Internal Revenue
bulletin

Bulletin No. 2008-18
May 5, 2008

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2008–23, page 852.

Employee leasing arrangements. This ruling addresses which party is subject to the Code section 274(n) limitation when a trucking company leases truck drivers from a leasing company and the leasing company reimburses the drivers for meal and incidental expenses they incur in the course of performing services.

Rev. Rul. 2008–24, page 861.

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 642, 1274, 1288, and other sections of the Code, tables set forth the rates for May 2008.

REG–168745–03, page 871.

Proposed regulations explain how section 263(a) of the Code applies to amounts paid to acquire, produce, or improve tangible property. The regulations clarify what amounts must be capitalized, rather than deducted currently, and how those capitalized amounts should be treated. The regulations withdraw and replace the proposed regulations issued in August 2006 under section 263(a). A public hearing is scheduled for June 24, 2008.

Notice 2008–46, page 868.

This notice provides guidance regarding implementation of the tax return preparer penalty provisions under section 6694 of the Code. Notice 2008–13 supplemented.

Notice 2008–47, page 869.

The Department of Treasury and the Service invite public comments on recommendations for items that should be included on the 2008–2009 Guidance Priority List. Taxpayers may submit recommendations for guidance at any time during the year. Recommendations submitted by May 31, 2008, will be reviewed for possible inclusion on the original 2008–2009 Guidance Priority List. Recommendations received after May 31, 2008, will be reviewed for inclusion in the next periodic update.

EMPLOYEE PLANS

Notice 2008–46, page 868.

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Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

EXEMPT ORGANIZATIONS

T.D. 9390, page 855.
Final regulations amend the existing regulations under sections 501(c)(3) and 4958 of the Code and clarify the relationship between the substantive requirements for tax exemption for public charities described in section 501(c)(3) and the imposition of section 4958 excise taxes on excess benefit transactions between public charities and their insiders. Specifically, the regulations set forth a non-exhaustive list of factors the IRS will consider in deciding whether to revoke the tax-exempt status of organizations that have engaged in excess benefit transaction(s). The regulations also add several examples to illustrate the requirement that an organization serve a public rather than a private interest. Furthermore, the regulations clarify that section 4958 does not apply at the time of the initial determination of exempt status.

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ESTATE TAX

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Notice 2008–47, page 869.
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GIFT TAX

Notice 2008–46, page 868.
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Notice 2008–47, page 869.
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EMPLOYMENT TAX

Notice 2008–46, page 868.
This notice provides guidance regarding implementation of the tax return preparer penalty provisions under section 6694 of the Code. Notice 2008–13 supplemented.

Notice 2008–47, page 869.
The Department of Treasury and the Service invite public comments on recommendations for items that should be included on the 2008–2009 Guidance Priority List. Taxpayers may submit recommendations for guidance at any time during the year. Recommendations submitted by May 31, 2008, will be reviewed for possible inclusion on the original 2008–2009 Guidance Priority List. Recommendations received after May 31, 2008, will be reviewed for inclusion in the next periodic update.

SELF-EMPLOYMENT TAX

Notice 2008–46, page 868.
This notice provides guidance regarding implementation of the tax return preparer penalty provisions under section 6694 of the Code. Notice 2008–13 supplemented.

(Continued on the next page)

EXCISE TAX

T.D. 9390, page 855.
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TAX CONVENTIONS

Announcement 2008–39, page 867.
This announcement provides interim guidance concerning the "commencement date" for Mutual Agreement Procedure (MAP) cases eligible for arbitration under the December 28, 2007, Protocol to the U.S.-Germany Tax Treaty.

ADMINISTRATIVE

T.D. 9389, page 863.
REG–114942–07, page 901.
Temporary and proposed regulations under section 6103 of the Code describe the circumstances by which officers and employees of the Treasury Department may disclose return information to whistleblowers and, if applicable, their legal representatives in connection with written contracts for services relating to the detection of violations of the internal revenue laws or related statutes.

Notice 2008–47, page 869.
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The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are compiled semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2008. See Rev. Rul. 2008-24, page 861.

Section 62.—Adjusted Gross Income Defined

26 CFR 1.62–2: Reimbursements and other expense allowance arrangements.

A revenue ruling addresses which party is subject to the section 274(n) limitation when a trucking company leases truck drivers from a leasing company and the leasing company reimburses the drivers for meal and incidental expenses they incur in the course of performing services. See Rev. Rul. 2008-23, page 852.

Section 274.—Disallowance of Certain Entertainment, etc., Expenses

26 CFR 1.274–2: Disallowance of deductions for certain expenses for entertainment, amusement, recreation, or travel.
(Also §§ 62, 1.62–2.)

Employee leasing arrangements. This ruling addresses which party is subject to the Code section 274(n) limitation when a trucking company leases truck drivers from a leasing company and the leasing company reimburses the drivers for meal and incidental expenses they incur in the course of performing services.

Rev. Rul. 2008–23

ISSUE

If a Client leases employees from a Leasing Company, and the Leasing Company reimburses the employees for meal and incidental expenses (M&IE) they incur in the course of performing services, which party's deduction for reimbursement of the M&IE is subject to the limitation under § 274(n) of the Internal Revenue Code?

FACTS

Leasing Company and Client, who are unrelated parties, enter into a written employee leasing contract under which Leasing Company leases drivers to Client to haul products in exchange for Client's periodic payments to Leasing Company. The employee leasing contract provides that Leasing Company will calculate Client's periodic payments to cover Leasing Company's expenditures (wages due to drivers, payments of the M&IE to drivers under a reimbursement arrangement between Leasing Company and the drivers, and other expenses) plus a profit.

Each driver (Driver) performs services as an employee in the trucking industry. Driver incurs M&IE while traveling overnight away from home in connection with Driver's employment. In addition to receiving wages, Driver receives a separately stated reimbursement at the M&IE rate from Leasing Company. All the reimbursements paid to Driver are paid under a "reimbursement or other expense allowance arrangement," within the meaning of § 274(e)(3), between Leasing Company and Driver.

Neither Leasing Company nor Client deducts the M&IE amounts as compensation on its originally filed income tax return, nor does either treat the M&IE amounts as wages for purposes of withholding under Chapter 24. The employee leasing contract does not address which party reimburses the drivers' M&IE for purposes of applying the § 274(n) limitation. In each situation described below, either Leasing Company or Client may be the Driver's employer under the usual common law rules applicable to determining the employer-employee relationship. *See* § 31.3121(d)–1 of the Employment Tax Regulations.

Situation 1. Driver adequately accounts to Leasing Company for the M&IE to satisfy the substantiation requirements of § 274(d) pursuant to an annually updated revenue procedure, Rev. Proc. 2007–63, 2007–42 I.R.B. 809 (or any successor). After calculating Driver's wages and any M&IE payments that may be due, Leasing Company sends Client a billing invoice for a periodic payment due. The invoice is for a lump-sum and does not itemize for the amount of any M&IE reimbursement. Client pays Leasing Company the lump-sum periodic payment. Upon receiving Client's periodic payment, Leasing Company pays both Driver's wages and M&IE reimbursement.

Situation 2. Driver adequately accounts to Leasing Company for the M&IE to satisfy the substantiation requirements of § 274(d) pursuant to Rev. Proc. 2007–63 (or any successor). After Driver accounts to Leasing Company for M&IE, Leasing Company calculates Driver's wages and any M&IE payments that may be due. Leasing Company sends Client a billing invoice for a periodic payment due. The invoice is for a lump-sum and does not itemize for the amount of any M&IE reimbursement. Client pays Leasing Company the lump-sum periodic payment. Upon receiving Client's periodic payment, Leasing Company pays both Driver's wages and M&IE reimbursement. Immediately after Leasing Company pays Driver, Leasing Company sends Client a statement indicating the amount paid to Driver as a reimbursement of Driver's M&IE. Leasing Company also accounts for that amount by delivering to Client a copy of all of the substantiation that Driver had originally submitted to Leasing Company. Client accepts the substantiation submitted by Leasing Company and acknowledges that the portion of its periodic payment equal to the amount that Leasing Company paid to reimburse Driver's M&IE is paid under a reimbursement arrangement with Leasing Company and is subject to the § 274(n) limitation.

Situation 3. Driver is paid an allowance at the applicable M&IE rate by Leasing Company, but substantiates the expenses to Client. Client then immediately delivers to Leasing Company a copy of all of the information that Driver had originally submitted to Client to substantiate Driver's expenses, and Client informs Driver that it has done so. Leasing Company accepts the substantiation. Driver adequately accounts for the M&IE to satisfy the substantiation requirements of § 274(d) pursuant to Rev. Proc. 2007–63 (or any successor).

After receiving Driver's substantiation, Leasing Company calculates Driver's wages and any M&IE reimbursements that may be due. Leasing Company sends

Client a billing invoice for a periodic payment due. The invoice is for a lump-sum and does not itemize for the amount of any M&IE reimbursement. Client pays Leasing Company the lump-sum periodic payment. Upon receiving Client's periodic payment, Leasing Company pays both Driver's wages and M&IE reimbursement. Immediately after Leasing Company pays Driver, Leasing Company sends Client a statement indicating the amount paid to Driver as a reimbursement of Driver's M&IE. Leasing Company also accounts to Client by referring to the substantiation Client had received from Driver and had submitted (via a copy) to Leasing Company. Client accepts the substantiation submitted by Leasing Company and acknowledges that the portion of its periodic payment equal to the amount that Leasing Company paid to reimburse Driver's M&IE is paid under a reimbursement arrangement with Leasing Company and is subject to the § 274(n) limitation.

LAW

Section 162(a)(2) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including traveling expenses (such as M&IE) while away from home in the pursuit of a trade or business.

In general, § 274(d)(1) provides that no deduction is allowed under § 162 to a taxpayer for traveling expenses (including M&IE) unless the taxpayer substantiates the expenses. If the taxpayer is an employee and is reimbursed for M&IE by a payor (whether the employer, the employer's agent, or a third party), the employee satisfies § 274(d) by accounting to the payor with adequate records substantiating the amount of the expense, the time and place of the expense, and the business purpose of the expense. Section 1.274–5(f)(4)(i) (last sentence) and (f)(4)(iii) of the Income Tax Regulations. With some exceptions, an employee who adequately accounts for the M&IE is not again required to substantiate the expenses. Section 1.274–5T(f)(5) of the temporary Income Tax Regulations. If the payor and employee use the annually updated revenue procedure to substantiate the expenses, the M&IE amount (to the extent reimbursed and substantiated) is treated as an expense for food or beverages and is subject to § 274(n). *See* section 6.05 of Rev. Proc. 2007–63. If the taxpayer is an independent contractor and receives a payment for M&IE under a reimbursement or other expense allowance arrangement from a client, § 274(d) requires that the independent contractor account to the client with adequate records, or other sufficient evidence corroborating the independent contractor's own statement, substantiating the amount of the expense, the time and place of the expense, and the business purpose of the expense. Section 1.274–5T(h)(3). Unlike an employee, however, an independent contractor must maintain a copy of the records, or other sufficient evidence, to substantiate the expenses. Section 274(d); § 1.274–5T(h)(2).

Section 274(n)(1) generally limits the amount allowed as a deduction for any expense for food or beverages to 50 percent of the expense, although § 274(n)(3) generally imposes a lesser limitation on deductions for truck drivers' expenses. However, § 274(n)(2) excepts expenses described in § 274(e)(3) from the limitation imposed by § 274(n)(1).

Section 274(e)(3) expenses are those paid or incurred by a taxpayer in connection with the performance of services for another person (whether or not that other person is the taxpayer's employer) under a reimbursement or other expense allowance arrangement with that other person. If the payment is made to an employee, the § 274(e)(3)(A) exception applies to the employee only to the extent the employer does not report the payment as compensation to the employee on the employer's originally filed income tax return and as wages to the employee for purposes of withholding under Chapter 24. Section 1.274–2(f)(2)(iv)(*b*). If the payment is made to an independent contractor, the § 274(e)(3)(B) exception applies to the independent contractor to the extent the independent contractor accounts for the expenses to the payor in a manner satisfying § 274(d). Section 1.274–2(f)(2)(iv)(*c*).

For purposes of § 274(e)(3), a "reimbursement or other expense allowance arrangement" includes, but is not limited to, an "accountable plan" as that term is defined for purposes of § 62(c). *See* § 1.62–2(c)(1). Since 1963, § 1.274–2(f)(2)(iv)(*a*) has provided that the term "reimbursement or other expense allowance arrangement" in § 274(e)(3) has the same meaning it has "in section 62(2)(A), but without regard to whether the taxpayer is the employee of a person for whom services are performed." T.D. 6659, 1963–2 C.B. 113. The subsequent addition of § 62(c) in 1988 and its accompanying regulations did not change the meaning of "reimbursement or other expense allowance arrangement" for purposes of § 274(e)(3). Thus, the application of § 274(e)(3) does not require the existence of an accountable plan within the meaning of § 62(c) and the regulations under that section.

Section 274(n)(1) limits certain deductions allowable under § 162. If an employee or independent contractor incurs M&IE in connection with the performance of services for another person and is not reimbursed, § 274(n) limits any § 162(a)(2) deduction claimed by the employee or independent contractor. If an employee accounts for the expenses under § 274(d) to the payor, is reimbursed under a reimbursement or other expense allowance arrangement, and the payment is not treated both as additional compensation and as wages for income tax withholding purposes, then under § 274(e)(3)(A), the employee is not subject to § 274(n). *See* § 274(n)(2)(A) and § 1.274–2(f)(2)(iv)(*a*). The party initially making the reimbursement ("initial payor") bears the expenses, and § 274(n) limits that party's § 162(a)(2) deduction, unless that party also satisfies § 274(e)(3)(B). Sections 1.274–2(f)(2)(iv)(*b*) and 1.274–5(f)(4)(iii). If the initial payor, in connection with its performance of services for a third party, is reimbursed under a reimbursement or other expense allowance arrangement with the third party, and the initial payor accounts to the third party in the same manner that the employee accounted for the expenses to the initial payor, then the initial payor satisfies § 274(e)(3)(B). Section 1.274–2(f)(2)(iv)(*c*)(*1*). In that case, the third party bears the expenses, and § 274(n) limits the § 162(a)(2) deduction that the third party claims for those expenses.

In *Transport Labor Contract/Leasing, Inc. v. Commissioner*, 461 F.3d 1030 (8th Cir. 2006), *rev'g* 123 T.C. 154 (2004) (*TLC*), the question was the application of § 274(n) for taxable years ending in

1993 through 1996 to an employee leasing arrangement that provided for the payment to employees of *per diem* allowances for M&IE. The Court of Appeals for the Eighth Circuit found that the trucking company clients, not the leasing company (TLC), actually bore the *per diem* expenses under the reimbursement arrangement between the parties. The appellate court held that TLC qualified for the exception in § 274(e)(3)(B) and, therefore, that TLC's § 162(a)(2) deduction for the *per diem* expenses was not limited by § 274(n).

The appellate court reversed the Tax Court, which had held that § 274(n) limited TLC's § 162(a)(2) deduction because TLC was the drivers' common law employer. Under the Tax Court's analysis, the § 274(n) limitation necessarily applies to the employees' common law employer. *Compare Beech Trucking Co. v. Commissioner*, 118 T.C. 428, 443 (2002) (relying on common law employer factor and identity of party ultimately bearing the expense to determine incidence of § 274(n) limitation). The appellate court opined that the Tax Court had erroneously failed to examine whether TLC qualified for the exception in § 274(e)(3)(B).

In *TLC*, the Court of Appeals for the Eighth Circuit determined that TLC's § 162 deduction ultimately was not limited by § 274(n) because TLC was not the party that ultimately bore the *per diem* expenses. The appellate court concluded that status as a common law employer is not dispositive in the § 274(n) analysis, but did not explicitly reject that status as a relevant factor. The Internal Revenue Service acquiesces in the result in *TLC* and agrees with the appellate court's opinion that the § 274(n) limitation should apply to the party that ultimately bears the *per diem* expenses. However, the Internal Revenue Service does not agree with the opinion to the extent that it could be read to imply that status as a common law employer is relevant to the § 274(n) analysis.

ANALYSIS

In each situation below, Driver is an employee who incurs M&IE in connection with the performance of services for another person, receives a reimbursement at the M&IE rate, and accounts for the reimbursement under a "reimbursement or other expense allowance arrangement" within the meaning of § 274(e)(3). Neither Leasing Company nor Client deducts the M&IE amounts as compensation paid to Driver on its originally filed income tax return, nor treats the M&IE amounts as wages paid to Driver for purposes of withholding under Chapter 24. Therefore, under § 274(e)(3)(A), Driver is not subject to § 274(n).

Situation 1. Leasing Company, as payor of the substantiated M&IE reimbursement to Driver, must determine if its deduction of the expenses under § 162(a) is subject to the § 274(n) limitation. Although Leasing Company pays the M&IE of each driver in connection with its performance of services for Client, Leasing Company has provided Client only an invoice for a lump-sum periodic payment due. Therefore, Leasing Company does not satisfy § 274(e)(3)(B) because it has not accounted to Client in a manner satisfying § 274(d) and does not have a reimbursement or other expense allowance arrangement with Client. Under these circumstances, Leasing Company bears the expense of the M&IE, and § 274(n) limits Leasing Company's § 162(a)(2) deduction for the M&IE, regardless of whether Leasing Company or Client is Driver's employer under the usual common law rules. Even if Leasing Company had provided an itemized invoice to Client designating a portion of the periodic payment as a reimbursement of Driver's M&IE, Leasing Company still does not satisfy § 274(e)(3)(B) because it has not accounted to Client in a manner satisfying § 274(d) and does not have a reimbursement or other expense allowance arrangement with Client.

Situation 2. Leasing Company, as payor of the substantiated M&IE reimbursement to Driver, must determine if its deduction of the expenses under § 162(a) is subject to the § 274(n) limitation. Leasing Company has the information Driver originally submitted to account for Driver's M&IE. Immediately after Leasing Company pays Driver, Leasing Company sends Client a statement indicating the amount paid to Driver that was a reimbursement of Driver's M&IE. Leasing Company also accounts to Client by delivering to Client a copy of the substantiation that Driver had originally provided to Leasing Company. Client accepts the substantiation submitted by Leasing Company and acknowledges that the portion of its periodic payment equal to the amount that Leasing Company paid to reimburse Driver's M&IE is paid under a reimbursement arrangement and is subject to the § 274(n) limitation. Leasing Company meets the requirements of § 274(e)(3)(B) because (1) under the employee leasing contract and as indicated by their course of dealing, Leasing Company can prove that it has established a reimbursement or other expense allowance arrangement with Client within the meaning of § 274(e)(3), and (2) Leasing Company accounts to Client by delivering a copy of the substantiation that Driver had provided to Leasing Company (*i.e.*, in a manner satisfying § 274(d)). Therefore, Leasing Company is not subject to § 274(n), Client bears the expense of the M&IE, and § 274(n) limits Client's § 162(a)(2) deduction for the M&IE, regardless of whether Leasing Company or Client is Driver's employer under the usual common law rules.

Situation 3. Leasing Company has a copy of the information Driver originally submitted to Client to account for Driver's M&IE. Leasing Company, as payor of the substantiated M&IE reimbursement to Driver, must determine if its deduction of the expenses under § 162(a) is subject to the § 274(n) limitation. Immediately after Leasing Company pays Driver, Leasing Company sends Client a statement indicating the amount paid to Driver that was a reimbursement of Driver's M&IE. Leasing Company also accounts to Client by referring to the substantiation Client had received from Driver and had submitted (via a copy) to Leasing Company. Client accepts the substantiation submitted by Leasing Company, and acknowledges that the portion of its periodic payment equal to the amount that Leasing Company paid to reimburse Driver's M&IE is paid under a reimbursement arrangement and is subject to the § 274(n) limitation. Leasing Company meets the requirements of § 274(e)(3)(B) because (1) under the employee leasing contract and as indicated by their course of dealing, Leasing Company can prove that it has established a reimbursement or other expense allowance arrangement with Client within the meaning of § 274(e)(3), and (2) Leasing Company accounts to Client by referring to the substantiation that Driver originally submitted to Client (*i.e.*, in a manner satisfying

§ 274(d)). Therefore, Leasing Company is not subject to § 274(n), Client bears the expense of the M&IE, and § 274(n) limits Client's § 162(a)(2) deduction for the M&IE, regardless of whether Leasing Company or Client is Driver's employer under the usual common law rules.

HOLDINGS

(1) In *Situation 1*, Leasing Company's deduction for reimbursement of the M&IE to Driver is subject to the § 274(n) limitation.

(2) In *Situation 2*, Client's deduction for reimbursement of the M&IE to Leasing Company is subject to the § 274(n) limitation.

(3) In *Situation 3*, Client's deduction for reimbursement of the M&IE to Leasing Company is subject to the § 274(n) limitation.

DRAFTING INFORMATION

The principal author of this revenue ruling is Jeffrey T. Rodrick of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue ruling, contact Mr. Rodrick at (202) 622–4930 (not a toll-free call).

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of May 2008. See Rev. Rul. 2008-24, page 861.

Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted applicable federal long-term rate is set forth for the month of May 2008. See Rev. Rul. 2008-24, page 861.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2008. See Rev. Rul. 2008-24, page 861.

Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2008. See Rev. Rul. 2008-24, page 861.

Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2008. See Rev. Rul. 2008-24, page 861.

Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of May 2008. See Rev. Rul. 2008-24, page 861.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2008. See Rev. Rul. 2008-24, page 861.

Section 501.—Exemption From Tax on Corporations, Certain Trusts, etc.

26 CFR 1.501(c)(3)–1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

T.D. 9390

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 53

Standards for Recognition of Tax-Exempt Status if Private Benefit Exists or if an Applicable Tax-Exempt Organization Has Engaged in Excess Benefit Transaction(s)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that clarify the substantive requirements for tax exemption under section 501(c)(3) of the Internal Revenue Code (Code). This document also contains provisions that clarify the relationship between the substantive requirements for tax exemption under section 501(c)(3) and the imposition of section 4958 excise taxes on excess benefit transactions. These regulations affect organizations described in section 501(c)(3) of the Code and organizations applying for exemption as organizations described in section 501(c)(3) of the Code.

DATES: Effective Date: These regulations are effective March 28, 2008.

