units of Property and Major Components in the Mining Industry

(6) This memorandum is intended to provide technical guidance to effectively reduce exam time and taxpayer burden. The matrix contained in Attachment A is intended only to assist agents in determining the units of property (UOP) and major components frequently used in the mining industry as addressed in Treas. Reg. Section 1.263(a)-3(e). The tangible property regulations must then be applied to determine whether expenditures replace or improve tangible property and must be capitalized under I.R.C. Section 263(a).

(7) Background

- Taxpayers in the mining industry incur significant expenditures to repair, maintain, replace, and improve mining property. Whether these expenditures are deductible as repairs under I.R.C. Section 162 or must be capitalized as improvements under I.R.C. Section 263(a) depends on whether the expenditures improve or repair a UOP. The regulations under I.R.C. Section 263(a) generally require taxpayers to capitalize as improvements expenditures that constitute a betterment to a UOP, restore a UOP, or adapt a UOP to a new or different use.
- Mining property is composed of numerous functionally interdependent items of machinery and equipment, and it can be difficult to identify which items constitute discrete units of property, major components, or something else under the tangible property regulations. Consequently, taxpayers and the Internal Revenue Service may disagree about whether the cost to replace a particular item is a capital expenditure or a deductible expense.

(8) Planning and Examination Risk Analysis – Tax Years Beginning on or after January 1, 2014.

- The final regulations are applicable to taxable years beginning on or after January 1, 2014. A taxpayer also had the option to apply the regulations to taxable years beginning on or after January 1, 2012, and before January 1, 2014.
- The final regulations provide rules for determining whether a taxpayer must treat amounts related to tangible property as improvements to property, and as a result, whether a taxpayer must capitalize the costs of such improvements under I.R.C. Section 263(a) and recover such costs in accordance with I.R.C. Section 167 and 168. Under Treas. Reg. Section 1.263(a)-3(d), amounts are characterized as improvements if they are for betterments to the UOP or adapt the UOP to a new or different use. In order to apply these criteria, a taxpayer must first identify the UOP that is the subject of this analysis.
- The final tangible regulations under Treas. Reg. Section 1.263(a)-3(e), provide new rules for identifying the UOP to which the improvement analysis must be applied. For tangible real or personal property other than buildings, Treas. Reg. Section 1.263(a)-3(e)(3) defines a UOP as all the components that are functionally interdependent. Under this “functional interdependence test,” components are functionally interdependent if the placing in service of one component by the taxpayer is dependent on the placing in service of another component. However, if the non-building property is comprised of “plant property,” a taxpayer must do further analysis to identify the UOP.

- For plant property (i.e., machinery or equipment used to perform an industrial process, such as manufacturing, generation, warehousing, distributions, automated materials handling, or other similar activities), the UOP is determined by first applying the functional inter-dependence test and then dividing the functionally interdependent property into each component (or group of components) that perform a discrete and major function or operation within such functionally interdependent property. See Treas. Reg. Section 1.263(a)-3(e)(3)(ii)(B).
- In determining whether an amount is paid for an improvement to a UOP, another important inquiry is whether the expenditure is for the replacement of a major component of a UOP. Under Treas. Reg. Section 1.263(a)-3(k)(1)(vi) and (k)(6), an amount is paid for a restoration of a UOP, and therefore, is considered an improvement to that UOP, if it is paid for the replacement of a part or combination of parts that is a major component. A major component is further defined under Treas. Reg. Section 1.263(a)-3(k)(6)(i)(A) as a part that is not incidental and that performs a discrete and critical function in the operation of the UOP. Thus, once the taxpayer identifies the appropriate UOP, to apply the restoration criteria for improvements, the taxpayer may have to complete another analysis of the UOP by then identifying its major components.
- The tangible property regulations contain a “routine maintenance safe harbor.” Expenditures falling within this safe harbor are deemed to not improve the UOP. The safe harbor definition for routine maintenance on property other than buildings is provided in Treas. Reg. Section 1.263(a)-3(i)(1)(ii). Aside from determining the appropriate UOP upon which to apply the routine maintenance safe harbor, nothing in this directive changes the application of the routine maintenance safe harbor in accordance with the regulations.

(9) Taxpayer Under Examination

- When examining returns of mining industry taxpayers for taxable years beginning on or after January 1, 2012, examiners should determine if the taxpayer filed a Form 3115, Application for Change in Accounting Method, to change its method of identifying the UOP for purposes of deducting amounts paid or incurred for repair and maintenance or for purposes of capitalizing amounts paid or incurred for improvements to tangible property in compliance with Rev. Proc. 2014-16, 2014-9 I.R.B. 606, Rev. Proc. 2015-14, 2015-5 I.R.B. 450, Rev. Proc. 2016-29, 2016-21 I.R.B. 880, or Rev. Proc. 2017-30, 2017-18 I.R.B. 1131 (whichever applicable).
- If the taxpayer changed its method for taxable years on or after January 1, 2012, the examiner should determine if the change (including the IRC Section 481(a) adjustment) is consistent with the categorization in the Mining Industry UOP and Major Component Matrix – Attachment A. If so,

the examiner should not make adjustments to the UOP or major components for purposes of applying the tangible property regulations.

- If the taxpayer did not change its method for taxable years on or after January 1, 2012, or the change is not consistent with the categorization in Attachment A, and
    - The mining industry taxpayer wants to apply the provisions of this Directive, LB&I examiners, in consultation with the taxpayer, will decide whether the most appropriate way to implement this Directive is to make a Service-imposed change to the taxpayer's method of accounting for the UOP and major components or for the taxpayer to file a Form 3115 to change its method of accounting to be consistent with this Directive. The examiner may consult with the Deductible and Capital Expenditure Practice Network for further assistance.
    - The mining industry taxpayer does not want to apply the provisions of this Directive, LB&I examiners should consult with the Deductible and Capital Expenditure Practice Network for further assistance.

(10)Taxpayer Not Under Examination

- A taxpayer that chooses to change the definition of its UOP and major components as described in this directive must follow the automatic change in method of accounting provisions contained in section 11.08 of Rev. Proc. 2017-30, 2017-18 I.R.B. 1131. Such a change constitutes a change in method of accounting to which the provisions of I.R.C. Section 446 and 481, and the associated regulations thereunder, apply.

(11)Application

- This directive is intended only to clarify the definition of a UOP or major component. A taxpayer may not rely on the UOP definitions provided in this directive for any other purpose of the Code or Regulations, including but not limited to, determining the UOP under other Code sections (for example, I.R.C. Section 263A), or determining the asset for depreciation purposes (including placed in service dates, retirement, disposition, or classification), under I.R.C. Section 168(e) or Rev. Proc. 87-56, 1987-2 C.B. 674, for the same or similar type of assets used in the mining industry.

(12)Contact Information

- If you have any questions, please contact the Deductible and Capital Expenditures Practice Network for assistance.

(13)This Directive is not an official pronouncement of law and cannot be used, cited, or relied upon as such. In addition, nothing in this Directive should be construed as affecting the operation of any other provision of the Internal Revenue Code, Treasury Regulations, or guidance thereunder.