FOR FURTHER INFORMATION CONTACT: Galina Kolomietz, (202) 622–7971 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On September 9, 2005, a notice of proposed rulemaking (REG–111257–05, 2005–2 C.B. 759) clarifying the substantive requirements for tax exemption under section 501(c)(3) of the Code, and the relationship between the substantive requirements for tax exemption under section 501(c)(3) and the imposition of section 4958 excise taxes was published in the **Federal Register** (70 FR 53599). The IRS received several written comments responding to this notice. After consideration of all comments received, the proposed regulations under sections 501(c)(3) and 4958 are revised and published in final form. The major areas of comments and revisions are discussed in the following preamble. See §601.601(d)(2)(ii)(*b*)).

Explanation and Summary of Comments

Private Benefit

The proposed regulations added several examples to illustrate the requirement in §1.501(c)(3)–1(d)(1)(ii) that an organization serve a public rather than a private interest. The purpose of the examples is

to illustrate that prohibited private benefit may involve non-economic benefits as well as economic benefits and that prohibited private benefit may arise regardless of whether payments made to private interests are reasonable or excessive.

One comment suggested that, rather than add three isolated examples on private benefit to the regulations, the IRS consider a broader revision of the regulations under section 501(c)(3) to provide a more detailed discussion of the underlying principles of the private benefit doctrine. In particular, this comment suggested that the regulations address the relative quantity of private benefit that could preclude exemption. The IRS and the Treasury Department are not revising the existing regulations under section 501(c)(3) at this time. The new examples in the proposed regulations clarify the principles of the private benefit doctrine under current law. In §1.501(c)(3)–1(d)(1)(iii), *Example 1* illustrates that private benefit may involve non-economic benefits. *Example 2* illustrates that private benefit is inconsistent with tax-exempt status under section 501(c)(3) if it is substantial and not merely incidental to the accomplishment of the organization's exempt purposes. *Example 3* illustrates that private benefit may exist even though the transaction is at fair market value. Moreover, these examples are intended to illustrate the principle that private benefit remains an independent basis for revocation even if it does not involve economic benefit or raise fair market value issues. Accordingly, these examples are adopted in final form without revision.

Revocation Standards

The proposed regulations provided guidance on certain factors that the IRS will consider in determining whether an applicable tax-exempt organization described in section 501(c)(3) that engages in one or more excess benefit transactions continues to be described in section 501(c)(3). The comments received in response to the proposed regulations are discussed below. Overall, the commentators reacted favorably to the factors set forth in the proposed regulations. The factors described in the proposed regulations are finalized without major revisions. The application of the factors is refined by the addition of a new example to the final regulations.

a. *Interaction with determination of existence of excess benefit transaction*

Two comments suggested that the final regulations clarify the interaction between the determination of the organization's tax-exempt status and the determination of the existence of an excess benefit transaction. One of these comments specifically requested that the final regulations state that the IRS will not take any action to remove an organization's tax exemption on excess benefit transaction grounds while the IRS's determination of the existence of an excess benefit transaction is itself being contested in court. The final regulations do not adopt this comment. The determination of an organization's tax-exempt status and the determination of the existence of an excess benefit transaction are separate determinations, involving distinct parties, different legal elements, and separate processes, even though they may relate to the same facts.

b. *Clarification of terms*

Two comments voiced the need to clarify the terms "significant" and "*de minimis*" as they are used in the proposed regulations. One of these comments suggested adding an example of a safe harbor based on specific amounts the IRS would consider clearly insignificant, perhaps as a percentage of overall expenditures. Because the determination of whether an activity or an amount is "significant" or "*de minimis*" depends on the facts and circumstances, the final regulations do not adopt this comment.

One comment suggested adding examples combining potential *de minimis* values with other abating or negative factors and/or examples containing values that are not *de miminis*. The final regulations contain a new example that illustrates the application of the revocation factors to an excess benefit transaction that is neither significant in comparison to the size and scope of the organization's exempt activities nor *de minimis*.

One comment requested clarification of the term "repeated" as used in *Example 3* of §1.501(c)(3)–1(g) of the proposed regulations. The term was used in that example to correspond to the third factor in the proposed regulations, which looked to "whether the organization has been involved in repeated excess benefit transactions." In response to this comment, the third factor of the proposed regulations is revised to substitute the term "multiple" for the word "repeated." The term "multiple" refers to both (1) repeated instances of the same (or substantially similar) excess benefit transaction, regardless of whether the transaction involves the same or different persons; and (2) the presence of more than one excess benefit transaction, regardless of whether the transactions are the same or substantially similar and regardless of whether they involve the same or different persons.

Another comment requested guidance regarding when the IRS would consider the presence of a single excess benefit transaction to jeopardize an organization's tax-exempt status. Because such a determination would depend on the facts and circumstances, the final regulations do not adopt the comment.

c. *Due diligence and safeguards*

One comment requested that evidence that an organization's board of directors conducted appropriate due diligence or followed certain safeguards in connection with the excess benefit transaction be treated as a factor weighing in favor of continuing to recognize exemption. The IRS and the Treasury Department agree that the organization's reliance on objectively reasonable internal controls and procedures, such as the procedures for establishing a rebuttable presumption of reasonableness, in approving a transaction that is later determined to be an excess benefit transaction, should be treated as a factor weighing in favor of continuing to recognize exemption. Accordingly, the fourth factor under the proposed regulations is revised to make clear that implementation by an organization of safeguards that are reasonably calculated to prevent excess benefit transactions will be treated as a factor weighing in favor of continuing to recognize exemption regardless of whether such safeguards are implemented in direct response to the excess benefit transaction(s) at issue or as a general matter of corporate governance or fiscal management. Thus, an organization may be treated as having implemented safe-

guards reasonably calculated to prevent excess benefit transactions even though the organization is contesting the existence of the excess benefit transaction(s) at issue. An example is added to illustrate how implementation of safeguards, including preexisting safeguards, will be taken into account in determining whether to continue to recognize an organization's tax-exempt status.

One comment suggested that an organization's good faith attempt to establish a rebuttable presumption of reasonableness within the meaning of §53.4958–6 be treated as a factor weighing in favor of continuing to recognize exemption. Another comment suggested that a good faith attempt by an organization's board of directors to determine fair market value be treated as a factor precluding revocation even if the IRS disagrees with the board's fair market value analysis. The fourth factor, as revised in these final regulations, takes into account whether the organization has implemented safeguards that are reasonably calculated to prevent excess benefit transactions. This factor takes safeguards into account, regardless of whether they were implemented before or after an excess benefit transaction occurred. The comments raise the question of how this factor will apply where steps have been taken to avoid an excess benefit transaction, but nonetheless have failed to prevent the excess benefit transaction. The weight afforded to this particular circumstance will depend upon the specific facts and circumstances.

d. *Requests for additional examples*

Two comments suggested adding to the proposed regulations an example specifically addressing reasonable compensation. In response to these comments, the new example added by these final regulations addresses reasonable compensation.

One comment suggested that the regulations include examples involving health care organizations. The IRS and the Treasury Department note that the application of sections 501(c)(3) and 4958 to health care organizations is not unique. The examples in these regulations, although not specifically involving health care organizations, apply to health care organizations in the same manner as they apply to other organizations described in section 501(c)(3).

One comment criticized the examples in the proposed regulations as too "black-and-white" and suggested that the regulations be supplemented with examples that discuss less clear facts. Specifically, this comment requested guidance on situations involving more than *de minimis* amounts in which an applicable tax-exempt organization does not seek correction from the disqualified person involved. The new example added by these final regulations illustrates that, in some situations, even in the absence of correction of non-*de minimis* excess benefit transactions, an organization may retain its tax-exempt status if the other factors, in combination, warrant continued exemption. Under the fifth factor, the IRS will take into account the organization's good faith with respect to correction. Accordingly, the reasons behind the organization's failure to seek correction will be examined.

One comment suggested adding an example that would illustrate what factors, in addition to post-audit correction, would be sufficient to avoid revocation. The example that has been added illustrates a case where factors other than correction support continued exemption. The IRS and the Treasury Department may consider publication of future guidance on the application of the factors based on other specific fact patterns that the IRS encounters in the course of tax administration.

One comment requested adding an example discussing the effect of "automatic excess benefit transactions" that are not *de minimis* on the organization's tax-exempt status. The term "automatic excess benefit transaction" refers to a transaction in which a disqualified person provides services to an organization and receives economic benefits from the organization that are not substantiated, contemporaneously and in writing, as compensation within the meaning of §53.4958–4(c). After the enactment of the Pension Protection Act of 2006, Public Law 109–280 (120 Stat. 780 (2006)), the term "automatic excess benefit transaction" also refers to any grant, loan, compensation or other similar payment from a donor advised fund to a donor or donor advisor with respect to such fund and from a supporting organization to any of its disqualified persons. See section 4958(c)(2) and (3). Although not in the context of an automatic excess benefit transaction, the new example in the final regulations involves an excess benefit transaction that is not *de minimis*.

e. *Removal of disqualified person*

One comment suggested that the regulations address whether and under what circumstances removal of a disqualified person may be necessary to avoid revocation. The new example added by these final regulations illustrates that removal of a disqualified person is not a necessary condition for continued exemption. In the example, the organization implemented safeguards designed to prevent future excess benefit transactions involving the same disqualified persons.

f. *Best practices*

One comment described specific actions that boards of applicable tax-exempt organizations should be required to take to improve governance and to prevent excess benefit transactions at their organizations. This comment was not adopted because the purpose of these regulations is to set forth an analytical framework for determining whether to revoke tax-exempt status if an organization engages in one or more excess benefit transactions.

Special Analyses

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

Drafting Information

The principal authors of these regulations are Galina Kolomietz and Phyllis Haney, Office of Division Counsel/Associate Chief Counsel (Tax

Exempt and Government Entities). However, other personnel from the IRS and the Treasury Department participated in their development.

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Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 53 are amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.501(c)(3)–1 is revised by:

1. Redesignating paragraph (d)(1)(iii) as paragraph (d)(1)(iv) and adding a new paragraph (d)(1)(iii).

2. Redesignating paragraph (f) as paragraph (g) and adding a new paragraph (f).

The additions read as follows:

§1.501(c)(3)–1 Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

* * * * *

(d) * * *

(1) * * *

(iii) *Examples.* The following examples illustrate the requirement of paragraph (d)(1)(ii) of this section that an organization serve a public rather than a private interest:

Example 1. (i) O is an educational organization the purpose of which is to study history and immigration. O's educational activities include sponsoring lectures and publishing a journal. The focus of O's historical studies is the genealogy of one family, tracing the descent of its present members. O actively solicits for membership only individuals who are members of that one family. O's research is directed toward publishing a history of that family that will document the pedigrees of family members. A major objective of O's research is to identify and locate living descendants of that family to enable those descendants to become acquainted with each other.

(ii) O's educational activities primarily serve the private interests of members of a single family rather than a public interest. Therefore, O is operated for the benefit of private interests in violation of the restriction on private benefit in paragraph (d)(1)(ii) of this section. Based on these facts and circumstances, O is not operated exclusively for exempt purposes and, therefore, is not described in section 501(c)(3).

Example 2. (i) O is an art museum. O's principal activity is exhibiting art created by a group of unknown but promising local artists. O's activity, including organized tours of its art collection, promotes the arts. O is governed by a board of trustees unrelated to the artists whose work O exhibits. All of the art exhibited is offered for sale at prices set by the artist. Each artist whose work is exhibited has a consignment arrangement with O. Under this arrangement, when art is sold, the museum retains 10 percent of the selling price to cover the costs of operating the museum and gives the artist 90 percent.

(ii) The artists in this situation directly benefit from the exhibition and sale of their art. As a result, the principal activity of O serves the private interests of these artists. Because O gives 90 percent of the proceeds from its sole activity to the individual artists, the direct benefits to the artists are substantial and O's provision of these benefits to the artists is more than incidental to its other purposes and activities. This arrangement causes O to be operated for the benefit of private interests in violation of the restriction on private benefit in paragraph (d)(1)(ii) of this section. Based on these facts and circumstances, O is not operated exclusively for exempt purposes and, therefore, is not described in section 501(c)(3).

Example 3. (i) O is an educational organization the purpose of which is to train individuals in a program developed by P, O's president. The program is of interest to academics and professionals, representatives of whom serve on an advisory panel to O. All of the rights to the program are owned by Company K, a for-profit corporation owned by P. Prior to the existence of O, the teaching of the program was conducted by Company K. O licenses, from Company K, the right to conduct seminars and lectures on the program and to use the name of the program as part of O's name, in exchange for specified royalty payments. Under the license agreement, Company K provides O with the services of trainers and with course materials on the program. O may develop and copyright new course materials on the program but all such materials must be assigned to Company K without consideration if and when the license agreement is terminated. Company K sets the tuition for the seminars and lectures on the program conducted by O. O has agreed not to become involved in any activity resembling the program or its implementation for 2 years after the termination of O's license agreement.

(ii) O's sole activity is conducting seminars and lectures on the program. This arrangement causes O to be operated for the benefit of P and Company K in violation of the restriction on private benefit in paragraph (d)(1)(ii) of this section, regardless of whether the royalty payments from O to Company K for the right to teach the program are reasonable. Based on these facts and circumstances, O is not operated exclusively for exempt purposes and, therefore, is not described in section 501(c)(3).

* * * * *

(f) *Interaction with section 4958*—(1) *Application process.* An organization that applies for recognition of exemption under section 501(a) as an organization described in section 501(c)(3) must establish its eligibility under this section. The Commissioner may deny an application for exemption for failure to establish any of section 501(c)(3)'s requirements for exemption. Section 4958 does not apply to transactions with an organization that has failed to establish that it satisfies all of the requirements for exemption under section 501(c)(3). See §53.4958–2.

(2) *Substantive requirements for exemption still apply to applicable tax-exempt organizations described in section 501(c)(3)*—(i) *In general.* Regardless of whether a particular transaction is subject to excise taxes under section 4958, the substantive requirements for tax exemption under section 501(c)(3) still apply to an applicable tax-exempt organization (as defined in section 4958(e) and §53.4958–2) described in section 501(c)(3) whose disqualified persons or organization managers are subject to excise taxes under section 4958. Accordingly, an organization will no longer meet the requirements for tax-exempt status under section 501(c)(3) if the organization fails to satisfy the requirements of paragraph (b), (c) or (d) of this section. See §53.4958–8(a).

(ii) *Determination of whether revocation of tax-exempt status is appropriate when section 4958 excise taxes also apply.* In determining whether to continue to recognize the tax-exempt status of an applicable tax-exempt organization (as defined in section 4958(e) and §53.4958–2) described in section 501(c)(3) that engages in one or more excess benefit transactions (as defined in section 4958(c) and §53.4958–4) that violate the prohibition on inurement under section 501(c)(3), the Commissioner will consider all relevant facts and circumstances, including, but not limited to, the following—

(A) The size and scope of the organization's regular and ongoing activities that further exempt purposes before and after the excess benefit transaction or transactions occurred;

(B) The size and scope of the excess benefit transaction or transactions (collectively, if more than one) in relation to the size and scope of the organization's regular and ongoing activities that further exempt purposes;

(C) Whether the organization has been involved in multiple excess benefit transactions with one or more persons;

(D) Whether the organization has implemented safeguards that are reasonably calculated to prevent excess benefit transactions; and

(E) Whether the excess benefit transaction has been corrected (within the meaning of section 4958(f)(6) and §53.4958–7), or the organization has made good faith efforts to seek correction from the disqualified person(s) who benefited from the excess benefit transaction.

(iii) All factors will be considered in combination with each other. Depending on the particular situation, the Commissioner may assign greater or lesser weight to some factors than to others. The factors listed in paragraphs (f)(2)(ii)(D) and (E) of this section will weigh more heavily in favor of continuing to recognize exemption where the organization discovers the excess benefit transaction or transactions and takes action before the Commissioner discovers the excess benefit transaction or transactions. Further, with respect to the factor listed in paragraph (f)(2)(ii)(E) of this section, correction after the excess benefit transaction or transactions are discovered by the Commissioner, by itself, is never a sufficient basis for continuing to recognize exemption.

(iv) *Examples*. The following examples illustrate the principles of paragraph (f)(2)(ii) of this section. For purposes of each example, assume that O is an applicable tax-exempt organization (as defined in section 4958(e) and §53.4958–2) described in section 501(c)(3). The examples read as follows:

Example 1. (i) O was created as a museum for the purpose of exhibiting art to the general public. In Years 1 and 2, O engages in fundraising and in selecting, leasing, and preparing an appropriate facility for a museum. In Year 3, a new board of trustees is elected. All of the new trustees are local art dealers. Beginning in Year 3 and continuing to the present, O uses a substantial portion of its revenues to purchase art solely from its trustees at prices that exceed fair market value. O exhibits and offers for sale all of the art it purchases. O's Form 1023, "*Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*," did not disclose the possibility that O would purchase art from its trustees.

(ii) O's purchases of art from its trustees at more than fair market value constitute excess benefit transactions between an applicable tax-exempt organization and disqualified persons under section 4958. Therefore, these transactions are subject to the applicable excise taxes provided in that section. In addition, O's purchases of art from its trustees at more than fair market value violate the proscription against inurement under section 501(c)(3) and paragraph (c)(2) of this section.

(iii) The application of the factors in paragraph (f)(2)(ii) of this section to these facts is as follows. Beginning in Year 3, O does not engage primarily in regular and ongoing activities that further exempt purposes because a substantial portion of O's activities consists of purchasing art from its trustees and dealing in such art in a manner similar to a commercial art gallery. The size and scope of the excess benefit transactions collectively are significant in relation to the size and scope of any of O's ongoing activities that further exempt purposes. O has been involved in multiple excess benefit transactions, namely, purchases of art from its trustees at more than fair market value. O has not implemented safeguards that are reasonably calculated to prevent such improper purchases in the future. The excess benefit transactions have not been corrected, nor has O made good faith efforts to seek correction from the disqualified persons who benefited from the excess benefit transactions (the trustees). The trustees continue to control O's Board. Based on the application of the factors to these facts, O is no longer described in section 501(c)(3) effective in Year 3.

Example 2. (i) The facts are the same as in *Example 1*, except that in Year 4, O's entire board of trustees resigns, and O no longer offers all exhibited art for sale. The former board is replaced with members of the community who are not in the business of buying or selling art and who have skills and experience running charitable and educational programs and institutions. O promptly discontinues the practice of purchasing art from current or former trustees, adopts a written conflicts of interest policy, adopts written art valuation guidelines, hires legal counsel to recover the excess amounts O had paid its former trustees, and implements a new program of activities to further the public's appreciation of the arts.

(ii) O's purchases of art from its former trustees at more than fair market value constitute excess benefit transactions between an applicable tax-exempt organization and disqualified persons under section 4958. Therefore, these transactions are subject to the applicable excise taxes provided in that section. In addition, O's purchases of art from its trustees at more than fair market value violate the proscription against inurement under section 501(c)(3) and paragraph (c)(2) of this section.

(iii) The application of the factors in paragraph (f)(2)(ii) of this section to these facts is as follows. In Year 3, O does not engage primarily in regular and ongoing activities that further exempt purposes. However, in Year 4, O elects a new board of trustees comprised of individuals who have skills and experience running charitable and educational programs and implements a new program of activities to further the public's appreciation of the arts. As a result of these actions, beginning in Year 4, O engages in regular and ongoing activities that further exempt purposes. The size and scope of the excess benefit transactions that occurred in Year 3, taken collectively, are significant in relation to the size and scope of O's regular and ongoing exempt function activities that were conducted in Year 3. Beginning in Year 4, however, as O's exempt function activities grow, the size and scope of the excess benefit transactions that occurred in Year 3 become less and less significant as compared to the size and scope of O's regular and ongoing exempt function activities. O was involved in multiple excess benefit transactions in Year 3. However, by discontinuing its practice of purchasing art from its current and former trustees, by replacing its former board with independent members of the community, and by adopting a conflicts of interest policy and art valuation guidelines, O has implemented safeguards that are reasonably calculated to prevent future violations. In addition, O has made a good faith effort to seek correction from the disqualified persons who benefited from the excess benefit transactions (its former trustees). Based on the application of the factors to these facts, O continues to meet the requirements for tax exemption under section 501(c)(3).

Example 3. (i) O conducts educational programs for the benefit of the general public. Since its formation, O has employed its founder, C, as its Chief Executive Officer. Beginning in Year 5 of O's operations and continuing to the present, C caused O to divert significant portions of O's funds to pay C's personal expenses. The diversions by C significantly reduced the funds available to conduct O's ongoing educational programs. The board of trustees never authorized C to cause O to pay C's personal expenses from O's funds. Certain members of the board were aware that O was paying C's personal expenses. However, the board did not terminate C's employment and did not take any action to seek repayment from C or to prevent C from continuing to divert O's funds to pay C's personal expenses. C claimed that O's payments of C's personal expenses represented loans from O to C. However, no contemporaneous loan documentation exists, and C never made any payments of principal or interest.

(ii) The diversions of O's funds to pay C's personal expenses constitute excess benefit transactions between an applicable tax-exempt organization and a disqualified person under section 4958. Therefore, these transactions are subject to the applicable excise taxes provided in that section. In addition, these transactions violate the proscription against inurement under section 501(c)(3) and paragraph (c)(2) of this section.

(iii) The application of the factors in paragraph (f)(2)(ii) of this section to these facts is as follows. O has engaged in regular and ongoing activities that further exempt purposes both before and after the excess benefit transactions occurred. However, the size and scope of the excess benefit transactions engaged in by O beginning in Year 5, collectively, are significant in relation to the size and scope of O's activities that further exempt purposes. Moreover, O has been involved in multiple excess benefit transactions. O has not implemented any safeguards that are reasonably calculated to prevent future diversions. The excess benefit transactions have not been corrected, nor has O made good faith efforts to seek correction from C, the disqualified person who benefited from the excess benefit transactions. Based on the application of the factors to these facts, O is no longer described in section 501(c)(3) effective in Year 5.

Example 4. (i) O conducts activities that further exempt purposes. O uses several buildings in the conduct of its exempt activities. In Year 1, O sold one of the buildings to Company K for an amount that was substantially below fair market value. The sale was a significant event in relation to O's other activities. C, O's Chief Executive Officer, owns all of the voting stock of Company K. When O's board of trustees approved the transaction with Company K, the board did not perform due diligence that could have made it aware that the price paid by Company K to acquire the building was below fair market value. Subsequently, but before the IRS commences an examination of O, O's board of trustees determines that

Company K paid less than the fair market value for the building. Thus, O concludes that an excess benefit transaction occurred. After the board makes this determination, it promptly removes C as Chief Executive Officer, terminates C's employment with O, and hires legal counsel to recover the excess benefit from Company K. In addition, O promptly adopts a conflicts of interest policy and new contract review procedures designed to prevent future recurrences of this problem.

(ii) The sale of the building by O to Company K at less than fair market value constitutes an excess benefit transaction between an applicable tax-exempt organization and a disqualified person under section 4958 in Year 1. Therefore, this transaction is subject to the applicable excise taxes provided in that section. In addition, this transaction violates the proscription against inurement under section 501(c)(3) and paragraph (c)(2) of this section.

(iii) The application of the factors in paragraph (f)(2)(ii) of this section to these facts is as follows. O has engaged in regular and ongoing activities that further exempt purposes both before and after the excess benefit transaction occurred. Although the size and scope of the excess benefit transaction were significant in relation to the size and scope of O's activities that further exempt purposes, the transaction with Company K was a one-time occurrence. By adopting a conflicts of interest policy and new contract review procedures and by terminating C, O has implemented safeguards that are reasonably calculated to prevent future violations. Moreover, O took corrective actions before the IRS commenced an examination of O. In addition, O has made a good faith effort to seek correction from Company K, the disqualified person who benefited from the excess benefit transaction. Based on the application of the factors to these facts, O continues to be described in section 501(c)(3).

Example 5. (i) O is a large organization with substantial assets and revenues. O conducts activities that further its exempt purposes. O employs C as its Chief Financial Officer. During Year 1, O pays $2,500 of C's personal expenses. O does not make these payments pursuant to an accountable plan, as described in §53.4958–4(a)(4)(ii). In addition, O does not report any of these payments on C's Form W–2, "*Wage and Tax Statement*," or on a Form 1099–MISC, "*Miscellaneous Income*," for C for Year 1, and O does not report these payments as compensation on its Form 990, "*Return of Organization Exempt From Income Tax*," for Year 1. Moreover, none of these payments can be disregarded as nontaxable fringe benefits under §53.4958–4(c)(2) and none consisted of fixed payments under an initial contract under §53.4958–4(a)(3). C does not report the $2,500 of payments as income on his individual Federal income tax return for Year 1. O does not repeat this reporting omission in subsequent years and, instead, reports all payments of C's personal expenses not made under an accountable plan as income to C.

(ii) O's payment in Year 1 of $2,500 of C's personal expenses constitutes an excess benefit transaction between an applicable tax-exempt organization and a disqualified person under section 4958. Therefore, this transaction is subject to the applicable excise taxes provided in that section. In addition, this transaction violates the proscription against inurement in section 501(c)(3) and paragraph (c)(2) of this section.

(iii) The application of the factors in paragraph (f)(2)(ii) of this section to these facts is as follows. O engages in regular and ongoing activities that further exempt purposes. The payment of $2,500 of C's personal expenses represented only a *de minimis* portion of O's assets and revenues; thus, the size and scope of the excess benefit transaction were not significant in relation to the size and scope of O's activities that further exempt purposes. The reporting omission that resulted in the excess benefit transaction in Year 1 occurred only once and is not repeated in subsequent years. Based on the application of the factors to these facts, O continues to be described in section 501(c)(3).

Example 6. (i) O is a large organization with substantial assets and revenues. O furthers its exempt purposes by providing social services to the population of a specific geographic area. O has a sizeable workforce of employees and volunteers to conduct its work. In Year 1, O's board of directors adopted written procedures for setting executive compensation at O. O's executive compensation procedures were modeled on the procedures for establishing a rebuttable presumption of reasonableness under §53.4958–6. In accordance with these procedures, the board appointed a compensation committee to gather data on compensation levels paid by similarly situated organizations for functionally comparable positions. The members of the compensation committee were disinterested within the meaning of §53.4958–6(c)(1)(iii). Based on its research, the compensation committee recommended a range of reasonable compensation for several of O's existing top executives (the Top Executives). On the basis of the committee's recommendations, the board approved new compensation packages for the Top Executives and timely documented the basis for its decision in board minutes. The board members were all disinterested within the meaning of §53.4958–6(c)(1)(iii). The Top Executives were not involved in setting their own compensation. In Year 1, even though payroll expenses represented a significant portion of O's total operating expenses, the total compensation paid to O's Top Executives represented only an insubstantial portion of O's total payroll expenses. During a subsequent examination, the IRS found that the compensation committee relied exclusively on compensation data from organizations that perform similar social services to O. The IRS concluded, however, that the organizations were not similarly situated because they served substantially larger geographic regions with more diverse populations and were larger than O in terms of annual revenues, total operating budget, number of employees, and number of beneficiaries served. Accordingly, the IRS concluded that the compensation committee did not rely on "appropriate data as to comparability" within the meaning of §53.4958–6(c)(2) and, thus, failed to establish the rebuttable presumption of reasonableness under §53.4958–6. Taking O's size and the nature of the geographic area and population it serves into account, the IRS concluded that the Top Executives' compensation packages for Year 1 were excessive. As a result of the examination, O's board added new members to the compensation committee who have expertise in compensation matters and also amended its written procedures to require the compensation committee to evaluate a number of specific factors, including size, geographic area, and population covered by the organization, in assessing the comparability of compensation data. O's board renegotiated the Top Executives' contracts in accordance with the recommendations of the newly constituted compensation committee on a going forward basis. To avoid potential liability for damages under state contract law, O did not seek to void the Top Executives' employment contracts retroactively to Year 1 and did not seek correction of the excess benefit amounts from the Top Executives. O did not terminate any of the Top Executives.

(ii) O's payments of excessive compensation to the Top Executives in Year 1 constituted excess benefit transactions between an applicable tax-exempt organization and disqualified persons under section 4958. Therefore, these payments are subject to the applicable excise taxes provided under that section, including second-tier taxes if there is no correction by the disqualified persons. In addition, these payments violate the proscription against inurement under section 501(c)(3) and paragraph (c)(2) of this section.

(iii) The application of the factors in paragraph (f)(2)(ii) of this section to these facts is as follows. O has engaged in regular and ongoing activities that further exempt purposes both before and after the excess benefit transactions occurred. The size and scope of the excess benefit transactions, in the aggregate, were not significant in relation to the size and scope of O's activities that further exempt purposes. O engaged in multiple excess benefit transactions. Nevertheless, prior to entering into these excess benefit transactions, O had implemented written procedures for setting the compensation of its top management that were reasonably calculated to prevent the occurrence of excess benefit transactions. O followed these written procedures in setting the compensation of the Top Executives for Year 1. Despite the board's failure to rely on appropriate comparability data, the fact that O implemented and followed these written procedures in setting the compensation of the Top Executives for Year 1 is a factor favoring continued exemption. The fact that O amended its written procedures to ensure the use of appropriate comparability data and renegotiated the Top Executives' compensation packages on a going forward basis are also factors favoring continued exemption, even though O did not void the Top Executives' existing contracts and did not seek correction from the Top Executives. Based on the application of the factors to these facts, O continues to be described in section 501(c)(3).

(3) *Applicability.* The rules in paragraph (f) of this section will apply with respect to excess benefit transactions occurring after March 28, 2008.

* * * * *

PART 53—FOUNDATION AND SIMILAR EXCISE TAXES

Par. 3. The authority citation for part 53 continues to read, in part, as follows:

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

Par. 4. In §53.4958–2, paragraph (a)(6) is added to read as follows:

§53.4958–2 Definition of applicable tax-exempt organization.

(a) * * *

(6) *Examples*. The following examples illustrate the principles of this section, which defines an applicable tax-exempt organization for purposes of section 4958:

Example 1. O is a nonprofit corporation formed under state law. O filed its application for recognition of exemption under section 501(c)(3) within the time prescribed under section 508(a). In its application, O described its plans for purchasing property from some of its directors at prices that would exceed fair market value. After reviewing the application, the IRS determined that because of the proposed property purchase transactions, O failed to establish that it met the requirements for an organization described in section 501(c)(3). Accordingly, the IRS denied O's application. While O's application was pending, O engaged in the purchase transactions described in its application at prices that exceeded the fair market values of the properties. Although these transactions would constitute excess benefit transactions under section 4958, because the IRS never recognized O as an organization described in section 501(c)(3), O was never an applicable tax-exempt organization under section 4958. Therefore, these transactions are not subject to the excise taxes provided in section 4958.

Example 2. O is a nonprofit corporation formed under state law. O files its application for recognition of exemption under section 501(c)(3) within the time prescribed under section 508(a). The IRS issues a favorable determination letter in Year 1 that recognizes O as an organization described in section 501(c)(3). Subsequently, in Year 5 of O's operations, O engages in certain transactions that constitute excess benefit transactions under section 4958 and violate the proscription against inurement under section 501(c)(3) and §1.501(c)(3)–1(c)(2). The IRS examines the Form 990, "*Return of Organization Exempt From Income Tax*", that O filed for Year 5. After considering all the relevant facts and circumstances in accordance with §1.501(c)(3)–1(f), the IRS concludes that O is no longer described in section 501(c)(3) effective in Year 5. The IRS does not examine the Forms 990 that O filed for its first four years of operations and, accordingly, does not revoke O's exempt status for those years. Although O's tax-exempt status is revoked effective in Year 5, under the *lookback* rules in paragraph (a)(1) of this section and §53.4958–3(a)(1) of this chapter, during the five-year period prior to the excess benefit transactions that occurred in Year 5, O was an applicable tax-exempt organization and O's directors were disqualified persons as to O. Therefore, the transactions between O and its directors during Year 5 are subject to the applicable excise taxes provided in section 4958.

* * * * *

Linda E. Stiff,
Deputy Commissioner for Services and Enforcement.

Approved March 19, 2008.

Eric Solomon,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on March 27, 2008, 8:45 a.m., and published in the issue of the Federal Register for March 28, 2008, 73 F.R. 16519)

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of May 2008. See Rev. Rul. 2008-24, page 861.

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2008. See Rev. Rul. 2008-24, page 861.

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2008. See Rev. Rul. 2008-24, page 861.

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also Sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 642, 1274, 1288, and other sections of the Code, tables set forth the rates for May 2008.

Rev. Rul. 2008–24

This revenue ruling provides various prescribed rates for federal income tax purposes for May 2008 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 2008–24 TABLE 1

Applicable Federal Rates (AFR) for May 2008

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term				
AFR	1.64%	1.63%	1.63%	1.62%
110% AFR	1.80%	1.79%	1.79%	1.78%
120% AFR	1.97%	1.96%	1.96%	1.95%
130% AFR	2.13%	2.12%	2.11%	2.11%
Mid-term				
AFR	2.74%	2.72%	2.71%	2.70%
110% AFR	3.01%	2.99%	2.98%	2.97%
120% AFR	3.29%	3.26%	3.25%	3.24%
130% AFR	3.57%	3.54%	3.52%	3.51%
150% AFR	4.12%	4.08%	4.06%	4.05%
175% AFR	4.82%	4.76%	4.73%	4.71%
Long-term				
AFR	4.21%	4.17%	4.15%	4.13%
110% AFR	4.64%	4.59%	4.56%	4.55%
120% AFR	5.06%	5.00%	4.97%	4.95%
130% AFR	5.49%	5.42%	5.38%	5.36%

REV. RUL. 2008–24 TABLE 2

Adjusted AFR for May 2008

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	2.07%	2.06%	2.05%	2.05%
Mid-term adjusted AFR	3.17%	3.15%	3.14%	3.13%
Long-term adjusted AFR	4.71%	4.66%	4.63%	4.62%

REV. RUL. 2008–24 TABLE 3

Rates Under Section 382 for May 2008

Adjusted federal long-term rate for the current month	4.71%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	4.71%

REV. RUL. 2008–24 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for May 2008

Appropriate percentage for the 70% present value low-income housing credit	7.80%
Appropriate percentage for the 30% present value low-income housing credit	3.34%

REV. RUL. 2008–24 TABLE 5	
Rate Under Section 7520 for May 2008	
Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	3.2%

Section 1288.—Treatment of Original Issue Discount on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2008. See Rev. Rul. 2008-24, page 861.

Section 6103.—Confidentiality and Disclosure of Returns and Return Information

26 CFR 301.6103(n)–2T: Disclosure of return information in connection with written contracts among the IRS, whistleblowers, and legal representatives of whistleblowers (temporary).

T.D. 9389

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 301

Disclosure of Return Information in Connection With Written Contracts Among the IRS, Whistleblowers, and Legal Representatives of Whistleblowers

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the disclosure of return information, pursuant to section 6103(n) of the Internal Revenue Code (Code), by an officer or employee of the Treasury Department, to a whistleblower and, if applicable, the legal representative of the whistleblower, to the extent necessary in connection with a written contract among the IRS, the whistleblower and, if applicable, the legal representative of the whistleblower, for services relating to the detection of violations of the internal revenue laws or related statutes. The temporary regulations will affect officers and employees of the Treasury Department who disclose return information to whistleblowers, or their legal representatives, in connection with written contracts among the IRS, whistleblowers and, if applicable, their legal representatives, for services relating to the detection of violations of the internal revenue laws or related statutes. The temporary regulations will also affect any whistleblower, or legal representative of a whistleblower, who receives return information in connection with a written contract among the IRS, the whistleblower and, if applicable, the legal representative of the whistleblower, for services relating to the detection of violations of the internal revenue laws or related statutes. The text of the temporary regulations also serves as the text of the proposed regulations (REG–114942–07) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin.

DATES: *Effective Date:* These temporary regulations are effective on March 25, 2008.

Applicability Date: For dates of applicability, see §301.6103(n)–2T(f).

FOR FURTHER INFORMATION CONTACT: Helene R. Newsome, 202–622–7950 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Procedure and Administration Regulations (26 CFR part 301) under section 6103(n) relating to the disclosure of return information in connection with written contracts among the IRS, whistleblowers and, if applicable, their legal representatives.

The Tax Relief and Health Care Act of 2006, Public Law 109–432 (120 Stat. 2958), (the Act) was enacted on December 20, 2006. Section 406 of the Act amends section 7623, concerning the payment of awards to whistleblowers, and establishes a Whistleblower Office within the IRS that has responsibility for the administration of a whistleblower program. The Whistleblower Office, in connection with administering a whistleblower program, will analyze information provided by a whistleblower, and either investigate the matter itself or assign it to the appropriate IRS office for investigation. In analyzing information provided by a whistleblower, or investigating a matter, the Whistleblower Office may determine that it requires the assistance of the whistleblower, or the legal representative of the whistleblower. The legislative history of section 406 of the Act states that "[t]o the extent the disclosure of returns or return information is required [for the whistleblower or his or her legal representative] to render such assistance, the disclosure must be pursuant to an IRS tax administration contract." Joint Committee on Taxation, *Technical Explanation of H.R. 6408, The "Tax Relief and Health Care Act of 2006*," as Introduced in the House on December 7, 2006, at 89 (JCX–50–06), December 7, 2006. The legislative history further states that "[i]t is expected that such disclosures will be infrequent and will be made only when the assigned task cannot be properly or timely completed without the return information to be disclosed." *Id.*

Under section 6103(a), returns and return information are confidential unless the Internal Revenue Code (Code) authorizes disclosure. Section 6103(n) is the authority by which returns and return information may be disclosed pursuant to a tax administration contract. Section 6103(n) authorizes, pursuant to regulations prescribed by the Secretary, returns and return information to be disclosed to any person, including any person described in section 7513(a), for purposes of tax administration, to the extent necessary in connection with: (1) the processing, storage, transmission, and reproduction of returns and return information; (2) the

programming, maintenance, repair, testing, and procurement of equipment; and (3) the providing of other services. These temporary regulations describe the circumstances, pursuant to section 6103(n), under which officers and employees of the Treasury Department may disclose return information to whistleblowers and, if applicable, their legal representatives, in connection with written contracts for services relating to the detection of violations of the internal revenue laws or related statutes.

Explanation of Provisions

General Rule

The temporary regulations, at §301.6103(n)–2T(a)(1), provide that an officer or employee of the Treasury Department may, pursuant to sections 6103(n) and 7623, disclose return information to a whistleblower and, if applicable, the legal representative of the whistleblower, to the extent necessary in connection with a written contract among the IRS, the whistleblower and, if applicable, the legal representative of the whistleblower, for services relating to the detection of violations of the internal revenue laws or related statutes. If a whistleblower has retained the services of a legal representative, then, in addition to the whistleblower, the whistleblower's legal representative must be a party to the written contract with the IRS. These temporary regulations do not provide for the disclosure of returns to whistleblowers or their legal representatives.

The temporary regulations, at §301.6103(n)–2T(a)(2), provide that the Commissioner has the discretion to determine whether to enter into a written contract with the whistleblower and, if applicable, the legal representative of the whistleblower, for services as described in §301.6103(n)–2T(a)(1). The IRS expects to enter into these contracts only infrequently, and any contract that is entered into, and any disclosures made pursuant to this type of contract, will be carefully tailored to the specific facts of the case.

Limitations

The temporary regulations, at §301.6103(n)–2T(b)(1), set forth the condition that the disclosure of return information in connection with a written contract for services described in §301.6103(n)–2T(a)(1) may be made only to the extent the IRS deems it necessary in connection with the reasonable or proper performance of the contract. In this regard, disclosures should relate to relevant taxable years and types of tax. The temporary regulations, at §301.6103–2T(b)(2), set forth the additional condition that if the IRS determines that the services of a whistleblower and, if applicable, the legal representative of the whistleblower as described in §301.6103(n)–2T(a)(1) can be performed reasonably or properly by disclosure of only parts or portions of return information, then only the parts or portions of the return information are to be disclosed.

The temporary regulations, at §301.6103(n)–2T(b)(3), provide that, upon written request by a whistleblower, or a legal representative of a whistleblower, with whom the IRS has entered into a written contract for services as described in §301.6103(n)–2T(a)(1), the Director of the Whistleblower Office, or designee of the Director, may inform the whistleblower and, if applicable, the legal representative of the whistleblower, of the status of the whistleblower's claim for award under section 7623, including whether the claim is being evaluated for potential investigative action, or is pending due to an ongoing examination, appeal, collection action, or litigation. This information may be disclosed only if the Commissioner determines that the disclosure would not seriously impair Federal tax administration.

The temporary regulations, at §301.6103(n)–2T(b)(4), impose the condition that return information disclosed to a whistleblower and, if applicable, a legal representative of a whistleblower, may not be disclosed or otherwise used by the whistleblower or a legal representative of a whistleblower, except as expressly authorized by the IRS.

Penalties

The temporary regulations, at §301.6103(n)–2T(c), set forth the civil and criminal penalties to which whistleblowers and their legal representatives are subject for unauthorized inspection or disclosure of return information by operation of sections 7431(a)(2), 7213(a)(1), and 7213A(a)(1)(B).

Safeguards

The temporary regulations, at §301.6103(n)–2T(d)(1), provide that whistleblowers and their legal representatives who receive return information under these regulations must comply with all applicable conditions and requirements as the IRS may prescribe from time to time (prescribed requirements) for the purposes of protecting the confidentiality of the return information and preventing unauthorized disclosures and inspections of the return information (*e.g.*, requirements pertaining to computer security, physical security of return information, methods of destruction of return information).

The temporary regulations, at §301.6103(n)–2T(d)(2), provide that any written contract for services as described in §301.6103(n)–2T(a)(1) must provide that any whistleblower and, if applicable, the legal representative of a whistleblower, who has access to return information under these regulations shall comply with the prescribed requirements.

The temporary regulations, at §301.6103(n)–2T(d)(3), impose the requirement that whistleblowers, and their legal representatives who receive return information under these regulations, must agree in writing, before any disclosure of return information is made, to permit an inspection of their premises by the IRS relative to the maintenance of the return information disclosed to them under these regulations and, upon completion of services as described in the written contract with the IRS, to dispose of all return information by returning the return information, including any and all copies or notes made, to the IRS, or to the extent that it cannot be returned, by destroying the information in a manner consistent with security guidelines and other safeguards for protecting return information in guidance published by the IRS.

The temporary regulations, at §301.6103(n)–2T(d)(4), provide that if the IRS determines that any whistleblower, or the legal representative of a whistleblower, who has access to return information under these regulations, has failed to, or does not, satisfy the prescribed requirements, the IRS, using the procedures described in

the regulations under section 6103(p)(7), may take any action it deems necessary to ensure that the prescribed requirements are or will be satisfied.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6) refer to the Special Analyses section of the preamble to the cross-reference notice of proposed rulemaking published in this issue of the Bulletin. Pursuant to section 7805(f) of the Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Helene R. Newsome, Office of the Associate Chief Counsel (Procedure & Administration).

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR part 301 is amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 is amended by adding an entry in numerical order to read as follows:

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

Section 301.6103(n)–2T also issued under 26 U.S.C. 6103(n); * * *

Par. 2. Section 301.6103(n)–2T is added to read as follows:

§301.6103(n)–2T Disclosure of return information in connection with written contracts among the IRS, whistleblowers, and legal representatives of whistleblowers (temporary).

(a) *General rule*. (1) Pursuant to the provisions of sections 6103(n) and 7623 of the Internal Revenue Code and subject to the conditions of this section, an officer or employee of the Treasury Department is authorized to disclose return information (as defined in section 6103(b)(2)) to a whistleblower and, if applicable, the legal representative of the whistleblower, to the extent necessary in connection with a written contract among the Internal Revenue Service (IRS), the whistleblower and, if applicable, the legal representative of the whistleblower, for services relating to the detection of violations of the internal revenue laws or related statutes.

(2) The Commissioner shall have the discretion to determine whether to enter into a written contract pursuant to section 7623 with the whistleblower and, if applicable, the legal representative of the whistleblower for services described in paragraph (a)(1) of this section.

(b) *Limitations*. (1) Disclosure of return information in connection with a written contract for services described in paragraph (a)(1) of this section shall be made only to the extent the IRS deems it necessary in connection with the reasonable or proper performance of the contract. Disclosures may include, but are not limited to, disclosures to accomplish properly any purpose or activity of the nature described in section 6103(k)(6) and the regulations thereunder.