(14) Attachment A

(15)cc: Division Counsel, LB&I Chief, Appeals

(16)Attachment A

- Mining Industry Unites of Property and Major Components
  - This matrix is intended to assist in determining the unit of property ("UOP") and major components as described in Treas. Reg. Section 1.263(a)-3(e)(2), (3) and 1.263(a)-3(k)(6).
  - For purposes of this matrix, the term "mine" means any excavation or other workings or series of related excavations or related workings for extracting any known mineral deposit except oil and gas deposits. The terms "excavations" and "workings" include quarries, pits, shafts, underground excavations, and wells (except oil and gas wells).
  - Each UOP or major component that is driven by a motor (e.g., electric, gas, hydraulic, or diesel) includes the motor with that UOP unless otherwise indicated below. Units of property unique to a mine are considered separately. Units of property that are shared jointly with two or more mines are considered one UOP.
  - Not all of the units of property discussed below are necessarily present at all mines; for example, some mines do not have a dragline. Similarly, not all of the identified major components are necessarily present in a UOP; for example, a continuous miner may or may not contain an integrated bolter.
  - Further, in certain circumstances, the regulations and other guidance published in the Internal Revenue Bulletin provide special UOP rules or alternative methods of accounting for some types of property referenced in this matrix. Specifically, Treas. Reg. Section 1.263(a)-3(e)(5) provides that certain tangible building and non-building components must be treated as separate units of property if the taxpayer properly utilizes a different asset class or method of depreciation for a particular component.
  - Similarly, Rev. Proc. 2002-27 provides a safe harbor method of accounting for the costs of original and replacement tires for certain qualifying vehicles property if the taxpayer chooses to utilize such method for all such property. Thus, to the extent that a mining industry taxpayer has property that qualifies under Treas. Reg. Section 1.263(a)-3(e)(5) or properly utilizes the accounting methods

authorized under Rev. Proc. 2002-27, the identification of units of property or major components in this matrix do not affect the determinations or treatment under those provisions. For example, if this matrix identifies “tire sets” as a major component of a UOP for certain mining vehicles, but the taxpayer properly utilizes the original tire capitalization method under Rev. Proc. 2002-7 for those tires or the properly classifies those tires as having a different recovery period than the underlying property under Treas. Reg. Section 1.263(a)-3(e)(5), then the UOP determinations and/or treatment afforded under those specific provisions will be respected. See also Treas. Reg. Section 1.263(a)-3(e)(6), Example 16.

- SUBSURFACE MINING PROPERTY
  - Longwall System. Each longwall system consists of the following units of plant property (shearer through electrical distribution panel).
  - Shearer
    - Each shearer is a single UOP. Each shearer contains/may contain the following major components:
      - Gear case including motor,
      - Cutting heads including motor, and
      - Shearer undercarriage, including tram system and motors.
  - Hydraulic Roof Support
    - Each hydraulic roof support (shield) is a single UOP. Each hydraulic roof support contains/may contain the following major components:
      - Hydraulic cylinder/legs including valve,
      - Canopy, and
      - Base.
  - Armored Face Conveyor/Panline
    - Each armored face conveyor/panline is a single UOP. Each armored face conveyor/panline contains/may contain the following major components:
      - Drive Motor,
      - Conveyor chain, and
      - Frame including pan.

- Stage Loader
    - Each stage loader is a single UOP (transfer point between the panline and conveyors). Each stage loader contains/may contain the following major components:
        - Drive motor,
        - Conveyor chain,
        - Crusher, and
        - Frame.
- Hydraulic Pump
    - Each Hydraulic pump (including motor) is a single UOP.
- Electrical Distribution Panel
    - Each electrical distribution panel comprises a single UOP.
- Continuous Miner. Each continuous miner is a single UOP. Each continuous miner contains/may contain the following major components:
    - Drive motor,
    - Conveyor,
    - Drum,
    - Gathering arm (pot),
    - Integrated bolter,
    - Hydraulic system,
    - Undercarriage, and
    - Track set.
- Roof Bolter. Each roof bolter is a single UOP. Each roof bolter contains/may contain the following major components:
    - Electric Motor,
    - Hydraulic system,
    - Undercarriage, and
    - Tire set.
- Rotary & Percussion Drills. Each rotary or percussion drill is a single UOP. Each rotary or percussion drill contains/may contain the following major components:

    - Motor,
    - Hydraulic system,
    - Boom,
    - Undercarriage,
    - Track set, and
    - Tire set.
- Track Haulage/Rail System. Each track haulage/rail system within a set capacity comprises a single UOP. Track haulage/rail systems of different capacities comprise separate units of property, (for example, an 80-pound track haulage/rail system would be a separate UOP from a 40-pound track/rail system).
- Locomotive. Each locomotive constitutes a single UOP (includes electric motor locomotives). Each locomotive contains/may contain the following major components:
    - Each diesel engine,
    - Each generator,
    - Each battery set,
    - Each traction motor,
    - Control system,
    - Each truck set,
    - Body, and
    - Frame.
- Rail Car. Each rail car constitutes a single UOP. Each rail car contains/may contain the following major components:
    - Each coupler system,
    - Truck set, and
    - Body.
- Shuttle Car. Each shuttle car is a single UOP. Each shuttle car contains/may contain the following major components:
    - Drive motor,
    - Conveyor,
    - Hydraulics,
    - Undercarriage, and

    - Tire set.
- Scoop/Ram Car/Mucker. Each scoop, ram car, or mucker is a single UOP. Each scoop, ram car, or mucker contains/may contain the following major components:
    - Drive motor,
    - Battery packs,
    - Bucket,
    - Hydraulic system,
    - Undercarriage, and
    - Tire set.
- Loading Machine. Each loading machine is a single UOP. Each loading machine contains/may contain the following major components:
    - Drive motor,
    - Gathering arms including motor,
    - Conveyor including motor,
    - Undercarriage, and
    - Track set.
- Primary Ventilation System. Each primary ventilation system is a single UOP. Each primary ventilation system includes/may include the following major components:
    - Each primary ventilation fan (including booster and bleeder fans) and the respective fan blades, housings, and motors is a major component. Auxiliary fans in the nature of portable supplemental ventilation equipment are not considered part of the primary ventilation system.
- Pump. Each pump is a single UOP.
- Elevator. Each elevator, skip or hoist is a single UOP.
- Conveyor System. Each conveyor system is a single UOP. Each conveyor system contains/may contain the following major components:
    - Each belt drive including head frame, controls, motor drive including take up is a major component, and
    - Each conveyor belt section, excluding the belt drive is a major component. A conveyor belt section includes all components of

the belt section, including the belt feeder, the frame, guides, and rollers, but excluding the belt drive.

- Power/Lighting System. Each power/lighting system including the main cabling for each mine is a single UOP.
- Substation. Each substation contains/may contain the following units of property (transformer through electrical devices).
- Transformer
  - Each transformer at a substation is a single UOP.
- Rectifier
  - Each rectifier at a substation is a single UOP.
- Substation Surround
  - All fencing, walls, enclosures, or other structures surrounding each substation or supporting the substation's electrical devices (excluding enclosures or buildings suitable for occupation), and land improvements that are not properly capitalized to land is a single UOP.
- Electrical Devices
  - All other electrical devices at each substation, such as load centers, fuses, breakers, other switches, regulators, insulators, meters, and the pad on which the equipment is installed collectively is a single UOP.
- Transformer. Each transformer is a single UOP.
- Load Centers. Each load center is a single UOP.

- SURFACE MINING PROPERTY
  - Highwall Miner. Each highwall miner is a single UOP. Each major component of the highwall miner includes the motor(s) associated with that major component. Each highwall miner contains/may contain the following major components:
    - Power head drive,
    - Cutting machine,
    - Control System,
    - Reel and Chain,
    - Conveyor system,
    - Push beam,
    - Undercarriage, and

- Track set.

- Auger. Each auger is a single UOP. Each major component of the auger includes the motor(s) associated with that major component. Each auger contains/may contain the following major components:
  - Power head drive,
  - Cutting head,
  - Gathering arms,
  - Control system,
  - Conveyor system,
  - Undercarriage, and
  - Track set.
- Bucket Wheel Excavator (BWE). Each BWE is a single UOP. Each major component of the BWE includes the motor(s) associated with that major component. Each BWE contains/may contain the following major components:
  - Bucket wheel,
  - Control system,
  - Conveyor system,
  - Undercarriage, and
  - Track set.
- Dragline. Each dragline is a single UOP. Each dragline contains/may contain the following major components:
  - Tub or base (includes circle rail, swing rack, and center pin),
  - Rotating frame, machinery housing, and operators cab,
  - Swing machinery (includes motors, gear cases, and swing pinions),
  - Hoist and Drag machinery (includes motors, gear cases, hoist pinions, hoist drum with bull gear, drag pinions and drag drum with bull gear),
  - Bucket,
  - Walking mechanism (includes cam assembly, shoes, propel motors, and gear cases),
  - AC Synchronous motors,
  - DC Generators,