(2) If the IRS determines that the services of a whistleblower and, if applicable, the legal representative of the whistleblower, as described in paragraph (a)(1) of this section can be performed reasonably or properly by disclosure of only parts or portions of return information, then only the parts or portions of the return information shall be disclosed.

(3) Upon written request by a whistleblower, or a legal representative of a whistleblower, with whom the IRS has entered into a written contract for services as described in paragraph (a)(1) of this section, the Director of the Whistleblower Office, or designee of the Director, may inform the whistleblower and, if applicable, the legal representative of the whistleblower, of the status of the whistleblower's claim for award under section 7623, including whether the claim is being evaluated for potential investigative action, or is pending due to an ongoing examination, appeal, collection action, or litigation. The information may be disclosed only if the Commissioner determines that the disclosure would not seriously impair Federal tax administration.

(4) Return information disclosed to a whistleblower and, if applicable, a legal representative of a whistleblower, under this section, shall not be disclosed or otherwise used by the whistleblower or a legal representative of a whistleblower, except as expressly authorized in writing by the Director of the Whistleblower Office.

(c) *Penalties*. Any whistleblower, or legal representative of a whistleblower, who receives return information under this section, is subject to the civil and criminal penalty provisions of sections 7431, 7213, and 7213A for the unauthorized inspection or disclosure of the return information.

(d) *Safeguards*. (1) Any whistleblower, or the legal representative of a whistleblower, who receives return information under this section, shall comply with all applicable conditions and requirements as the IRS may prescribe from time to time (prescribed requirements) for the purposes of protecting the confidentiality of the return information and preventing any disclosure or inspection of the return information in a manner not authorized by this section.

(2) Any written contract for services as described in paragraph (a)(1) of this section shall provide that any whistleblower and, if applicable, the legal representative of a whistleblower, who has access to return information under this section, shall comply with the prescribed requirements.

(3) Any whistleblower, or the legal representative of a whistleblower, who may receive return information under this section, shall agree in writing, before any disclosure of return information is made, to permit an inspection of his or her premises by the IRS relative to the maintenance of the return information disclosed under these regulations and, upon completion of services as described in the written contract with the IRS, to dispose of all return information by returning the return information, including any and all copies or notes made, to the IRS, or to the extent that it cannot be returned, by destroying the information in a manner consistent with security guidelines and other safeguards for protecting return information in guidance published by the IRS.

(4) If the IRS determines that any whistleblower, or the legal representative of a whistleblower, who has access

to return information under this section, has failed to, or does not, satisfy the prescribed requirements, the IRS, using the procedures described in the regulations under section 6103(p)(7), may take any action it deems necessary to ensure that the prescribed requirements are or will be satisfied, including—

(i) Suspension of further disclosures of return information by the IRS to the whistleblower and, if applicable, the legal representative of the whistleblower, until the IRS determines that the conditions and requirements have been or will be satisfied; and

(ii) Suspension or termination of any duty or obligation arising under a contract with the IRS.

(e) *Definitions*. For purposes of this section—

(1) The term *Treasury Department* includes the IRS and the Office of the Chief Counsel for the IRS.

(2) The term *whistleblower* means an individual who provides information to the IRS regarding violations of the tax laws or related statutes and submits a claim for an award under section 7623 with respect to the information.

(3) The term *legal representative* means any individual who is a member in good standing in the bar of the highest court of any state, possession, territory, commonwealth, or the District of Columbia, and who has a written power of attorney executed by the whistleblower.

(f) *Effective/applicability date*. This section is applicable on March 25, 2008.

(g) *Expiration date*. This section will expire on March 23, 2011.

Linda E. Stiff,
Deputy Commissioner for Services and Enforcement.

Approved March 12, 2008.

Eric Solomon,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on March 24, 2008, 8:45 a.m., and published in the issue of the Federal Register for March 25, 2008, 73 F.R. 15668)

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2008. See Rev. Rul. 2008-24, page 861.

Section 7872.—Treatment of Loans With Below-Market Interest Rates

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2008. See Rev. Rul. 2008-24, page 861.

Part II. Treaties and Tax Legislation
Subpart A.—Tax Conventions and Other Related Items

German Mutual Agreement Procedure Arbitration Announcement

Announcement 2008–39

Following is a copy of the announcement posted by the LMSB Deputy Commissioner (International) on the Internal Revenue Service LMSB Website on April 3, 2008.[1]

Announcement Concerning Mutual Agreement Procedure Arbitration under the Recent Protocol Between the United States and Germany

Background

On December 28, 2007, the Protocol Amending the Convention Between the United States and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital and to Certain Other Taxes (the 2006 Protocol) entered into force. The 2006 Protocol modified certain provisions of the Convention between the United States and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital and to Certain Other Taxes (the Convention). Among other things, the 2006 Protocol revises Article 25 (Mutual Agreement Procedure) of the Convention to provide for mandatory arbitration of certain cases in the mutual agreement procedure (MAP). The competent authorities of the United States and Germany are jointly developing procedures for implementing the arbitration process. Information regarding the relevant procedures will be incorporated into a mutual agreement at a future date. This Announcement provides interim guidance concerning the "commencement date" for MAP cases for purposes of the arbitration process until a formal mutual agreement is published.

Commencement date

New paragraph 6(c)(aa) of Article 25 of the Convention provides that arbitration proceedings generally shall begin two years after the commencement date of a MAP case. Under paragraph 4 of Article XVII of the 2006 Protocol, the commencement date for a MAP case that was already under consideration by the competent authorities as of December 28, 2007, shall be December 28, 2007.

For requests for competent authority assistance received on or after December 28, 2007, new paragraph 6(b) of Article 25 of the Convention provides that the commencement date of such a MAP case is the earliest date on which the information necessary to undertake substantive consideration for a mutual agreement has been received by both competent authorities. For purposes of a competent authority request in the United States, the information necessary to undertake substantive consideration for a mutual agreement is the information required to be submitted to the U.S. competent authority under Revenue Procedure 2006–54, Section 4.05. For purposes of a competent authority request in Germany, the information necessary to undertake substantive consideration for a mutual agreement is the information required to be submitted to the German competent authority under Memorandum IV B 6 – B 1300- 340/06. See paragraph 22(p) of Article XVI of the 2006 Protocol.

The competent authorities of the United States and Germany agree that, within 45 days after receipt of a request for competent authority assistance, each competent authority shall determine whether the taxpayer's request provides information necessary to undertake substantive consideration. The agreement will also provide that, if the necessary information has been provided, then the relevant competent authority will advise the taxpayer and the other competent authority that the information submitted with the taxpayer's request is sufficient to undertake substantive consideration of the request.

If the necessary information is not provided, the relevant competent authority will inform the taxpayer and other competent authority of what additional information is needed. After the relevant competent authority has determined that it has the necessary information it will inform the taxpayer and the other competent authority of its determination.

The agreement will also provide that the competent authorities shall inform taxpayers in writing of the commencement date consistent with new paragraph 6(b) of Article 25 of the Convention.

A case initially submitted to the competent authorities as a request for an Advance Pricing Agreement (APA) is eligible for arbitration, but only to the extent tax returns have been filed with respect to all taxable years at issue. For purposes of establishing a commencement date for cases initially submitted as a request for an APA, paragraph 22(p)(aa) of Article XVI of the 2006 Protocol provides that the information necessary to undertake substantive consideration for a mutual agreement is the information required to be submitted to the Internal Revenue Service under Revenue Procedure 2006–9, section 4 (or any applicable successor provisions). The competent authorities agree that they will modify this rule pursuant to paragraph 22(q) of Article XVI of the 2006 Protocol to take into account the procedures related to processing APA requests. Such agreement will indicate that the commencement date for cases initially submitted as a request for an APA shall be the earlier of, the date the countries exchange position papers, or two years from the date the taxpayer submits the information required by Revenue Procedure 2006–9, section 4. The competent authorities shall inform the taxpayers in writing of the commencement date.

[1] *http://www.irs.gov/businesses/international/article/0,,id=181003,00.html*

Part III. Administrative, Procedural, and Miscellaneous

Supplemental Guidance Under the Preparer Penalty Provisions of the Small Business and Work Opportunity Tax Act of 2007

Notice 2008–46

This notice provides guidance regarding implementation of the tax return preparer penalty provisions under section 6694 of the Internal Revenue Code, as amended by the Small Business and Work Opportunity Tax Act of 2007, Pub. L. No. 110–28, 121 Stat. 190, by adding certain returns and documents supplementing Exhibits 1, 2, and 3 of Notice 2008–13, 2008–3 I.R.B. 282.

A. *Returns and Claims for Refund Subject to 6694 Penalty*

Notice 2008–13 describes categories of returns and other documents to which section 6694 could apply. Notice 2008–13 provides that, solely for purposes of section 6694, a return or claim for refund includes the tax returns listed in Exhibit 1 or a claim for refund with respect to any such return. The notice further provides that a person who for compensation prepares all or a substantial portion of any of the tax returns listed on Exhibit 1 is a tax return preparer who is subject to section 6694.

Notice 2008–13 also provides that solely for purposes of section 6694, an information return or document listed on Exhibit 2 that includes information that is or may be reported on a taxpayer's tax return or claim for refund is a return to which section 6694 could apply if the information reported constitutes a *substantial portion* of that taxpayer's tax return or claim for refund. A person who for compensation prepares any of the information returns or documents listed on Exhibit 2, which return or document does not report a tax liability but affects an entry or entries on a tax return and constitutes a substantial portion of the tax return or claim for refund that does report a tax liability, is a tax return preparer who is subject to section 6694.

Notice 2008–13 also provides that solely for purposes of section 6694, a document listed on Exhibit 3 that includes information that is or may be reported on a taxpayer's tax return or claim for refund (and that constitutes a substantial portion of such tax return or claim for refund) will not subject the preparer to a penalty under section 6694(a). A document listed on Exhibit 3, however, may subject the preparer to a willful or reckless conduct penalty under section 6694(b) if the information reported on the document constitutes a substantial portion of the tax return or claim for refund and is prepared willfully in any manner to understate the liability of tax on a tax return or claim for refund, or in reckless or intentional disregard of rules or regulations. A person who for compensation prepares all or a substantial portion of any of the documents listed on Exhibit 3 is not a tax return preparer subject to section 6694(a) unless the document was prepared willfully in any manner to understate the liability of tax on a tax return or claim for refund or in reckless or intentional disregard of rules or regulations.

Notice 2008–13 also provides that the Treasury Department and the Internal Revenue Service may add or remove forms or documents from any of the categories or exhibits to Notice 2008–13 in future guidance. Accordingly, the following returns and documents are added to Exhibits 1, 2, and 3 of Notice 2008–13:

Exhibit 1 — Tax Returns Reporting Tax Liability

(1) Form 1040–C, *U.S. Departing Alien Income Tax Return;*

(2) Form 1040NR, *U.S. Nonresident Alien Income Tax Return;*

(3) Form 1040NR–EZ, *U.S. Income Tax Return for Certain Nonresident Aliens With No Dependents;*

(4) Form 1041–N, *U.S. Income Tax Return for Electing Alaska Native Settlement Trusts;*

(5) Form 1041–QFT, *U.S. Income Tax Return for Qualified Funeral Trusts;*

(6) Form 1120–FSC, *U.S. Income Tax Return of a Foreign Sales Corporation;*

(7) Form 1120–H, *U.S. Income Tax Return for Homeowners Associations;*

(8) Form 1120–L, *U.S. Life Insurance Company Income Tax Return;*

(9) Form 1120–ND, *Return for Nuclear Decommissioning Funds and Certain Related Persons;*

(10) Form 1120–PC, *U.S. Property and Casualty Insurance Company Income Tax Return;*

(11) Form 1120–POL, *U.S. Income Tax Return for Certain Political Organizations;*

(12) Form 1120–REIT, *U.S. Income Tax Return for Real Estate Investment Trusts;*

(13) Form 1120–RIC, *U.S. Income Tax Return for Regulated Investment Companies;*

(14) Form 1120–SF, *U.S. Income Tax Return for Settlement Funds (Under Section 468B);*

(15) Form 1040–SS, *U.S. Self-Employment Tax Return (Incuding the Additional Child Tax Credit for Bona Fide Residents of Puerto Rico);*

(16) Form 2438, *Undistributed Capital Gains Tax Return;*

(17) Form 8288, *U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests;*

(18) Form 8752, *Required Payment or Refund Under Section 7519;* and

(19) Form 8804, *Annual Return for Partnership Withholding Tax (Section 1446).*

Exhibit 2 — Information Returns That Report Information That is or May be Reported on Another Tax Return That May Subject a Tax Return Preparer to the Section 6694(a) Penalty if the Information Reported Constitutes a Substantial Portion of the Other Tax Return

(1) Form 3520, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts;*

(2) Form 3520–A, *Annual Information Return of Foreign Trust With a U.S. Owner (Under section 6048(b));*

(3) Form 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations;*

(4) Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Under Sections 6038A and 6038C of the Internal Revenue Code);*

(5) Form 8805, *Foreign Partner's Information Statement of Section 1446 Withholding Tax;*

(6) Form 8858, *Information Return of U.S. Persons With Respect To Foreign Disregarded Entities;* and

(7) Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*.

Exhibit 3 — Forms That Would Not Subject a Tax Return Preparer to the Section 6694(a) Penalty Unless Prepared Willfully in any Manner to Understate the Liability of Tax on a Return or Claim for Refund or in Reckless or Intentional Disregard of Rules or Regulations

(1) Form 8288–A, *Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests;* and

(2) Form 8288–B, *Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests*.

EFFECTIVE DATE

This notice is effective as of April 16, 2008.

EFFECT ON OTHER DOCUMENTS

Notice 2008–13, 2008–3 I.R.B. 282, is supplemented.

CONTACT INFORMATION

The principal authors of this notice are Matthew S. Cooper and Michael E. Hara of the Office of Associate Chief Counsel (Procedure and Administration). For further information regarding this notice, contact Mr. Cooper at (202) 622–4940 or Mr. Hara at (202) 622–4910 (not toll-free calls).

Public Comment Invited on Recommendations for 2008–2009 Guidance Priority List

Notice 2008–47

The Department of Treasury and Internal Revenue Service invite public comment on recommendations for items that should be included on the 2008–2009 Guidance Priority List.

The Treasury Department's Office of Tax Policy and the Service use the Guidance Priority List each year to identify and prioritize the tax issues that should be addressed through regulations, revenue rulings, revenue procedures, notices, and other published administrative guidance. The 2008–2009 Guidance Priority List will establish the guidance that the Treasury Department and the Service intend to issue from July 1, 2008, through June 30, 2009. The Treasury Department and the Service recognize the importance of public input to formulate a Guidance Priority List that focuses resources on guidance items that are most important to taxpayers and tax administration. Published guidance plays an important role in increasing voluntary compliance by helping to clarify ambiguous areas of the tax law.

As is the case whenever significant legislation is enacted, the Treasury Department and the Service have continued to dedicate substantial resources during the current plan year to published guidance projects necessary to implement the provisions of the American Jobs Creation Act of 2004, Pub. L. No. 108–357, 118 Stat. 1418, which was enacted on October 22, 2004; the Energy Policy Act of 2005, Pub. L. No. 109–58, 119 Stat. 594, which was enacted on August 8, 2005; the Gulf Opportunity Zone Act of 2005, Pub. L. No. 109–135, 119 Stat. 2577, which was enacted on December 21, 2005; the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109–222, 120 Stat. 345, which was enacted on May 17, 2006; the Pension Protection Act of 2006, Pub. L. No. 109–280, 120 Stat. 780, which was enacted on August 17, 2006; the Tax Relief

and Health Care Act of 2006, Pub. L. No. 109–432, 120 Stat. 2921, which was enacted on December 20, 2006; the Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110–142, 121 Stat. 1803, which was enacted on December 20, 2007; and the Economic Stimulus Act of 2008, Pub. L. No. 110–185, 122 Stat. 613, which was enacted on February 13, 2008. The Treasury Department and the Service will continue to evaluate the priority of each guidance project in light of the above-mentioned tax legislation and other developments occurring during the 2008–2009 plan year.

In reviewing recommendations and selecting projects for inclusion on the 2008–2009 Guidance Priority List, the Treasury Department and the Service will consider the following:

1. Whether the recommended guidance resolves significant issues relevant to many taxpayers;
2. Whether the guidance may be appropriate for enhanced public involvement through the process described in Notice 2007–17, 2007–12 I.R.B. 748;
3. Whether the recommended guidance promotes sound tax administration;
4. Whether the recommended guidance can be drafted in a manner that will enable taxpayers to easily understand and apply the guidance;
5. Whether the Service can administer the recommended guidance on a uniform basis; and
6. Whether the recommended guidance reduces controversy and lessens the burden on taxpayers or the Service.

Taxpayers may submit recommendations for guidance at any time during the year. Please submit recommendations by May 31, 2008, for possible inclusion on the original 2008–2009 Guidance Priority List. The Treasury Department and the Service plan to update the 2008–2009 Guidance Priority List periodically to reflect additional guidance that the Treasury Department and the Service intend to publish during the plan year. The periodic updates allow the Treasury Department and the Service to respond to the need for additional guidance that may arise during the plan year. Recommendations for guidance received after May 31, 2008, will be reviewed for inclusion in the next periodic update.

Taxpayers are not required to submit recommendations for guidance in any particular format. Taxpayers should, however, briefly describe the recommended guidance and explain the need for the guidance. In addition, taxpayers may include an analysis of how the issue should be resolved. It would be helpful if taxpayers suggesting more than one guidance project prioritize the projects by order of importance. If a large number of projects are being suggested, it also would be helpful if the projects were grouped in terms of high, medium or low priority.

Taxpayers should send written comments to:

Internal Revenue Service
Attn: CC:PA:LPD:PR
(Notice 2008–47)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

or hand deliver comments Monday through Friday between the hours of 8 a.m. and 4 p.m. to:

Courier's Desk
Internal Revenue Service
Attn: CC:PA:LPD:PR
(Notice 2008–47)
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Alternatively, taxpayers may submit comments electronically via e-mail to the following address: *Notice.Comments@irscounsel.treas.gov*. Taxpayers should include "Notice 2008–47" in the subject line. All comments will be available for public inspection and copying in their entirety.

For further information regarding this notice, contact Henry Schneiderman of the Office of Associate Chief Counsel (Procedure and Administration) at (202) 622–3400 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking, a Notice of Public Hearing, and Withdrawal of Previously Proposed Regulations

Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property

REG–168745–03

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking, a notice of public hearing, and withdrawal of previously proposed regulations.

SUMMARY: This document contains proposed regulations that explain how section 263(a) of the Internal Revenue Code (Code) applies to amounts paid to acquire, produce, or improve tangible property. The proposed regulations clarify and expand the standards in the current regulations under section 263(a), as well as provide some bright-line tests (for example, a *de minimis* rule for acquisitions). The proposed regulations will affect all taxpayers that acquire, produce, or improve tangible property. This document also provides a notice of public hearing on the proposed regulations and withdraws the proposed regulations published in the **Federal Register** on August 21, 2006 (71 FR 161).

DATES: Written or electronic comments must be received by June 9, 2008. Outlines of topics to be discussed at the public hearing scheduled for June 24, 2008, at 10 a.m., must be received by June 3, 2008.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–168745–03), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8:00 a.m. and 4:00 p.m. to CC:PA:LPD:PR (REG–168745–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224, or sent electronically, via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–168745–03). The public hearing will be held in the auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Merrill D. Feldstein or Mon L. Lam, (202) 622–4950; concerning submission of comments, the hearing, and/or to be placed on the building access list to attend the hearing, *Richard.A.Hurst@irscounsel.treas.gov*.

SUPPLEMENTARY INFORMATION:

Background

On August 21, 2006, the IRS and Treasury Department published in the **Federal Register** (71 FR 161) proposed amendments to the regulations under section 263(a) (2006 proposed regulations) relating to amounts paid to acquire, produce, or improve tangible property. The IRS and Treasury Department received numerous written comments. A public hearing was held on December 19, 2006. After considering the comment letters and the statements at the public hearing, the IRS and Treasury Department are withdrawing the 2006 proposed regulations and are proposing new regulations.

Summary of Comments and Explanation of Provisions

I. *Overview*

These new proposed regulations include many of the provisions contained in the 2006 proposed regulations, including the proposed format changes in which §1.263(a)–1 provides general rules for capital expenditures, §1.263(a)–2 provides rules for amounts paid for the acquisition or production of tangible property, and §1.263(a)–3 provides rules for amounts paid for the improvement of tangible property. However, these new proposed regulations provide many additional rules that were not included in the 2006 proposed regulations. For example, these new proposed regulations provide a definition of materials and supplies under §1.162–3 (including a special 12-month rule and a $100 *de minimis* rule), a book conformity *de minimis* rule for acquisitions of units of property under §1.263(a)–2, a safe harbor for routine maintenance under §1.263(a)–3, and an optional simplified method for regulated taxpayers under §1.263(a)–3. Additionally, these new proposed regulations provide significant changes to the rules relating to unit of property and restorations, and allow for industry-specific repair allowance methods in future Internal Revenue Bulletin guidance. These new proposed regulations generally will apply to taxable years beginning on or after the date that final regulations are published in the **Federal Register**.

II. *Withdrawal and Re-Proposal of Regulations*

In addition to providing specific comments, many commentators suggested that, given the broad scope and effect of the regulations and the numerous comments received on the 2006 proposed regulations, consideration should be given to re-proposing the regulations in their entirety. This suggestion has been adopted and the 2006 proposed regulations are withdrawn and replaced with these new proposed regulations.

III. *Materials and Supplies under §1.162–3*

Various commentators thought that the 2006 proposed regulations failed to fully address the relationship between the rules for capitalization of tangible property under section 263(a) and the materials and supplies rules provided in §1.162–3 of the current regulations because the 2006 proposed regulations did not provide special rules for the interaction between the two provisions. Specifically, commentators noted that under the 2006 proposed regulations, tangible property with a useful life of 12 months or less was not treated as a material and supply, which treatment was inconsistent with existing authorities, particularly with regard to the timing of when to deduct amounts paid to acquire the property with a useful life of 12 months

or less. Commentators pointed out that the 2006 proposed regulations were inconsistent with §1.162–3 and would create uncertainty with regard to which provision should be applied to which property. In response, the IRS and Treasury Department decided to revise §§1.162–3 and 1.263(a)–2 to provide clear and consistent treatment for those items that traditionally have been considered to be materials and supplies and to provide distinct, but coordinated, treatment for those items that should be addressed under section 263(a).

The new proposed regulations provide additional guidance under §1.162–3 with respect to the definition of materials and supplies. Specifically, the proposed rules define a material and supply as tangible property that (a) is not a unit of property, (b) is a unit of property with an economic useful life of 12 months or less, (c) is a unit of property that costs $100 or less, or (d) is identified as a material and supply in future guidance.

Under the existing regulations, the costs of non-incidental materials and supplies are deducted as the materials and supplies are used or consumed, and the costs of incidental materials and supplies are deducted as the costs are incurred. These new proposed regulations retain this treatment of materials and supplies, except with respect to rotable and temporary spare parts. These new proposed regulations provide that rotable or temporary spare parts treated as materials and supplies will be considered used or consumed in the taxable year in which the taxpayer disposes of the parts. This rule prevents taxpayers from prematurely deducting the cost of a unit of property by systematically replacing components with rotable spare parts. The IRS and Treasury Department anticipate that taxpayers with rotable or temporary spare parts that are not discarded after their original use generally will prefer to capitalize their costs and treat those parts as depreciable assets. These new proposed regulations provide for an election to capitalize these costs.

Taxpayers should recognize that the used or consumed standard for non-incidental materials and supplies generally is met later than the placed in service standard used for depreciation. In addition, taxpayers are reminded that after a material or supply is used or consumed, capitalization of the material or supply cost to another property may be required. For example, amounts paid for materials and supplies used in the production of inventory or a self-constructed asset generally are required to be capitalized under section 263A. Similarly, amounts paid to produce materials and supplies generally are required to be capitalized as part of the production costs of the materials and supplies. Nothing in these new proposed regulations is intended to change this treatment.

First, these new proposed regulations provide that property that is not a unit of property as defined in §1.263(a)–3 will be considered a material and supply. In general, this definition is intended to describe spare and replacement parts and is consistent with the current characterization of these items.

Second, these new proposed regulations provide that property that has an economic useful life of 12 months or less will be considered a material and supply. Commentators requested clarification concerning the application of the 12-month rule provided in the 2006 proposed regulations. For purposes of applying the 12-month rule, these new proposed regulations generally adopt the economic useful life definition in §1.167(a)–1(b) and provide that, for purposes of these new proposed materials and supplies regulations, the measurement period for economic useful life begins when the item is first used or consumed in the taxpayer's trade or business. Therefore, the time prior to when an item is used or consumed is not taken into consideration in determining the economic useful life of the asset for purposes of these new proposed regulations, notwithstanding the fact that the item may have been placed in service (ready and available for its intended use) for depreciation.

In addition, these new proposed regulations provide a special economic useful life test under the 12-month rule for taxpayers with applicable financial statements (AFS). Under this rule, taxpayers with AFS are required to determine the economic useful life in a manner consistent with the economic useful life used for purposes of determining depreciation in the books and records supporting their AFS. An exception is provided if a taxpayer does not assign a useful life to certain property in its AFS (for example, the item is currently expensed in the taxpayer's AFS because it is considered *de minimis*).

The 2006 proposed regulations did not provide a *de minimis* rule for the acquisition or production of property but requested comments on whether a *de minimis* rule should be adopted. Commentators generally agreed that the regulations should include a *de minimis* rule but varied on how that rule should be structured.

Third, these new proposed regulations provide a $100 *de minimis* rule within the definition of materials and supplies. Materials and supplies include a unit of property that has a production or acquisition cost of $100 or less, without regard to the treatment of the item in the taxpayer's financial statements. Allowing small items to be treated as materials and supplies resolves uncertainty with respect to whether those items represent a depreciable asset or a material and supply, and $100 is a low enough threshold to alleviate concerns about the potential distortion of income. However, treating a small unit of property as a material and supply may affect the timing of the deduction for the material and supply cost because expensing an amount paid for a non-incidental material and supply will only occur in the period in which the item is used or consumed.

Various commentators pointed out that taxpayer burden may be reduced by allowing taxpayers to capitalize amounts paid for items that otherwise would qualify as materials and supplies and treat the items as depreciable assets. For example, many taxpayers currently treat rotable spare parts as capital expenditures depreciable over the life of the unit of property in which the rotables are used. See Rev. Rul. 69–200, 1969–1 C.B. 60. See §601.601(d)(2)(ii)(*b*).

Under these new proposed regulations, taxpayers may elect to treat an amount paid for a material and supply as a capital expenditure. In general, the election is made separately for each material and supply and is revocable only with the consent of the Commissioner. The election is made by capitalizing the cost of the material and supply in the year the cost is incurred and beginning depreciation of the item in the year it is placed in service.

IV. *Repairs under §1.162–4*

The 2006 proposed regulations revised §1.162–4 (the repair rules), to provide rules consistent with the improvement rules under §1.263(a)–3 of the 2006 proposed regulations. Commentators expressed concern that the proposed changes would result in challenges to the deductibility of costs that the IRS has long agreed with taxpayers are deductible. The IRS and Treasury Department do not think that the proposed change to §1.162–4 creates a burden of proof higher than that which exists under current law or requires capitalization of costs that are not required to be capitalized under current law. Therefore, these new proposed regulations do not propose any specific changes to the rules proposed in the 2006 proposed regulations. However, a routine maintenance safe harbor is provided in these new proposed regulations in §1.263(a)–3.

V. *Professional Expenses under §1.162–6*

The existing regulations under §1.162–6 provide rules for professional expenses. These new proposed regulations propose to remove §1.162–6. In general, the treatment of the items listed in §1.162–6 is adequately addressed in these new proposed regulations and other existing regulations. The proposed removal of §1.162–6 is not intended to result in any substantive changes in the treatment of professional expenses.

VI. Capital Expenditures

A. *Amounts Paid to Sell Property*

The 2006 proposed regulations provided rules for the capitalization of selling expenses, except in the case of dealers, under §1.263(a)–1. The 2006 proposed regulations included an example that required the capitalization of advertising costs as a selling expense that must be offset against the sale proceeds. Various commentators questioned this treatment of advertising costs. In general, advertising costs are not capital expenditures. Therefore, these new proposed regulations retain the general rule but remove the references to advertising costs provided in the 2006 proposed regulations and update the examples accordingly.

B. Interests in Land

The 2006 proposed regulations did not provide a specific capitalization rule for amounts paid to acquire or create intangible interests in land. The 2006 proposed regulations specifically requested comments on this issue, but no comments were received. These new proposed regulations provide that amounts paid to acquire or create interests in land, such as easements, life estates, mineral interests, timber rights, zoning variances, or other interests in land, are examples of capital expenditures. Comments are specifically requested on this proposed rule.

VII. *Amounts Paid to Acquire or Produce Tangible Property*

The 2006 proposed regulations provided rules for the capitalization of amounts paid to acquire or produce tangible property under §1.263(a)–2. These new proposed regulations generally retain the same format, but make some modifications to the 2006 proposed regulations. For example, modifications have been made to clarify the interaction of §1.263(a)–2 of these new proposed regulations with the materials and supplies rules under §1.162–3. Significant modifications and clarifications are discussed further in this preamble.

A. *Definition of Produce*

Commentators asked whether the term "produce" as used in the 2006 proposed regulations had the same meaning as the term "produce" under section 263A. These new proposed regulations clarify that the definition of the term produce for purposes of §1.162–3 and §1.263(a)–2 generally is the same as the definition of the term produce for section 263A purposes. The sole difference is that the term "improve" is not included in §1.162–3 and §1.263(a)–2 because "improve" under section 263A is specifically defined in §1.263(a)–3 of these new proposed regulations, relating to the improvement of tangible property.

B. *Transaction Costs*

The 2006 proposed regulations generally required a taxpayer to capitalize amounts paid to facilitate the acquisition of real or personal property, and included a list of typical transaction costs. Commentators suggested that with respect to the rules requiring the capitalization of facilitative transaction costs, an exception should be provided for transaction costs for pre-decisional investigatory costs, similar to the exception provided with respect to certain intangibles in §1.263(a)–4(e)(1)(iii) (creation of certain contract rights) and §1.263(a)–5(e) (acquisition of a trade or business). These new proposed regulations provide a general rule similar to the rules in the intangibles regulations requiring that taxpayers capitalize all costs that facilitate an acquisition of tangible property, including the costs of investigating the acquisition, but adopt the commentators' suggestion in part by providing an exception for certain costs incurred in the investigation of real property acquisitions. The IRS and Treasury Department think it is appropriate to provide an exception for real property acquisitions because these types of transactions most often raise the issue of whether the investigatory costs are deductible business expansion costs rather than capital expenditures to acquire a specific asset. The exception provides that costs relating to activities performed in the process of determining whether to acquire real property and which real property to acquire generally are deductible pre-decisional costs. Under this exception, capitalization will not be required for certain pre-decisional investigative activities, such as marketing studies, that are not specifically identified in these regulations as being inherently facilitative. These new proposed regulations provide that inherently facilitative costs must be capitalized and list the costs, such as transportation and shipping costs, that are inherently facilitative.

A commentator pointed out that section 263A does not apply to acquisitions of property that are not intended for resale, and thus, taxpayers should not be required to capitalize overhead costs to this type of property. These new proposed regulations address this comment by providing a simplifying convention for employee compensation and overhead costs similar to the rules provided for intangible property. However, the new proposed regulations reiterate that section 263A does apply to the production of real or personal property. Section 263A contains rules for certain costs incurred prior to production.

Under current law, if a taxpayer engages in multiple separate and distinct transactions, the taxpayer may allocate transaction costs to the separate transactions and recover the allocable transaction costs as each distinct transaction is abandoned. *Sibley, Lindsay & Curr Co. v. Commissioner*, 15 T.C. 106, 110 (1950), acq., 1951–1 C.B. 3. See §601.601(d)(2)(ii)(*b*). However, if the transactions are viewed as alternatives, only one of which the taxpayer can complete, the courts have held that the taxpayer must capitalize all the transaction costs to the one transaction ultimately completed. *United Dairy Farmers, Inc. v. United States*, 267 F.3d 510 (6th Cir. 2001); *Nicolazzi v. Commissioner*, 79 T.C. 109 (1982), aff'd, 722 F.2d 324 (6th Cir. 1983). To avoid the difficulty inherent in administering this rule, including ascertaining the intent of the taxpayer, the new proposed regulations provide a more objective rule. This rule allows taxpayers to allocate inherently facilitative costs among the separate and distinct properties considered, regardless of the taxpayer's ultimate intent or plan. The taxpayer capitalizes the allocable transaction costs to each property, including properties not acquired, and recovers the costs as appropriate under the applicable provision of the Code (for example, section 165, 167, or 168). Examples are provided to demonstrate the application of these rules.

In addition, a commentator noted that the rule contained in the 2006 proposed regulations with respect to costs incurred prior to placing property in service is really a rule for acquisition costs, not improvement costs. The IRS and Treasury Department agree that activities occurring prior to placing the property in service are conceptually more related to the acquisition of the property than to the improvement of property. Therefore, these new proposed regulations move to the acquisition cost section of these regulations the requirement to capitalize amounts paid for work performed prior to placing property in service.

C. *De Minimis Rule*

The 2006 proposed regulations did not provide a specific *de minimis* rule for the acquisition or production of property, but the preamble provided a detailed proposal of what might be an appropriate *de minimis* rule and requested comments from taxpayers on this issue. Numerous comments supported the adoption of a *de minimis* rule to the extent such a proposal would not alter the current understandings between taxpayers and examining agents with respect to what type of transactions are considered *de minimis* on examination for purposes of evaluating risk. Therefore, to reduce burden and provide simplification, these new proposed regulations provide a *de minimis* rule. With respect to the concerns raised by commentators as to the adoption of a *de minimis* rule, the IRS and Treasury Department want to make clear that the adoption of such a rule is not intended to alter the general risk analysis currently employed by examining agents. Therefore, the *de minimis* rule proposed in these regulations should not affect any current understandings between examining agents and taxpayers with respect to the size and character of transactions that will be the focus of examinations.

The proposed *de minimis* rule is based primarily on a qualifying taxpayer's financial statement standards. A qualifying taxpayer is a taxpayer that: (a) has an AFS, (b) has written accounting procedures for the expensing of *de minimis* items, and (c) recognizes *de minimis* costs as expenses on its AFS. Under the rule provided in these new proposed regulations, a qualifying taxpayer can use the *de minimis* standard adopted in its AFS to the extent the AFS *de minimis* standard does not result in a distortion of income. Although commentators varied regarding whether it is appropriate to require conformity with AFS to qualify for a *de minimis* rule, the IRS and Treasury Department think that it provides simplification and reduces burden only to allow deductions for *de minimis* amounts paid for property (other than the $100 rule for materials and supplies) that are already being deducted for AFS purposes.

The primary concern with the adoption of a *de minimis* rule is that expensing items under a *de minimis* rule may not clearly reflect income under section 446, particularly for aggregate or bulk purchases of *de minimis* items. In general, the IRS and Treasury Department recognize that accounting for an item using generally accepted accounting principles will not result in a distortion of income. Nonetheless, a distortion of income standard has been adopted in an effort to avoid intentional manipulations of the *de minimis* rule. These new proposed regulations provide a safe harbor in which the use of an AFS *de minimis* standard will be deemed not to distort income. Specifically, the safe harbor provides that an amount deducted under the AFS *de minimis* rule for the taxable year will be deemed not to distort income if that amount, added to the amounts deducted in the taxable year as materials and supplies for units of property costing $100 or less, is less than or equal to the lesser of (i) 0.1 percent of the taxpayer's gross receipts for the taxable year, or (ii) 2 percent of the taxpayer's total depreciation and amortization for the taxable year as determined in its AFS. The safe harbor provided in these new proposed regulations is based upon percentages and comparisons provided in case law. See *Alacare Home Health Services, Inc. v. Commissioner*, T.C. Memo. 2001–149; *Cincinnati, New Orleans & Tex. Pac. Ry. Co. v. United States*, 424 F.2d 563 (Ct. Cl. 1970). This safe harbor is not intended to be used in other contexts as a bright-line rule of an amount that distorts income. Whether amounts above the safe harbor result in a distortion of income depends upon the taxpayer's facts and circumstances.

These new proposed regulations also provide that gain on the sale or disposition of property accounted for under the *de minimis* rule is not treated as gain resulting from the sale or disposition of a capital asset under section 1221 or as property used in the trade or business under section 1231. These new proposed regulations also clarify that property accounted for under the *de minimis* rule is not a material or supply under §1.162–3.

Moreover, these new proposed regulations provide that taxpayers may elect to capitalize items that might otherwise be within the scope of the *de minimis* rule. In general, this election to capitalize is made separately for each asset by treating the amount paid as a capital expenditure on the tax return.

These new proposed regulations also make a conforming change to the regulations under section 263A to ensure that amounts paid for property produced by the taxpayer also qualify under the *de minimis* rule, because there is no basis for distinguishing between acquired and produced property for this purpose. This change

is provided in §1.263A–1(b)(14) of these new proposed regulations. The rule provides that the cost of property to which a taxpayer properly applies the *de minimis* rule contained in §1.263(a)–2(d)(4) of these new proposed regulations (including the requirement that it not distort income) is not required to be capitalized under section 263A as a separate unit of property, but may be required to be capitalized as a cost incurred by reason of the production of other property. This change is necessary because without a conforming change to section 263A, property produced by the taxpayer that qualified under the *de minimis* rule would be capitalized under section 263A despite the *de minimis* rule under section 263(a).

These new proposed regulations do not impose any specific record keeping requirements for the use of the *de minimis* rule. However, under section 6001, taxpayers are required to keep books and records sufficient to establish their eligibility to use the *de minimis* rule. Specifically, taxpayers must maintain books and records reasonably sufficient to determine (1) the total amounts paid and deducted as materials and supplies pursuant to §1.162–3(d)(1)(iii) of these new proposed regulations; (2) the total amounts paid and not capitalized pursuant to §1.263(a)–2(d)(4)(i) of these new proposed regulations; (3) the computation of the safe harbor amount provided by §1.263(a)–2(d)(4)(iii) of these new proposed regulations; (4) that income has not been distorted by the aggregate of the deductions under §§1.162–3(d)(1)(iii) and 1.263(a)–2(d)(4)(i) of these new proposed regulations if the aggregate amount exceeds the safe harbor amount determined pursuant to §1.263(a)–2(d)(4)(iii) of these new proposed regulations; and (5) that the requirements of §1.263(a)–2(d)(4)(i)(A)–(C) of these new proposed regulations have been met.

VIII. *Improvements*

In general, these proposed regulations are intended to reduce controversy and provide clarity on how to determine whether an amount paid must be capitalized under section 263(a) as an improvement cost. Consistent with that intent, the 2006 proposed regulations contained rules with respect to improvements, including rules to determine whether an amount paid results in a material increase in value or prolonged useful life. As described below, these regulations modify the rules set forth in the 2006 proposed regulations to reflect comments received. While these proposed regulations attempt to provide more certainty in an area of law that currently requires a subjective analysis, the IRS and Treasury Department request comments on whether the improvement rules in these regulations are consistent with the overriding goal of providing clarity and certainty in this area.

The IRS and Treasury Department received numerous comments regarding the improvement rules provided in the 2006 proposed regulations. Many of the comments received included a general request that consideration be given to providing more bright-line rules and clarifying definitions as well as providing greater consistency with other provisions of the Code. The rules contained in these new proposed regulations attempt to address these concerns.

Section 1.263(a)–3 of the 2006 proposed regulations provided that taxpayers are required to capitalize amounts paid to improve a unit of property. Under the general rule in the 2006 proposed regulations, a unit of property is improved if the amounts paid (i) materially increase the value of the unit of property; or (ii) restore the unit of property. Under the 2006 proposed regulations, amounts paid to adapt a unit of property to a new or different use were considered to materially increase the value of a unit of property. The 2006 proposed regulations also contained rules for determining the appropriate unit of property.

These new proposed regulations remove the new or different use standard from the material increase in value rules and provide a separate category for new or different use. Additionally, the material increase in value standard has been renamed the "betterment" standard because the betterment standard more closely reflects the manner in which section 263(a) has been interpreted and applied under current law. Therefore, these new proposed regulations identify three categories of costs that result in an improvement to property. Taxpayers under the new proposed regulations must capitalize amounts paid that:

(i) Result in a betterment to a unit of property;

(ii) Restore a unit of property; or

(iii) Adapt a unit of property to a new or different use.

These new proposed regulations continue to include rules for defining the unit of property to be used in making these determinations.

The 2006 proposed regulations did not prescribe a plan of rehabilitation doctrine as traditionally described in the case law. That judicially-created doctrine provides that a taxpayer must capitalize otherwise deductible repair costs if they are incurred as part of a general plan of rehabilitation to the property. See *Norwest Corp. v. Commissioner*, 108 T.C. 265 (1997); *Moss v. Commissioner*, 831 F.2d 833 (9th Cir. 1987); *United States v. Wehrli*, 400 F.2d 686 (10th Cir. 1968). Commentators requested that the regulations specifically state that the plan of rehabilitation doctrine either is eradicated or is limited to clearly defined circumstances.

Section 263A requires that all direct costs of an improvement and all indirect costs that directly benefit or are incurred by reason of the improvement must be capitalized. See section 263A(b)(1), which states that section 263A applies to real or tangible property produced by the taxpayer, and section 263A(g)(1), which states that the definition of "produce" includes improve. See also §1.263A–1(e), which requires the capitalization of direct costs and of all indirect costs that directly benefit or are incurred by reason of the performance of production activities. Section 263A, therefore, requires a taxpayer to capitalize otherwise deductible repair costs as part of an improvement if the taxpayer improves a unit of property and the otherwise deductible repair costs directly benefit or are incurred by reason of the improvement to the property. Thus, section 263A has eliminated the need for a plan of rehabilitation doctrine to determine the allocable costs that must be capitalized as part of an improvement. Although some commentators requested that the circumstances in which otherwise deductible repair costs must be capitalized as part of an improvement be limited, for example, to property that is totally dysfunctional and unsuitable for its intended purpose,

there is no authority for doing so because section 263A specifically applies to improvements. The legislative history to the Tax Reform Act of 1986, P.L. 99–514 (100 Stat. 2085) also indicates that Congress intended section 263A to apply to improvements to property. See, for example, S. Rep. No. 99–313, 99th Cong., 2d Sess. 133–152 (1986), which states that the uniform capitalization rules will apply to assets or improvements to assets constructed by a taxpayer for its own use in a trade or business or in an activity engaged in for profit, and that the rules are not intended to apply to expenditures properly treated as repair costs under present law that do not relate to the manufacture, remanufacture, or production of property.

Section 263A does not require otherwise deductible repair costs to be capitalized if the repairs do not directly benefit or are not incurred by reason of a production activity (for example, an improvement). The judicially-created plan of rehabilitation doctrine, however, has been cited to require capitalization of otherwise deductible repair costs solely because the taxpayer has a plan (written or otherwise) to perform periodic repairs or maintenance, or solely because the taxpayer performs several repairs to the same property at one time even though the property is not improved. As stated in the preamble to the 2006 proposed regulations, the IRS and Treasury Department do not think this characterization is appropriate. These new proposed regulations specifically provide that repairs that are made at the same time as an improvement, but that do not directly benefit or are not incurred by reason of the improvement, are not required to be capitalized under section 263(a). These new proposed regulations do not prescribe a plan of rehabilitation doctrine. Therefore, when these new proposed regulations are finalized, the judicially-created plan of rehabilitation doctrine will be obsolete, particularly with regard to the assertion that the doctrine transforms otherwise deductible repair costs into capital improvement costs solely because the repairs are performed at the same time as an improvement, or are pursuant to a maintenance plan, even though the repairs do not improve the property under §1.263(a)–3. However, section 263A continues to require a taxpayer to capitalize otherwise deductible repair costs if the taxpayer improves a unit of property and the otherwise deductible repair costs directly benefit or are incurred by reason of the improvement to the property.