    - Boom, mast, and A-frame (including boom support ropes, and rigging),
    - Electrical operating and control systems (transformers, rectifiers, motor control room and equipment, and computerized controls),
    - Diesel engines,
    - Undercarriage (crawler mounted draglines), and
    - Tracks (crawler mounted draglines).
- Shovel. Each Shovel is a single UOP. This UOP includes both hydraulic front shovels and electric rope shovels. Each shovel contains/may contain the following major components:
    - Hoist machinery (includes motors, gear cases, hoist pinions, and hoist drum with bull gear),
    - Swing machinery (includes motors, gear cases, and swing pinions),
    - Engine electric/diesel,
    - Drive train (including transmission, torque converter, driveline, and final drive),
    - Hydraulic system,
    - Electrical system with controls,
    - Boom and bucket arm,
    - Bucket,
    - Undercarriage, and
    - Track set.
- Dredger. Each dredger is a single UOP. Each dredger contains/may contain the following major components:
    - Dredge pump,
    - Control system,
    - Suction equipment including head, and
    - Vessel.
- Rotary & Track Drill. Each rotary or track drill is a single UOP. Each rotary or track drill contains/may contain the following major components:
    - Motor/engine,
    - Hydraulic system,

- Control system,
- Mast,
- Undercarriage,
- Drive train (including transmission, torque converter, and driveline),
- Track set, and
- Tire set.

- Track or Wheel Dozer. Each track or wheel dozer is a single UOP. Each track or wheel dozer contains/may contain the following major components:
  - Engine,
  - Drive train including transmission, torque converter, driveline, and final drive,
  - Hydraulic system,
  - Control system,
  - Blade,
  - Ripper carriage,
  - Frame or undercarriage,
  - Track set, and
  - Tire set.
- Front-End Loader. Each front-end loader is a single UOP. Each front-end loader contains/may contain the following major components:
  - Engine,
  - Drive train including transmission, torque converter, driveline, and final drive,
  - Hydraulic system,
  - Control system,
  - Bucket,
  - Ripper carriage,
  - Frame and suspension, and
  - Tire set.
- Bowl Scraper. Each bowl scraper is a single UOP. Each bowl scraper contains/may contain the following major components:

    - Engine,
    - Drive train including transmission, torque converter, driveline, and final drive,
    - Hydraulic system,
    - Control system,
    - Bowl,
    - Frame and suspension, and
    - Tire set.
- Grader. Each grader is a single UOP. Each grader contains/may contain the following major components:
    - Engine,
    - Drive train including transmission, torque converter, driveline, and final drive,
    - Hydraulic system,
    - Control system,
    - Blade,
    - Frame and suspension, and
    - Tire set.
- Hauler. Each hauler is a single UOP. This UOP includes both haul trucks and articulated haul trucks. Each hauler contains/may contain the following major components:
    - Engine or diesel electric motors,
    - Drive train, including transmission, torque converter, driveline, and final drive,
    - Hydraulic system,
    - Control system,
    - Bed,
    - Each wheel and motor set,
    - Frame and suspension, and
    - Tire set.
- Pump. Each pump is a single UOP.

- Conveyor System. Each conveyor system is a single UOP. Each conveyor system contains/may contain the following major components:
    - Each belt drive, including head frame, controls, motor drive including take up, and
    - Each conveyor belt section excluding belt drive. A conveyor belt section includes all components of the belt section including belt feeder except for the belt drive. A conveyor belt section major component includes the frame, guides, and rollers.
- Track Haulage/Rail System. Each track haulage/rail system within a set capacity is a single UOP. Track haulage/rail systems of different capacities comprise separate units of property, (for example, an 80-pound track haulage/rail system would be a separate UOP from a 40-pound track/rail system).
- Locomotive. Each locomotive is a single UOP. Each locomotive contains/may contain the following major components:
    - Each diesel engine,
    - Each generator,
    - Each traction motor,
    - Control system,
    - Each frame,
    - Each truck set, and
    - Each body.
- Rail Car. Each rail car is a single UOP. Each rail car contains/may contain the following major components:
    - Each truck set,
    - Each coupler system, and
    - Each body.

- MINING PROCESSING PLANT PROPERTY
    - Crusher. Each crusher is a single UOP. This UOP includes, but is not limited to, ball mills, roller mills, impact crusher, rotary breakers, cone crushers, and jaw crushers. This UOP includes both mobile or stationary and primary, or secondary crushers. However, in certain circumstances, crushers may function together and be functionally interdependent. In this case, two or more crushers together may be a single UOP. The facts and circumstances need to be considered in

each case. Each crusher contains/may contain the following major components:

- Drive mechanism for the crushing equipment, and
- Transport mechanism for portable crushers.

- Separator Equipment. Each separator is a single UOP. Separation machinery and equipment is used to sort material by size and separate desirable materials from non-desirable materials. The equipment includes but is not limited to heavy-media vessels, screens, Deister tables, and froth-flotation devices. However, in certain circumstances, separators may function together and be functionally interdependent. In this case, two or more separators together may be a single UOP. The facts and circumstances need to be considered in each case.
- Cleaning/Washing Equipment. Each cleaning unit is a single UOP.
- Wastewater/Recycling Water System. Each wastewater/recycling water system is a single UOP. A wastewater/recycling system that integrates multiple treatment processes into one system is a single UOP. Wholly separate and discrete wastewater/recycling water systems are treated as separate units of property. The wastewater system is the equipment that treats and disposes of wastewater. The recycling water system is the equipment that treats and recycles water used in the mining process. The wastewater/recycling water system contains/may contain the following major components:
  - Each treatment tank,
  - Each wastewater conveyance system,
  - Each barge,
  - Each pump, and
  - Instrumentation and controls.
- Solid Waste Disposal System. Each solid waste disposal system is a single UOP. A solid waste disposal system that integrates multiple treatment processes into one system is a single UOP. Wholly separate and discrete solid waste disposal systems are treated as separate units of property. The solid waste disposal system does not include land improvements. The solid waste disposal system contains/may contain the following major components:
  - Each slurry line (pipes),
  - Each pump,
  - Each belt drive, including head frame, controls, motor drive including take up,

    - Each conveyor belt section excluding belt drive. A conveyor belt section includes all components of the belt section including belt feeder except for the belt drive. A conveyor belt section major component, (includes the frame, guides, and rollers, and
    - Each cyclone.
- Settling Pond (waste impoundment). Each settling pond, including liners and blankets, is a single UOP. Each settling pond contains/may contain the following major components:
    - Each channel leading to or from the pond, and
    - Banks, berms, dams, and/or retaining walls, liners, and blankets.
- Dust Collection System. Each dust collection system is a single UOP. Wholly separate and discrete dust collection systems are treated as separate units of property. The dust collection system is a bag house, including bags and blowers.
- Dryer. Each dryer is a single UOP. The dryer equipment is the equipment that removes water from the mined product. This UOP includes different forms of dryers, such as vacuum filters, belt filters, and thermal dryers.
- Sampling System. Each sampling system is a single UOP. The sampling system is the equipment and instrumentation used to measure attributes such as size, composition, and heat content of the mined product.
- Scale Facility. Each scale facility is a single UOP. The scale facility is the equipment that measures the weight of the mineral passing this point.
- Product Storage & Management System. Each product storage and management system is a single UOP. The product storage management system receives and stores the product that has been mined. This UOP also includes the loading facilities. Each product storage and management system contains/may contain the following major components:
    - Each shed,
    - Each stacker,
    - Tipple structure and control system,
    - Loading apparatus,
    - Each silo, and
    - Product conveyance system, including reclaim tunnels.

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