A. *Unit of Property*

The 2006 proposed regulations began with an initial unit of property determination of all components that are functionally interdependent to define the largest unit of property as a starting point for the analysis. Special rules applied to buildings and their structural components and to property used in certain regulated industries. Network assets were excluded from the definition of unit of property. The unit of property determination for other personal property employed a facts and circumstances test based on the application of four exclusive factors—(1) marketplace treatment; (2) industry practice and financial accounting; (3) treatment as a rotable spare part; and (4) functional use. An overriding rule required taxpayers to treat property as a unit of property for purposes of section 263 if the taxpayer did so for any other Federal income tax purpose.

The IRS and Treasury Department received multiple comments on the definition of a unit of property provided in the 2006 proposed regulations. The commentators generally expressed dissatisfaction with the unit of property rules provided in the 2006 proposed regulations, particularly with respect to the regulated industry rules and the rule for rotable spare parts. Commentators generally agreed with the unit of property rules for a building, but raised objections that the remaining rules provided in the 2006 proposed regulations were overly complex and ambiguous. Many commentators recommended that the determination of a unit of property be based primarily on the functional interdependence test, similar to that used for depreciation and section 263A purposes, with no further factors, while other commentators recommended that the determination be based on the factors used in *FedEx Corp. v. United States*, 291 F. Supp. 2d 699 (W.D. Tenn. 2003), aff'd, 412 F.3d 617 (6th Cir. 2005).

The IRS and Treasury Department think that most of the factors listed in the 2006 proposed regulations were the same as the factors used in *FedEx*. However, commentators generally criticized the manner in which the 2006 proposed regulations applied these factors. Nonetheless, the IRS and Treasury Department agree that some factors, such as the rotable spare parts factor, may be overly burdensome, particularly for taxpayers that use small components in their businesses. Additionally, although some taxpayers in regulated industries favored the ability to conform to regulatory reporting, many that are not subject to regulatory accounting for all assets objected to the conformity rule as inappropriate and a potential source for uncertainty and controversy. Therefore, these new proposed regulations substantially modify the unit of property definition contained in the 2006 proposed regulations.

These new proposed regulations provide unit of property rules that generally are based on the functional interdependence standard, and include special rules for buildings, plant property, and network assets. Additional rules are provided that may require a smaller unit of property characterization in certain circumstances. Generally, improvements to a unit of property are not considered separate units of property even though the improvements are treated as separate assets for depreciation purposes.

These new proposed regulations generally provide the same rule for buildings as the 2006 proposed regulations. A building and its structural components are treated as a single unit of property. However, a special rule for condominiums and cooperatives is provided. Additionally, a leasehold improvement that is section 1250 property and is made by a lessee is a separate unit of property.

For property other than a building, these new proposed regulations provide that, in general, a single unit of property includes all components that are functionally interdependent. However, a number of special rules are provided that may require a smaller unit of property to be considered. The IRS and Treasury Department do not think that applying solely a functional interdependence test results in the appropriate unit for all types of property. For some types of property, such as machinery and equipment in a manufacturing plant, the functional interdependence test often results in a very expansive unit of property. The IRS and Treasury Department think it is inappropriate to use such a large unit

of property for making a determination regarding improvements.

These new proposed regulations provide a special rule for plant property, which is defined as "functionally interdependent machinery or equipment . . . used to perform an industrial process . . . ." This definition is not intended to include all types of property used in a taxpayer's trade or business, but is intended only to capture the functionally interdependent machinery and equipment used in industrial processes like manufacturing, electric generation, distribution, warehousing, as well as equipment used in providing industrial services such as automated materials handling equipment. This special rule requires that the functionally interdependent machinery and equipment be separated into a component or a group of components that performs a discrete and major function or operation. These new proposed regulations provide various examples to illustrate activities that will constitute a discrete and major function.

These new proposed regulations provide the same definition of network assets as the 2006 proposed regulations and continue to reserve on providing a special rule for networks assets. The IRS and Treasury Department think that in many situations, the unit of property for network assets should be smaller than the unit of property determined under the functional interdependence test. The IRS and Treasury Department generally think that the unit of property rules for network assets should be addressed on an industry by industry basis in Internal Revenue Bulletin guidance. Industries are invited to submit requests for guidance under the Industry Issue Resolution (IIR) program after these regulations are finalized.

These new proposed regulations also provide two additional rules that may require a smaller unit of property determination than that provided under the general rule. The first rule is triggered if the taxpayer has assigned different economic useful lives for financial statement or regulatory purposes to components of a single unit of property at the time the unit of property is placed in service by the taxpayer. Simply accounting for components separately (for example, recording the property separately in depreciation or other asset-tracking books and records) does not trigger this rule. However, assigning a different economic useful life to components will require that the unit of property determination be limited to those components that have been assigned the same useful life for financial statement purposes. The second rule applies when components of a single unit of property are depreciated by the taxpayer under different MACRS classes (including a different MACRS class that results from a change in method of accounting). This second rule also applies if components of a single unit of property are depreciated by the taxpayer using different recovery methods (for example, double-declining balance versus unit-of-production). Again, simply recording various components separately in the taxpayer's depreciation books and records will not trigger the rule.

These rules are intended to prevent overly broad unit of property determinations that are inconsistent with the taxpayer's characterization of the unit of property for depreciation purposes. In general, the IRS and Treasury Department anticipate that these limiting rules will apply only in unique circumstances. The IRS and Treasury Department encourage taxpayers to provide comments on the application of these limiting rules and to identify situations (if any) in which the limiting rules may not operate as intended.

B. *Routine Maintenance Safe Harbor*

The 2006 proposed regulations did not contain a routine maintenance safe harbor. Various commentators requested that the regulations provide guidance to clarify when the cost of a routine maintenance activity will be considered a deductible expense. In addition, commentators expressed concern that under the rules provided in the 2006 proposed regulations, routine maintenance activities are required to be capitalized if performed near the end of the economic useful life of the property, regardless that identical activities were considered deductible if performed earlier in the useful life.

To address this concern, these new proposed regulations provide a routine maintenance safe harbor under which qualifying activities will be deemed to not improve the unit of property. Under this safe harbor, routine maintenance activities include recurring activities that a taxpayer expects to perform more than once over the class life of the unit of property as a result of the taxpayer's use of the unit of property to keep the unit of property in its ordinarily efficient operating condition. Amounts paid for betterments do not keep the unit of property in an ordinarily efficient operating condition; however, the replacement of minor parts with improved but comparable parts generally does not result in a betterment. Thus, for example, the safe harbor includes amounts paid for replacement parts that the taxpayer expects to replace more than once during the class life of the unit of property, even if the replacement part is an improved but comparable part. As part of the safe harbor provisions, these new proposed regulations provide a list of relevant considerations to be taken into account in determining whether an amount is paid for routine maintenance. These considerations include the recurring nature of the activity, industry practice, manufacturer recommendations, taxpayer experience and the treatment of the activity on the taxpayer's AFS. The safe harbor maintenance rule specifically applies to maintenance activities performed on rotable or temporary spare parts, but reminds taxpayers that under the rules proposed in §1.162–3(b) of these new proposed regulations, the capitalized costs associated with rotable and temporary spare parts (that is, acquisition costs) may be deducted only in the taxable year in which the rotable or temporary spare part is discarded.

One concern with establishing a maintenance safe harbor that includes the costs of replacement parts is creating an incentive for taxpayers to componentize assets in an effort to recover basis upon the removal of a component while deducting the replacement cost as a repair or maintenance expense. Therefore, the safe harbor does not apply to the cost of replacement components in situations in which the taxpayer has taken into account the basis of the component being replaced in determining gain or loss resulting from a sale or exchange of the replacement component, has taken a loss related to the retirement of the component, or has taken a basis adjustment related to a casualty event under section 165.

The safe harbor is intended to operate only as a safe harbor in which qualifying costs will be deemed not to constitute an improvement. The IRS and Treasury Department recognize that many ac-

tivities that do not qualify for the safe harbor nonetheless may be activities that do not give rise to capitalization of costs under section 263(a). Additionally, costs deductible under the maintenance safe harbor may be required to be capitalized under section 263A to other property produced or acquired for resale.

C. *Betterments*

1. *Overview*

The 2006 proposed regulations used the term "material increase in value" to generally describe the concept of a betterment. In general, commentators agreed with the standards outlined in the 2006 proposed regulations to determine whether an amount paid materially increases the value of property. However, commentators differed on whether taxpayers should be allowed to override the material increase in value test by proving that the activity did not actually increase fair market value. Consistent with the preamble to the 2006 proposed regulations, the IRS and Treasury Department continue to think that whether an amount paid should be capitalized as a betterment to a unit of property depends upon the purpose, the physical nature, and the effect of the work for which the amounts were paid, and not upon an analysis of the fair market value of the property before and after the work. Therefore, to clarify this distinction, these new proposed regulations change the name of the material increase in value test to the betterment test. The general rule focuses on betterments to the condition of the property, the costs of which should be capitalized as an improvement if the betterment is material, regardless of whether the betterment increases the fair market value.

Commentators noted that the general concept of a betterment is difficult to apply and suggested that the language in the regulations better define what types of events would give rise to a betterment. Additionally, commentators pointed out that some of the betterment tests were redundant. The IRS and Treasury Department agree that the general concept of a betterment or improvement can be difficult to apply. In developing these new proposed regulations, consideration was given to retaining the rules provided in the current regulations without providing clarification of material increase in value, prolong useful life, and new or different use. The principal concern in providing detailed rules on the concept of an improvement is the potential to create controversy in areas where none currently exists, which would undermine one of the primary purposes of the project.

Nonetheless, because commentators generally did not oppose the tests provided for material increase in value under the 2006 proposed regulations, these new proposed regulations continue to provide an exclusive list of tests that determine whether an amount paid results in a betterment in an attempt to further solicit comments in this area. The IRS and Treasury Department specifically request comments as to whether the exclusive list of tests with respect to improvements provides additional certainty in this area and if not, why. Given the continuing evaluation of this area, taxpayers should be particularly aware that no reliance should be placed on the rules provided in these new proposed regulations until such rules are finalized.

The tests included in the original proposed regulations have been reorganized in these new proposed regulations in an attempt to provide additional clarification. Under these new proposed regulations, an amount paid results in a betterment if it:

(i) Ameliorates a material condition or material defect that existed prior to the acquisition or arose during the production of the property,

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

(iii) Results in a material increase in the capacity, productivity, efficiency, strength, or quality of the unit of property or its output.

2. *Ameliorates a Material Condition or Defect*

This rule generally follows the rule contained in the 2006 proposed regulations but clarifies, in response to comments received, that capitalization is only required to the extent the condition or defect is considered material. Commentators noted that a taxpayer may not know of a condition or defect that exists at the time property is acquired and that requiring capitalization of costs in this situation would create a hardship for those taxpayers. Although taxpayers may not be aware of defects that exist at the time of acquisition, the remedial activity being performed necessarily results in a betterment, regardless of whether the activity actually increases the fair market value of the property. The rule provided in these proposed regulations is consistent with established case law. See *United Dairy Farmers, Inc. v. United States*, 267 F.3d 510 (6th Cir. 2001); *Dominion Resources, Inc. v. United States*, 219 F.3d 359 (4th Cir. 2000).

Moreover, adopting a rule based on a taxpayer's knowledge at the time of acquisition or production would be difficult to administer. The IRS and Treasury Department recognize that application of this rule to used property acquired by a taxpayer will result in some costs that would otherwise be deductible as repair costs being capitalized the first time the repairs are performed (if the condition or defect is material) if the nature of the activities is to correct the effects of wear and tear that was not caused by the taxpayer's use of the property. This result is consistent with the routine maintenance safe harbor, which requires the activities under that safe harbor to be performed as a result of the taxpayer's own use of the property.

The IRS and Treasury Department understand that certain cases exist in which a taxpayer contaminates property during its operations, the taxpayer disposes of the property, and the taxpayer reacquires the property to clean up the contamination. Under the proposed rule, a taxpayer would be required to capitalize the costs incurred to clean up the property even though it was the taxpayer's own activities that contaminated the property. The IRS and Treasury Department request comments regarding the appropriate treatment of environmental remediation costs in these circumstances, considering that the remediation is performed as a result of the taxpayer's own use of the property. The IRS and Treasury Department also request comments regarding how to determine whether the contamination was due solely to the taxpayer's prior operations or, if an interim owner may have added to the contamination, how to determine the appropriate treatment of remediation costs in that circumstance.

3. *Results in a Material Increase in the Capacity, etc.*

This rule applies both to material increases in the capacity, efficiency, strength, or quality of the unit of property itself as well as to material increases in the capacity, efficiency, strength, or quality of the output of the unit of property.

4. *Application of Betterments Rule*

Commentators requested that, to the extent possible, additional guidance be provided with respect to how the betterments rules, including materiality, should be applied. The IRS and Treasury Department considered various possible bright-line rules with respect to materiality, but determined that each rule was inappropriate under certain circumstances. For example, the IRS and Treasury Department considered a rule that presumed materiality if the amounts paid are capitalized in the taxpayer's financial statements as a permanent improvement, that is, the betterment is capitalized in the taxpayer's financial statements over the remaining economic useful life of the unit of property or longer. The IRS and Treasury Department think that financial statement treatment is an important factor in determining materiality, because if the activity is material enough to treat as an improvement for financial statements, then generally it should be a material improvement for tax purposes. However, this bright-line rule was not adopted because the IRS and Treasury Department recognize that the standards used for financial statement purposes for capitalization of improvements do not coincide with the rules for capitalization of improvements in these proposed regulations. For example, some taxpayers may defer major maintenance expenses and amortize the expenses over the period until the next maintenance cycle rather than immediately expensing the costs for financial statement purposes. The taxpayer's reason for not immediately expensing the cost for financial statement purposes (that is, treating the cost as a deferred expense or as a material capital expenditure) may not be readily apparent to the IRS, creating administrative burden and a potential source of controversy. Therefore, under these new proposed regulations, materiality will be based upon the facts and circumstances in each case. Examples are provided to illustrate to the application of materiality.

5. *Appropriate Comparison for Betterments*

The 2006 proposed regulations specifically provided that the appropriate comparison for determining whether an amount paid results in a betterment is made by comparing the condition of the unit of property immediately after the expenditure with the condition of the property prior to the circumstances necessitating the expenditure. These new proposed regulations retain the same comparison test.

D. *Restorations*

1. *Overview*

The 2006 proposed regulations provided that, consistent with section 263(a)(2), a taxpayer must capitalize amounts paid that restore a unit of property. The 2006 proposed regulations provided that amounts paid restore a unit of property only if they substantially prolong the economic useful life of the unit of property, and provided four rules for making that determination. The restoration of property rules contained in the 2006 proposed regulations were criticized by commentators as being overbroad and difficult to apply. In particular, the AFS definition of economic useful life and the bright-line one-year rule were denounced as providing inappropriate results. In response, these new proposed regulations make numerous modifications to the 2006 proposed regulations.

These new proposed regulations continue to require a taxpayer to capitalize amounts paid to restore a unit of property. However, the one-year rule and the AFS conformity requirement for economic useful life have been removed. These new proposed regulations provide a series of bright-line rules to determine when an amount paid is deemed to restore property. Although some commentators criticized rules that deem the cost of certain activities to be capitalized as restorations, the IRS and Treasury Department think that bright lines under this test will reduce controversy and help ease administration. These rules also expand on the rules provided in the 2006 proposed regulations with regard to the restoration of property after a casualty loss.

Section 263(a)(2) states that no deduction is allowed for any amount paid in restoring property or in making good the exhaustion thereof for which an allowance is or has been made. The IRS and Treasury Department think that this language requires capitalization of a replacement component if the taxpayer removes the basis of the replaced component from its books and records and takes the basis of the replaced component into account in its tax return. If a taxpayer takes into account the basis of a replaced component in its tax return, then the replacement of that component "makes good the exhaustion thereof for which an allowance has been made." Therefore, these new proposed regulations provide that if the taxpayer has properly taken a portion of the existing adjusted basis of the restored asset into account in the computation of gain or loss on a sale or exchange, or as a retirement loss or other loss under the Code, the replacement of that component will be deemed to restore the unit of property.

2. *Restoration of Property Destroyed in a Casualty*

The 2006 proposed regulations required a taxpayer to capitalize amounts paid to repair property if the taxpayer properly deducted a casualty loss under section 165 with respect to a unit of property and the amounts paid restore the unit of property to a condition that is the same or better than before the casualty. The casualty loss rule provided in the 2006 proposed regulations was criticized. In general, commentators thought there should be no link between the recognition of a casualty loss under section 165 and the determination of whether the cost to replace the property destroyed (in part or in whole) after a casualty event constitutes a capital expenditure. However, significant authority implies that a casualty-type event generally may only be characterized either as an extraordinary event (thus giving rise to a "loss" under section 165), or as an ordinary and necessary event in the operation of a trade or business (thus giving rise to an ordinary and necessary deduction under section 162). See, *e.g.*, *R. R. Hensler, Inc. v. Commissioner*, 73 T.C. 168, 179 (1979), acq., (1980–2 C.B. 1); *Hubinger*

v. Commissioner, 36 F.2d 724, 726 (2d Cir. 1929), cert. denied, 281 U.S. 741 (1930). Thus, a casualty is not an ordinary event, and the cost to repair property damaged by a casualty is not an ordinary expense. Stated differently, a loss under section 165 represents a destruction of property necessitating a replacement, which is capital, while an ordinary event generally represents damage to property necessitating a repair, which may or may not be capital. Because the restoration cost resulting from a loss is not ordinary, it is not allowed as an ordinary and necessary expense under section 162, but is treated as a capital expenditure under section 263(a). Although it is clear that a casualty event generally results in two economic costs to the taxpayer (the destruction of the previously invested capital and the costs to replace the destruction), the event giving rise to both of these costs is the same.

These new proposed regulations generally require consistent characterization of all costs arising from a single event. Therefore, under the rules provided in these new proposed regulations, a taxpayer that experiences an extraordinary loss event sufficiently destructive to invoke the provisions of section 165 will be required to treat the resulting restoration costs as a capitalized replacement of the destroyed property. This rule is required to ensure consistency in tax treatment among similarly situated taxpayers. For example, a taxpayer whose property is completely destroyed by a casualty event is required to capitalize the restoration of the loss because the restoration results in the replacement of the destroyed property with an entirely new unit of property. However, without a consistency rule, a taxpayer who experiences the same casualty event but only has part of a unit of property destroyed might argue that the cost to replace the destroyed portion of the unit of property is deductible because it simply returns the unit of property as a whole to its pre-casualty state. Allowing this type of disparity in tax treatment would provide an incentive to characterize destructions of property as partial destructions in order to leave open the position that a deduction may be taken for both the destruction of property resulting from the casualty event, as well as the ordinary and necessary expense of replacing the destroyed property. This rule also eliminates the dual characterization of minor costs incurred for items such as broken windows or blown-off shingles as both a casualty loss under section 165 and an ordinary and necessary expense under section 162.

Commentators noted that a rule requiring the capitalization of restoration costs following the recognition of a casualty loss would unfairly burden taxpayers that routinely experience extraordinary loss events in their trade or business. However, it should be noted that under these new proposed regulations, capitalization is required only if a loss or basis adjustment to the property is recognized by the taxpayer with respect to the event.

Various judicial authorities have held that events that generally are viewed as extraordinary loss events may nonetheless be considered ordinary occurrences in a particular industry. See *Atlantic Greyhound Corp. v. United States*, 111 F. Supp. 953 (Ct. Cl. 1953). In this situation, the costs to replace property destroyed in what would normally be characterized as a casualty event may result in an ordinary and necessary expenditure under section 162 rather than a loss under section 165. In this regard, the IRS and Treasury Department will consider providing guidance on what types of events may be considered ordinary in a particular industry. Taxpayers are encouraged to provide comments on this issue.

Commentators also noted that the rule provided in the 2006 proposed regulations created a disparity between taxpayers that recognized a loss under section 165 and taxpayers that received untaxed insurance proceeds as a result of a casualty event and adjusted the basis of the damaged asset accordingly. These new proposed regulations eliminate this disparity.

3. *Other Restorations*

Similar to the 2006 proposed regulations, these new proposed regulations provide additional circumstances in which a restoration is deemed to occur. Capitalization is required for amounts paid to return a unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and can no longer function for its intended purpose. The IRS and Treasury Department anticipate that these types of restorations will occur either as a result of lack of maintenance by the taxpayer or after the end of the property's useful life. A unit of property that is damaged by a casualty is not considered to be deteriorated to a state of disrepair.

These new proposed regulations also require capitalization of amounts paid to rebuild a unit of property to a like-new condition after the end of its economic useful life. The IRS and Treasury Department anticipate that this standard will apply to the traditional rebuilding of a unit of property to return it to a like-new condition. In general, a restoration under this rule will not result from routine maintenance activities, even if performed near the end of the useful life of the property, but instead represents a fundamental renewal of the economic useful life of the asset.

Similar to the 2006 proposed regulations, the new proposed regulations require capitalization of amounts paid to replace a major component or substantial structural part of a unit of property. In response to comments regarding the uncertainty in applying this standard, these new proposed regulations define the term "major component or substantial structural part." Specifically, these new proposed regulations provide that the replacement of a major component or substantial structural part will be deemed to occur only if (a) the replacement costs constitute 50 percent or more of the replacement cost of the unit of property or (b) the replacement part or parts constitute 50 percent or more of the physical structure of the unit of property. These 50 percent thresholds apply solely for purposes of the restoration rules and are not intended to be applied to the betterment or new or different use rules.

E. *New or Different Use*

In general, these new proposed regulations contain the rules set forth in the 2006 proposed regulations with respect to the capitalization of amounts paid to adapt property to a new or different use. However, these new proposed regulations remove the parenthetical contained in the 2006 proposed regulations relating to "structural alterations to the unit of property." Commentators noted that, although permanent structural alterations may result in adapting property to a new or different use, those alterations also could result in betterments to the unit of prop-

erty and, in certain circumstances, could constitute routine maintenance. Commentators also noted that adapting property to a new or different use does not necessarily make the property better or increase its value, but nevertheless is a capital expenditure. Therefore, the new or different use rules are provided separately from the betterment rules in these new proposed regulations.

These new proposed regulations also clarify that amounts paid will be deemed to adapt property to a new or different use only if the new use is not consistent with the taxpayer's intended use of the property at the time the property is placed in service by the taxpayer. Additional examples have been added to clarify the application of this rule.

F. *Repair Allowance*

The 2006 proposed regulations provided a repair allowance similar to the CLADR repair allowance, but did not specify different repair allowance percentages for different industries. Commentators generally favored the idea of a repair allowance; however, they widely criticized the lack of percentages tailored to specific industries. Some commentators in regulated industries requested that they be allowed to determine their deductible repair costs and their capital improvement costs for tax purposes based on conformity with regulatory accounting reporting.

These new proposed regulations adopt the request by certain regulated industries to conform the tax treatment of amounts paid to maintain, repair, or improve tangible property to their regulatory accounting treatment. An optional regulatory accounting method is proposed for amounts paid to maintain, repair, or improve tangible property subject to regulatory accounting. For purposes of this method, regulated accounting industries include industries regulated by the Federal Energy Regulatory Commission (FERC), the Federal Communications Commission (FCC), and the Surface Transportation Board (STB). The IRS and Treasury Department recognize that conformity with the regulatory accounting rules in these industries frequently may result in the overcapitalization of costs, and sometimes the undercapitalization of costs, as compared to the general rules for improvements under these new proposed regulations. The regulatory accounting method is not intended to be used as a definitive test of what should be capitalized for taxpayers that do not elect to use the method.

These new proposed regulations do not propose a detailed repair allowance like the one that was provided in the 2006 proposed regulations. Some commentators stated that very large taxpayers will want to have a repair allowance, because applying the general rules asset-by-asset is too burdensome because of their numerous assets. The commentators made clear, however, that taxpayers would not widely use a one-size-fits-all approach and that any repair allowance must be tailored to individual industries. Therefore, these new proposed regulations provide authority for issuing industry-specific repair allowance guidance in the future.

IX. *Accounting Method Changes*

These new proposed regulations do not provide any specific rules for changes in method of accounting. Because these proposed regulations are not effective until they are published as final regulations, taxpayers may not change their accounting method to conform to a method of accounting provided in these proposed regulations. Generally, a taxpayer's treatment of an amount paid to conform with these proposed regulations will be a change in method of accounting under section 446(e). For example, a change to the routine maintenance safe harbor in §1.263(a)–3(e) of these proposed regulations or to the optional regulatory accounting method in §1.263(a)–3(i) of these proposed regulations is a change in method of accounting. The IRS and Treasury Department request comments on whether a change to or from the use of the *de minimis* rule in §1.263(a)–2(d)(4) of these proposed regulations is a change in method of accounting under section 446(e).

Proposed Effective Date

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

Special Analyses

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

Comments and Public Hearing

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

A public hearing has been scheduled for June 24, 2008, at 10 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments by June 9, 2008 and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by June 3, 2008. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

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

Withdrawal of Proposed Amendments to the Regulations

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking (REG–168745–03) published in the **Federal Register** on August 21, 2006, (71 FR 161) is withdrawn.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.162–3 is revised to read as follows:

§1.162–3 Materials and supplies.

(a) *In general*—(1) *Non-incidental materials and supplies*. Amounts paid to acquire or produce materials and supplies are deductible in the taxable year in which the materials and supplies are used or consumed in the taxpayer's operations.

(2) *Incidental materials and supplies*. Amounts paid to acquire or produce incidental materials and supplies that are carried on hand and for which no record of consumption is kept or 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.

(b) *Rotable and temporary spare parts*. For purposes of this section, rotable spare parts are parts that are removable from the unit of property, generally repaired or improved, and either reinstalled on other property, or stored for later installation. Temporary spare parts are parts that are used temporarily until a new or repaired part can be installed, and then removed and stored for later (emergency or temporary) installation. For purposes of paragraph (a)(1) of this section, rotable and temporary spare parts are used or consumed in the taxpayer's business in the taxable year in which the taxpayer disposes of the parts.

(c) *Coordination with other provisions of the Internal Revenue Code*. Nothing in this section changes the treatment of any amount that is specifically provided for under any provision of the Internal Revenue Code (Code) or regulations other than section 162(a) or section 212 and the regulations under those sections. For example, see §1.263(a)–3, which requires taxpayers to capitalize amounts paid to improve units of property and section 263A and the regulations under section 263A, which require taxpayers to capitalize the direct and allocable indirect costs, including the cost of materials and supplies, to property produced or to property acquired for resale.

(d) *Definitions*—(1) *Materials and supplies*. For purposes of this section, *materials and supplies* means tangible property that is used or consumed in the taxpayer's operations and that—

(i) Is not a unit of property (as determined under §1.263(a)–3(d)(2)) and is not acquired as part of a single unit of property;

(ii) Is a unit of property (as determined under §1.263(a)–3(d)(2)) that has an economic useful life of 12 months or less, beginning when the property is used or consumed in the taxpayer's operations;

(iii) Is a unit of property (as determined under §1.263(a)–3(d)(2)) that has an acquisition cost or production cost (as determined under section 263A) of $100 or less; or

(iv) Is identified in published guidance in the **Federal Register** or in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter) as materials and supplies for which treatment is permitted under this section.

(2) *Economic useful life*—(i) *General rule*. The economic useful life of a unit of property is not necessarily the useful life inherent in the property but is the period over which the property may reasonably be expected to be useful to the taxpayer or, if the taxpayer is engaged in a trade or business or an activity for the production of income, the period over which the property may reasonably be expected to be useful to the taxpayer in its trade or business or for the production of income, as applicable. See §1.167(a)–1(b) for the factors to be considered in determining this period.

(ii) *Taxpayers with an applicable financial statement*. For taxpayers with an applicable financial statement (as defined in paragraph (d)(2)(iii) of this section), the economic useful life of a unit of property, solely for the purposes of applying the provisions of paragraph (d)(1)(ii) of this section, is the useful life initially used by the taxpayer for purposes of determining depreciation in its applicable financial statement, regardless of any salvage value of the property. If a taxpayer does not have an applicable financial statement for the taxable year in which the property was originally acquired or produced, the economic useful life of the unit of property must be determined under paragraph (d)(2)(i) of this section. Further, if a taxpayer treats amounts paid for a unit of property as an expense in its applicable financial statement on a basis other than the useful life of the property or if a taxpayer does not depreciate the unit of property on its applicable financial statement, the economic useful life of the unit of property must be determined under paragraph (d)(2)(i) of this section. For example, if a taxpayer has a policy of treating as an expense on its applicable financial statement amounts paid for property costing less than a certain dollar amount, notwithstanding that the property has a useful life of more than one year, the economic useful life of the property must be determined under paragraph (d)(2)(i) of this section.

(iii) *Definition of applicable financial statement*. The taxpayer's applicable financial statement is the taxpayer's financial statement listed in paragraphs (d)(2)(iii)(A) through (C) of this section that has the highest priority (including

within paragraph (d)(2)(iii)(B) of this section). The financial statements are, in descending priority—

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

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

(*1*) Credit purposes;

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

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

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

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

(4) *Produce*. For purposes of this section, *produce* means construct, build, install, manufacture, develop, create, raise or grow. See also §1.263(a)–2(b)(4). This definition is intended to have the same meaning as the definition used for purposes of section 263A(g)(1) and §1.263A–2(a)(1)(i), except that improvements are excluded from the definition in this paragraph (d)(4) and are separately defined and addressed in §1.263(a)–3. Amounts paid to produce materials and supplies must be capitalized under section 263A.

(e) *Election to capitalize*. A taxpayer may elect to treat as a capital expenditure the cost of any material or supply as defined in paragraph (d)(1) of this section, unless the material or supply is a component of a unit of property as described in paragraph (d)(1)(i) of this section, and the unit of property is a material or supply under paragraph (d)(1)(ii)–(iv) of this section, rather than a capital expenditure. An election made under this paragraph (e) applies to amounts paid during the taxable year to acquire or produce any material or supply to which paragraph (a) of this section would apply (but for the election under this paragraph (e)). A taxpayer makes the election by capitalizing the amounts paid to acquire or produce a material or supply in the taxable year the amounts are paid and by recovering the costs when the material or supply is placed in service by the taxpayer for the purposes of determining depreciation under the applicable Code and regulation provisions. A taxpayer must make this election in its timely filed original Federal income tax return (including extensions) for the taxable year the material or supply is placed in service by the taxpayer for purposes of determining depreciation. See §1.263(a)–2 for the treatment of amounts paid to acquire or produce real or personal tangible property. In the case of a pass-through entity, the election is made by the pass-through entity, and not by the shareholders, partners, etc. An election must be made for each material and/or supply. A taxpayer may revoke an election made under this paragraph (e) with respect to a material or supply only by filing a request for a private letter ruling and obtaining the Commissioner's consent to revoke the election. An election may not be made or revoked through the filing of an application for change in accounting method or by an amended Federal income tax return. A taxpayer that revokes an election may not re-elect to capitalize the material or supply for a period of at least 60 months, beginning with the taxable year of revocation.

(f) *Examples*. The rules of this section are illustrated by the following examples, in which it is assumed (unless otherwise stated) that the property is not an incidental material or supply, that the taxpayer is a calendar year, accrual method taxpayer, and that the taxpayer has not elected to capitalize under paragraph (e) of this section.

Example 1. Not a unit of property; component of personal property. X operates a fleet of aircraft. In 2008, X purchases a stock of spare parts, which it uses to maintain and repair its aircraft. The spare parts are not units of property as determined under §1.263(a)–3(d)(2) and are not rotable or temporary spare parts. In 2009, X uses the spare parts in a repair and maintenance activity that does not improve the property under §1.263(a)–3. Under paragraph (a)(1) of this section, the amounts paid for the spare parts are deductible as materials and supplies in 2009, the taxable year in which the spare parts are used to repair and maintain the aircraft.

Example 2. Not a unit of property; rotable spare parts. X operates a fleet of specialized vehicles that it uses in its service business. At the time that it acquires a new type of vehicle, X also acquires a substantial number of rotable spare parts that will be kept on hand to quickly replace similar parts in X's vehicles as those parts break down or wear out. These rotable replacement parts are not units of property as determined under §1.263(a)–3(d)(2), are removable from the vehicles, and are repaired or reconditioned, so that they can be reinstalled on the same or similar vehicles. In 2008, X acquires several vehicles and associated rotable spare parts. In 2009, X makes repairs to several vehicles by using these rotable spare parts to replace worn or damaged parts. In 2010, X removes these rotable spare parts from its vehicles, repairs them and reinstalls them on other similar vehicles. In 2012, X can no longer use the rotable parts it acquired in 2008 and disposes of them as scrap. Under paragraph (d)(1) of this section, the rotable spare parts acquired in 2008 are materials and supplies. However, under paragraph (b) of this section, these parts are not used or consumed until the taxable year in which X disposes of the parts. Therefore, under paragraph (a)(1) of this section, X may deduct the amounts paid for the rotable spare parts in 2012, the taxable year in which X disposes of the parts.

Example 3. Not a unit of property; part of a single unit of real property. X owns an apartment building and discovers that a window in one of the apartments is broken. In 2008, X pays for the acquisition, delivery, and installation of a new window to replace the broken window. In the same year, the new window is installed. The window is not a unit of property as determined under §1.263(a)–3(d)(2), and the replacement of the window does not improve the property under §1.263(a)–3. Under paragraph (a)(1) of this section, the amounts paid for the acquisition, delivery, and installation of the window are deductible as materials and supplies in 2008, the taxable year in which the window is installed in the apartment building.

Example 4. Economic useful life of 12 months or less. X operates a fleet of aircraft that carries freight for its customers. X owns a storage tank on its premises, which can hold a one-month supply of jet fuel for its aircraft. On December 31, 2008, X purchases a one-month supply of jet fuel. In 2009, X uses the jet fuel purchased on December 31, 2008, to fuel the aircraft used in its business. Under paragraph (a)(1) of this section, the amounts paid for the jet fuel are deductible as materials and supplies in 2009, the taxable year in which the jet fuel is used or consumed in the operation of X's aircraft.

Example 5. Unit of property that costs $100 or less. X operates a rental business that rents out a variety of small individual items to customers (rental items). X maintains a supply of rental items on hand to replace worn or damaged items. In 2008, X purchases a large quantity of rental items to use in its rental business. Each of these rental items is a unit of property that costs $100 or less. In 2009, X begins using all of the rental items purchased in 2008 by providing them to customers of its rental business. X does not sell or exchange these items on established retail markets at any time after the items are used in the rental business. Under paragraph (a)(1) of this section, the amounts paid for the rental items are deductible as materials and supplies in 2009, the taxable

year in which the rental items are used in X's business.

Example 6. Unit of property that costs $100 or less. X provides billing services to its customers. In 2008, X incurs costs to purchase 50 facsimile machines to be used by its employees. Each facsimile machine is a unit of property that costs less than $100. In 2008, X's employees begin using 35 of the facsimile machines, and X stores the remaining 15 machines for use in a later taxable year. Under paragraph (a)(1) of this section, the amounts paid for 35 of the facsimile machines are deductible as materials and supplies in 2008, the taxable year in which X uses those machines. The amounts paid for each of the remaining 15 machines are deductible in the taxable year in which each machine is used.

Example 7. Materials and supplies used in improvements; coordination with §1.263(a)–3. X owns various machines that are used in its business. In 2008, X purchases a supply of spare parts for its machines. The spare parts are not units of property as determined under §1.263(a)–3(d)(2) and are not rotable or temporary spare parts. The spare parts may be used by X in the repair or maintenance of a machine under §1.162–4 or in the improvement of a machine under §1.263(a)–3. In 2009, X uses all of these spare parts in an activity that improves the unit of property under §1.263(a)–3. Under paragraph (d)(1)(i) of this section, the spare parts purchased by X in 2008 are materials and supplies. Under paragraph (a)(1) of this section, the amounts paid for the spare parts are otherwise deductible as materials and supplies in 2009, the taxable year in which X uses those parts. However, because these materials and supplies are used to improve X's property, X is required to capitalize the amounts paid for those spare parts under §1.263(a)–3. See also section 263A requiring taxpayers to capitalize the direct and allocable indirect costs of property produced or acquired for resale.

Example 8. Cost of producing materials and supplies; coordination with section 263A. X is a manufacturer that produces liquid waste as part of its operations. X determines that its current liquid waste disposal process is inadequate. To remedy the problem, in 2008, X constructs a leaching pit to provide a draining area for the liquid waste. The leaching pit has an economic useful life of less than 12 months, starting on the date that X begins to use the leaching pit as a draining area. At the end of this period, X's factory will be connected to the local sewer system. In 2009, X starts using the leaching pit in its operations. The amounts paid to construct the leaching pit (including the direct and allocable indirect costs of property produced under section 263A) are amounts paid for a material or supply under paragraph (d)(1)(ii) of this section. Under paragraph (a)(1) of this section, the amounts paid for the leaching pit are otherwise deductible as materials and supplies in 2009, the taxable year in which X uses the leaching pit. However, because the amounts paid to construct the leaching pit are incurred by reason of X's manufacturing operations, X is required to capitalize the amounts paid to construct the leaching pit to X's property produced. See §1.263A–1(e)(3)(ii)(E).

Example 9. Costs of acquiring materials and supplies for production of property; coordination with section 263A. In 2008, X purchases jigs, dies, molds, and patterns for use in the manufacture of X's products. The economic useful life of each jig, die, mold, and pattern is 12 months or less, beginning when each item is used in the manufacturing process. X begins using the purchased items in 2009 to manufacture its products. These items are materials and supplies under paragraph (d)(1)(ii) of this section. Under paragraph (a)(1) of this section, the amounts paid for the items are otherwise deductible as materials and supplies in 2009, the taxable year in which X uses those items. However, because the amounts paid for these materials and supplies directly benefit or are incurred by reason of the taxpayer's production activities, X is required to capitalize the amounts paid for these items to X's property produced. See §1.263A–1(e)(3)(ii)(E).

Example 10. Election to capitalize. X operates a rental business that rents out a variety of items (rental items) to its customers, each of which is a separate unit of property as determined under §1.263(a)–3(d)(2). X does not sell or exchange these items on established retail markets at any time after the items are used in the rental business. In 2008, X incurs costs to purchase various rental items, all of which cost less than $100 or have an economic useful life of less than 12 months, beginning when used or consumed. X begins using the rental items in its business in 2008. Under paragraph (a)(1) of this section, the amounts paid for each rental item purchased in 2008 are deductible as a material or supply in the taxable year in which the item is used. However, for administrative reasons, X would prefer to treat all of its rental items as capital expenditures subject to depreciation. Under paragraph (e) of this section, X may elect not to apply the rule contained in paragraph (a)(1) of this section to the rental items. X makes this election by capitalizing the amounts paid for each rental item in the taxable year the costs are incurred and by beginning to recover the costs of each item on its timely filed Federal income tax return for the taxable year that the item is placed in service by X for purposes of determining depreciation under the applicable Code and regulation provisions. See §1.263(a)–2(e) for the treatment of capital expenditures.

Example 11. Election to capitalize. X is an electric utility. In 2008, X acquires certain temporary spare parts, which it keeps on hand to avoid operational time loss in the event it must make emergency repairs to a unit of property that is subject to depreciation. These parts are not units of property as determined under §1.263(a)–3(d)(2) and are not used to improve property under §1.263(a)–3(d)(1). These temporary spare parts are used until a new or repaired part can be installed, and then removed and stored for later emergency installation. Under paragraphs (a)(1) and (b) of this section, the amounts paid for the temporary spare parts are deductible as materials and supplies in the taxable year in which they are disposed of by the taxpayer. However, because it is unlikely that the temporary spare parts will be disposed of in the near future, X would prefer to treat the spare parts as capital expenditures subject to depreciation. Accordingly, X may elect under paragraph (e) of this section not to apply the rule contained in paragraph (a)(1) of this section to each of its temporary spare parts. X makes this election by capitalizing the amounts paid for each spare part in the taxable year the costs are incurred and by beginning to recover the costs of each part on its timely filed Federal income tax return for the taxable year that the part is placed in service by X for purposes of determining depreciation under the applicable Code and regulation provisions. See §1.263(a)–2(e) for the treatment of capital expenditures and section 263A requiring taxpayers to capitalize the direct and allocable indirect costs of property produced or acquired for resale.

Par. 3. Section 1.162–4 is revised to read as follows:

§1.162–4 Repairs.

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

§1.162–6 [Removed]

Par. 4. Section 1.162–6 is removed.

Par. 5. Section 1.263(a)–0 is amended by revising the entries for §§1.263(a)–1, 1.263(a)–2 and 1.263(a)–3 to read as follows:

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* * * * *

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Par. 6. Section 1.263(a)–1 is revised to read as follows:

§1.263(a)–1 Capital expenditures; in general.

(a) *General rule for capital expenditures*. Except as provided in chapter 1 of the Internal Revenue Code (Code), no deduction is allowed for—

(1) Any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate, or

(2) Any amount paid in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

(b) *Coordination with section 263A*. 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 the direct and indirect costs that must be capitalized to property produced or improved by the taxpayer and property acquired for resale.

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

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

(2) An amount paid to improve real or personal tangible property. See §1.263(a)–3.

(3) An amount paid to acquire or create intangibles. See §1.263(a)–4.

(4) An amount paid or incurred to facilitate an acquisition of a trade or business, a change in capital structure of a business entity, and certain other transactions. See §1.263(a)–5.

(5) An amount paid to acquire or create interests in land, such as easements, life estates, mineral interests, timber rights, zoning variances, or other interests in land.

(6) An amount assessed and paid under an agreement between bondholders or shareholders of a corporation to be used in a reorganization of the corporation or voluntary contributions by shareholders to the capital of the corporation for any corporate purpose. See section 118 and §1.118–1.

(7) An amount paid by a holding company to carry out a guaranty of dividends at a specified rate on the stock of a subsidiary corporation for the purpose of se-

curing new capital for the subsidiary and increasing the value of its stockholdings in the subsidiary. This amount must be added to the cost of the stock in the subsidiary.

(d) *Amounts paid to sell property*—(1) *In general*. Except in the case of dealers in property, commissions and other transaction costs paid to facilitate the sale of property generally must be capitalized. However, in the case of dealers in property, amounts paid to facilitate the sale of property are treated as ordinary and necessary business expenses. See §1.263(a)–5(g) for the treatment of amounts paid to facilitate the disposition of assets that constitute a trade or business.

(2) *Treatment of capitalized amount*. Amounts capitalized under paragraph (d)(1) of this section are treated as a reduction in the amount realized and generally are taken into account either in the taxable year in which the sale occurs or in the taxable year in which the sale is abandoned if a loss deduction is permissible. The capitalized amount is not added to the basis of the property and is not treated as an intangible under §1.263(a)–4.

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

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

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

Example 3. Sales costs of personal property used in a trade or business. X owns a truck for use in X's trade or business. X decides to sell the truck and on November 15, 2008, X pays for an appraisal to determine a reasonable asking price. On February 15, 2009, X sells the truck to Y. X is required to capitalize in 2008 the amount paid to appraise the truck and, in 2009, is required to offset the amount paid against the amount realized from the sale of the truck.

Example 4. Costs of abandoned sale of personal property used in a trade or business. Assume the same facts as in *Example 3*, except that, instead of selling the truck on February 15, 2009, X decides on that date not to sell the truck and takes the truck off the market. X is required to capitalize in 2008 the amount paid to appraise the truck. However, X may treat the amount paid to appraise the truck as a loss under section 165 in 2009 when the sale is abandoned.

Example 5. Sales costs of personal property not used in a trade or business. Assume the same facts as in *Example 3*, except that X does not use the truck in X's trade or business, but instead uses it for personal purposes. X decides to sell the truck and on November 15, 2008, X pays for an appraisal to determine a reasonable asking price. On February 15, 2009, X sells the truck to Y. X is required to capitalize in 2008 the amount paid to appraise the truck and, in 2009, is required to offset the amount paid against the amount realized from the sale of the truck.

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

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

(f) [Reserved]

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

Par. 7. Section 1.263(a)–2 is revised to read as follows:

§1.263(a)–2 Amounts paid to acquire or produce tangible property.

(a) *Overview*. This section provides rules for applying section 263(a) to amounts paid to acquire or produce a unit of real or personal property. Paragraph (b) of this section contains definitions. Paragraph (c) of this section contains the rules for coordinating this section with other provisions of the Internal Revenue Code (Code). Paragraph (d) of this section provides the rules for determining the treatment of amounts paid to acquire or produce a unit of real or personal property, including amounts paid to defend or perfect title to real or personal property and amounts paid to facilitate the acquisition of property. Paragraph (d) also provides a *de minimis* rule.

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

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

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

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

(4) *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 §1.263A–2(a)(1)(i), except that improvements are excluded from the definition in this paragraph (b)(4) and are separately defined and addressed in §1.263(a)–3.

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

(2) *Materials and supplies*. Nothing in this section changes the treatment of amounts paid to acquire or produce property that is properly treated as materials and supplies under §1.162–3.

(d) *Acquired or produced tangible property*—(1) *In general*—(i) *Requirement of capitalization*. Except as provided in paragraph (d)(4) of this section (relating to the *de minimis* rule) and in §1.162–3(d)(1)(ii), (iii), and (iv) (relating to certain materials and supplies), a taxpayer must capitalize amounts paid to acquire or produce a unit of real or

personal property (as determined under §1.263(a)–3(d)(2)), including leasehold improvement property, land and land improvements, buildings, machinery and equipment, and furniture and fixtures. Amounts paid to acquire or produce a unit of real or personal property include the invoice price, transaction costs as determined under paragraph (d)(3) of this section, and costs for work performed prior to the date that the unit of property is placed in service by the taxpayer (without regard to any applicable convention under section 168(d)). A taxpayer also must capitalize amounts paid to acquire real or personal property for resale and to produce real or personal property. See section 263A for the costs required to be capitalized to property produced by the taxpayer or to property acquired for resale.

(ii) *Examples*. The rules of this section are illustrated by the following examples, in which it is assumed that the taxpayer does not apply the *de minimis* rule under paragraph (d)(4) of this section:

Example 1. Acquisition of personal property. In 2008, X purchases new cash registers for use in its retail store located in leased space in a shopping mall. Assume each cash register is a unit of property as determined under §1.263(a)–3(d)(2), and is not a material or supply under §1.162–3. X must capitalize under this paragraph (d)(1) the amount paid to purchase each cash register.

Example 2. Relocation of personal property. Assume the same facts as in *Example 1*, except that X's lease expires in 2009 and X decides to relocate its retail store to a different building. In addition to various other costs, X pays $5,000 to move the cash registers. X is not required to capitalize under this paragraph (d)(1) the $5,000 amount paid for moving the cash registers.

Example 3. Acquisition of personal property that is not a unit of property; coordination with §1.162–3. X operates a fleet of aircraft. In 2008, X purchases a stock of spare parts, which it uses to maintain and repair its aircraft. Assume that the spare parts are not units of property as determined under §1.263(a)–3(d)(2). X does not make elections under §1.162–3(e) to treat the materials and supplies as capital expenditures. In 2009, X uses the spare parts in a repair and maintenance activity that does not improve the property under §1.263(a)–3. Because the parts are not units of property, X is not required to capitalize the amounts paid for the parts under this paragraph (d)(1). Rather, X must apply the rules in §1.162–3, governing the treatment of materials and supplies, to determine the treatment of these amounts.

Example 4. Acquisition of unit of personal property; coordination with §1.162–3. X operates a rental business that rents out a variety of small individual items to customers (rental items). X maintains a supply of rental items on hand to replace worn or damaged items. In 2008, X purchases a large quantity of rental items to be used in its business. Assume that each of these items is a unit of property under §1.263(a)–3(d)(2) and that several of these rental items are materials and supplies under the definition provided in §1.162–3(d). Therefore, X must apply the rules in §1.162–3 to determine the treatment of the amounts paid to acquire rental items that are materials and supplies. Under this paragraph (d)(1), X must capitalize the amounts paid for the rental items that are units of property and do not otherwise qualify as materials and supplies under §1.162–3(d).

Example 5. Acquisition or production cost. X purchases or produces jigs, dies, molds, and patterns for use in the manufacture of X's products. Assume that each of these items is a unit of property as determined under §1.263(a)–3(d)(2), and is not a material and supply under §1.162–3(d). X is required to capitalize under this paragraph (d)(1) the amounts paid to produce or purchase the jigs, dies, molds, and patterns. See section 263A for the costs to be capitalized to property produced by X.

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

Example 7. Acquisition of building. X purchases a building. X must capitalize under this paragraph (d)(1) the amount paid to acquire the building. See §1.263(a)–2(d)(3) for the treatment of amounts paid to facilitate the acquisition of real property.

Example 8. Acquisition of property for resale. X purchases goods for resale. X must capitalize under this paragraph (d)(1) the amounts paid to acquire the goods. See section 263A for the costs to be capitalized to property acquired for resale.

Example 9. Production of property for sale. X produces goods for sale. X must capitalize under this paragraph (d)(1) the amount paid to produce the goods. See section 263A for the costs to be capitalized to property produced by X.

Example 10. Production of building. X constructs a building. X must capitalize under this paragraph (d)(1) the amount paid to construct the building. See section 263A for the costs to be capitalized to real property produced by X.

Example 11. Acquisition of assets constituting a trade or business. Y owns tangible and intangible assets that constitute a trade or business. X purchases all the assets of Y in a taxable transaction. X must capitalize under this paragraph (d)(1) the amount paid for the tangible assets of Y. See §1.263(a)–4 for the treatment of amounts paid to acquire intangibles and §1.263(a)–5 for the treatment of amounts paid to facilitate the acquisition of assets that constitute a trade or business. See section 1060 for special allocation rules for certain asset acquisitions.

Example 12. Work performed prior to placing the property in service. In 2008, X purchases a building for use as a business office. The building is in a state of disrepair. Prior to placing the building in service, X incurs costs to repair cement steps, shore up parts of the first and second floors, replace electrical wiring, remove and replace old plumbing, and paint the outside and inside of the building. All the work was performed on the building or its structural components. In 2010, X places the building in service and begins using the building as its business office. Assume the building and its structural components is the unit of property. The amounts paid must be capitalized as costs of acquiring the building because they were for work performed prior to X's placing the building in service.

Example 13. Work performed prior to placing the property in service. In January 2008, X purchases a new machine for use in an existing production line of its manufacturing business. Assume that the machine is a unit of property under §1.263(a)–3(d)(2). After the machine is installed, X performs critical testing on the machine to ensure that it is operational. On November 1, 2008, the critical testing is complete and X places the machine in service on the production line. X continues to perform testing for quality control. The amounts paid for the installation and critical testing must be capitalized as costs of acquiring the machine because they were for work performed prior to X's placing the machine in service. However, amounts paid for quality control testing after the machine is placed in service by X are not required to be capitalized as a cost of acquiring the machine.

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

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

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

Example 2. Amounts paid to invalidate ordinance. X is in the business of quarrying and supplying for sale sand and stone in a certain municipality. Several years after X establishes its business, the municipality in which it is located passes an ordinance that prohibits the operation of X's business. X incurs attorney's fees in a successful prosecution of a suit to invalidate the municipal ordinance. X prosecutes the suit to preserve its business activities and not to defend X's title in the property. Therefore, attorney's fees paid by X are not required to be capitalized under this paragraph (d)(2). However, under section 263A, all indirect costs, including otherwise deductible costs, that directly benefit or are incurred by reason of the taxpayer's production activities must be capitalized to the property produced for sale. See §1.263A–1(e)(3)(i). Therefore, because the amounts paid to invalidate the ordinance are incurred by reason of X's production activities, the amounts paid must be capitalized under section 263A to the property produced for sale by X.

Example 3. Amounts paid to challenge building line. The board of public works of a municipality establishes a building line across X's business property, adversely affecting the value of the property. X incurs legal fees in unsuccessfully litigating the establishment of the building line. Amounts paid by X to

the attorney must be capitalized because they were to defend X's title to the property.

(3) *Transaction costs*—(i) *In general*. A taxpayer must capitalize amounts paid to facilitate the acquisition or production of real or personal property. See section 263A for the costs required to be capitalized to property produced by the taxpayer or to property acquired for resale. See §1.263(a)–5 for the treatment of amounts paid to facilitate the acquisition of assets that constitute a trade or business.

(ii) *Scope of facilitate*—(A) *In general*. Except as otherwise provided in this section, an amount is paid to facilitate the acquisition of real or personal property if the amount is paid in the process of investigating or otherwise pursuing the acquisition. Whether an amount is paid in the process of investigating or otherwise pursuing the acquisition is determined based on all of the facts and circumstances. In determining whether an amount is paid to facilitate an acquisition, the fact that the amount would (or would not) have been paid but for the acquisition is relevant, but is not determinative. These amounts include, but are not limited to, inherently facilitative amounts specified in paragraph (d)(3)(ii)(B) of this section.

(B) *Inherently facilitative amounts*. An amount paid in the process of investigating or otherwise pursuing the acquisition of real or personal property facilitates the acquisition if the amount is inherently facilitative. An amount is inherently facilitative if the amount is paid for—

(*1*) Transporting the property (for example, shipping fees and moving costs);

(*2*) Securing an appraisal or determining the value or price of property;

(*3*) Negotiating the terms or structure of the acquisition and obtaining tax advice on the acquisition;

(*4*) Application fees, bidding costs, or similar expenses;

(*5*) Preparing and reviewing the documents that effectuate the acquisition of the property (for example, preparing the bid, offer, sales contract, or purchase agreement);

(*6*) Examining and evaluating the title of property;

(*7*) Obtaining regulatory approval of the acquisition or securing permits related to the acquisition, including application fees;

(*8*) Conveying property between the parties, including sales and transfer taxes, and title registration costs;

(*9*) Finders' fees or brokers' commissions, including amounts paid that are contingent on the successful closing of the acquisition;

(*10*) Architectural, geological, engineering, environmental or inspection services pertaining to particular properties; and

(*11*) Services provided by a qualified intermediary or other facilitator of an exchange under section 1031.

(C) *Special rule for acquisitions of real property*. Except as provided in paragraph (d)(3)(ii)(B) of this section (relating to inherently facilitative amounts), 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.

(D) *Employee compensation and overhead costs*—(*1*) *In general*. For purposes of this paragraph (d)(3), amounts paid for employee compensation (within the meaning of §1.263(a)–4(e)(4)(ii)) and overhead are treated as amounts that do not facilitate the acquisition of real or personal property. See section 263A for the treatment of employee compensation and overhead costs required to be capitalized to property produced by the taxpayer or to property acquired for resale.

(*2*) *Election to capitalize*. A taxpayer may elect to treat amounts paid for employee compensation or overhead as amounts that facilitate the acquisition of property. The election is made separately for each acquisition and applies to employee compensation or overhead, or both. For example, a taxpayer may elect to treat overhead, but not employee compensation, as amounts that facilitate the acquisition of property. A taxpayer makes the election by treating the amounts to which the election applies as amounts that facilitate the acquisition in the taxpayer's timely filed original Federal income tax return (including extensions) for the taxable year during which the amounts are paid. In the case of an S corporation or partnership, the election is made by the S corporation or by the partnership, and not by the shareholders or partners. A taxpayer may revoke an election made under this paragraph (d)(3)(ii)(D)(*2*) with respect to each acquisition only by filing a request for a private letter ruling and obtaining the Commissioner's consent to revoke the election. An election may not be made or revoked through the filing of an application for change in accounting method or by an amended Federal income tax return.

(iii) *Treatment of transaction costs*. All amounts paid to facilitate the acquisition or production of real or personal property are capital expenditures. Inherently facilitative amounts allocable to real or personal property are capital expenditures related to such property even if the property is not eventually acquired or produced. Facilitative amounts allocable to real or personal property actually acquired or produced must be included in the basis of the property acquired or produced. See paragraph (f) of this section for the recovery of capitalized amounts.

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

Example 1. Broker's fees to facilitate an acquisition. X decides to purchase a building in which to relocate its offices and hires a real estate broker to find a suitable building. X pays fees to the broker to find property for X to acquire. Under paragraph (d)(3)(i) of this section, X must capitalize the amounts paid to the broker because these costs are inherently facilitative of the acquisition of real property.

Example 2. Inspection and survey costs to facilitate an acquisition. X decides to purchase building A and pays amounts to third-party contractors for a termite inspection and an environmental survey of building A. Under paragraph (d)(3)(i) of this section, X must capitalize the amounts paid for the inspection and the survey of the building because these costs are inherently facilitative of the acquisition of real property.

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

Example 4. Scope of facilitate. X is in the business of providing legal services to clients. X is interested in acquiring a new conference table for its office. X hires and incurs fees for an interior designer to shop for, evaluate, and make recommendations to X regarding which new table to acquire. Under paragraph (d)(3)(i) of this section, X must capitalize the amounts paid to the interior designer to provide these services because they are paid in the process of investigating or otherwise pursuing the acquisition of personal property.

Example 5. Transaction costs allocable to other property. X, a retailer, wants to acquire land for the purpose of building a new distribution facility for its products. X considers various properties on highway A in state B. In evaluating the feasibility of several sites, X incurs fees for the services of an architect to advise and prepare preliminary plans for a facility that X is reasonably likely to construct at one of the sites. The architect's fees are not inherently facilitative to the acquisition of land, but are inherently facilitative to the acquisition of a building under paragraph (d)(3)(ii)(B)(*10*) of this section. In addition, these costs are allocable as construction costs of the building under section 263A. Therefore, X does not capitalize these fees as amounts to acquire the building under paragraph (d)(3)(ii)(B) of this section, but instead must capitalize these costs as indirect costs allocable to the production of property under section 263A.

Example 6. Special rule for acquisitions of real property. X owns several retail stores. X decides to examine the feasibility of opening a new store in City A. In October 2008, X hires and incurs costs for a development consulting firm to study City A and perform market surveys, evaluate zoning and environmental requirements, and make preliminary reports and recommendations as to areas that X should consider for purposes of locating a new store. In December 2008, X continues to consider whether to purchase real property in City A and which property to acquire. X hires, and incurs fees for, an appraiser to perform appraisals on two different sites to determine a fair offering price for each site. In March 2009, X decides to acquire one of these two sites for the location of its new store. At the same time, X determines not to acquire the other site. Under paragraph (d)(3)(ii)(C) of this section, X is not required to capitalize amounts paid to the development consultant in 2008 because the amounts relate to activities performed in the process of determining whether to acquire real property and which real property to acquire and the amounts are not inherently facilitative costs under paragraph (d)(3)(ii)(B) of this section. However, X must capitalize amounts paid to the appraiser in 2008 because the appraisal costs are inherently facilitative costs under paragraph (d)(3)(ii)(B)(*2*) of this section. In 2009, X must include the appraisal costs allocable to property acquired in the basis of the property acquired and may recover the appraisal costs allocable to the property not acquired in accordance with paragraph (f) of this section.

Example 7. Employee compensation and overhead. X, a freight carrier, maintains an acquisition department whose sole function is to arrange for the purchase of vehicles and aircraft from manufacturers or other parties to be used in its freight carrying business. As provided in paragraph (d)(3)(ii)(D)(*1*) of this section, X is not required to capitalize any portion of the compensation paid to employees in its acquisition department or any portion of its overhead allocable to its acquisition department. However, under paragraph (d)(3)(ii)(D)(*2*) of this section, X may elect to capitalize the compensation and overhead costs allocable to the acquisition of a vehicle or aircraft by treating these amounts as costs that facilitate the acquisition of that property in its timely filed original Federal income tax return for the year the amounts are paid.

(4) *De minimis rule*—(i) *In general.* Except as otherwise provided in this paragraph (d)(4), a taxpayer is not required to capitalize under paragraph (d) of this section amounts paid for the acquisition or production (including any amounts paid to facilitate the acquisition or production) of a unit of property (as determined under §1.263(a)–3(d)(2)) if—

(A) The taxpayer has an applicable financial statement (as defined in §1.263(a)–2(d)(4)(vi));

(B) The taxpayer has at the beginning of the taxable year, written accounting procedures treating as an expense for non-tax purposes the amounts paid for property costing less than a certain dollar amount;

(C) The taxpayer treats the amounts paid during the taxable year as an expense on its applicable financial statement in accordance with its written accounting procedures; and

(D) The total aggregate of amounts paid and not capitalized under paragraphs (d)(4)(i)(A), (B), and (C) of this section for the taxable year do not distort the taxpayer's income for the taxable year.

(ii) *Exceptions to de minimis rule.* The *de minimis* rule in paragraph (d)(4)(i) of this section does not apply to the following:

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

(B) Amounts paid for property that is or is intended to be included in property produced or acquired for resale.

(C) Amounts paid for land.

(iii) *Safe harbor.* The total aggregate amount that is not required to be capitalized under the *de minimis* rule of paragraphs (d)(4)(i)(A), (B) and (C) of this section for the taxable year is deemed to not distort the taxpayer's income under paragraph (d)(4)(i)(D) of this section if this amount, added to the amount the taxpayer deducts in the taxable year as materials and supplies under the definition provided under §1.162–3(d)(1)(iii) (relating to certain property costing $100 or less), is less than or equal to the lesser of—

(A) 0.1 percent of the taxpayer's gross receipts for the taxable year; or

(B) 2 percent of the taxpayer's total depreciation and amortization expense for the taxable year as determined in its applicable financial statement.

(iv) *Additional rules.* Property to which a taxpayer applies the *de minimis* rule contained in paragraph (d)(4) of this section is not treated upon sale or disposition as a capital asset under section 1221 or as property used in the trade or business under section 1231. Property to which a taxpayer applies the *de minimis* rule contained in paragraph (d)(4) of this section is not a material or supply under §1.162–3. The cost of property to which a taxpayer properly applies the *de minimis* rule contained in paragraph (d)(4) of this section is not required to be capitalized under section 263A to a separate unit of property, but may be required to be capitalized as a cost of other property if incurred by reason of the production of the other property. See, for example, §1.263A–1(e)(3)(ii)(O) requiring taxpayers to capitalize repair and maintenance costs allocable to property produced or acquired for resale.

(v) *Election to capitalize.* A taxpayer may elect not to apply the *de minimis* rule contained in paragraph (d)(4)(i) of this section. An election made under this paragraph (d)(4)(v) applies to any unit of property during the taxable year to which paragraphs (d)(4)(i)(A), (B), and (C) of this section would apply (but for the election under this paragraph (d)(4)(v)). A taxpayer makes the election by treating the amount paid as a capital expenditure in its timely filed original Federal income tax return (including extensions) for the taxable year in which the amount is paid. In the case of an S corporation or partnership, the election is made by the S corporation or by the partnership, and not by the shareholders or partners. A taxpayer may revoke an election made under this paragraph (d)(4)(v) with respect to a unit of property only by filing a request for a private letter ruling and obtaining the Commissioner's consent to revoke the election. An election may not be made or revoked through the filing of an application for change in accounting method or by an amended Federal income tax return.

(vi) *Definition of applicable financial statement.* For purposes of this paragraph (d)(4), the taxpayer's applicable financial statement is the taxpayer's financial statement listed in paragraphs (d)(4)(vi)(A) through (C) of this section that has the highest priority (including within paragraph (d)(4)(vi)(B) of this section). The financial statements are, in descending priority—

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

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

(*1*) Credit purposes;

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

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

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

(vii) *Examples*. The following examples illustrate the rule of this paragraph (d)(4):

Example 1. De minimis rule. X purchases 10 printers at $200 each for a total cost of $2000. Assume that each printer is a unit of property under §1.263(a)–3(d)(2). X has an applicable financial statement. X has a written policy at the beginning of the taxable year to expense amounts paid for property costing less than $500. X treats the amounts paid for the printers as an expense on its applicable financial statement. Assuming the total aggregate amounts not capitalized under the *de minimis* rule for the taxable year do not distort the taxpayer's income, X is not required to capitalize the amounts paid for the printers.

Example 2. De minimis rule safe harbor not met. X is a member of an affiliated group that files a consolidated return. In 2008, X purchases 300 computers at $400 each for a total cost of $120,000. Assume that each computer is a unit of property under §1.263(a)–3(d)(2). X has a written policy at the beginning of the taxable year to expense amounts paid for property costing less than $500. X treats the amounts paid for the computers as an expense on its applicable financial statement. In addition, in 2008 X purchases 300 desk chairs for $50 each for a total cost of $15,000. X intends to deduct the amounts paid for the desk chairs when used or consumed as non-incidental materials and supplies under §1.162–3(a)(1) and §1.162–3(d)(1)(iii) because they are units of property costing less than $100. For its 2008 taxable year, X has gross receipts of $125,000,000 and reports $7,000,000 of depreciation and amortization on its applicable financial statement. Thus, in order to meet the *de minimis* rule safe harbor for 2008, the sum of the amounts not required to be capitalized under the *de minimis* rule for 2008 ($120,000) plus the amounts X intends to deduct as materials and supplies under §1.162–3(a)(1) and §1.162–3(d)(1)(iii) for 2008 ($15,000), must be less than or equal to $125,000 (0.1% of X's total gross receipts of $125,000,000), which is less than $140,000 (2% of X's total deprecation and amortization of $7,000,000). Because $135,000 ($120,000 + $15,000) exceeds $125,000, X will not meet the *de minimis* rule safe harbor for its 2008 taxable year. As a result, to apply the *de minimis* rule to the $120,000 paid to acquire the computers, X will have to otherwise establish that this amount does not distort the taxpayer's income in 2008.

Example 3. De minimis rule safe harbor met. Assume the same facts as in *Example 2*, except X makes an election under paragraph (d)(4)(v) of this section to capitalize the $10,000 paid to acquire 25 of the 300 computers at $400 each. In this case, X is not required to capitalize the $110,000 paid to acquire the remaining 275 computers under paragraph (d)(4)(i) because this amount, when added to the $15,000 that X intends to deduct in 2008 as materials and supplies under §1.162–3(a)(1) and §1.162–3(d)(1)(iii), does not exceed the *de minimis* rule safe harbor of $125,000 for 2008.

Example 4. De minimis rule safe harbor; election to capitalize. Assume the same facts as in *Example 2*, except X does not otherwise establish that the deduction of amounts in excess of the $125,000 safe harbor do not distort X's income in 2008. Rather, X makes an election under §1.162–3(e) to capitalize $10,000 paid to acquire 200 of the 300 desk chairs at $50 each. In this case, X is not required to capitalize the $120,000 paid to acquire the 300 computers under paragraph (d)(4)(i) of this section because this amount, when added to the $5000 (the remaining 100 desk chairs at $50 each) that X intends to deduct in 2008 as materials and supplies under §1.162–3(a)(1) and §1.162–3(d)(1)(iii), does not exceed the *de minimis* rule safe harbor of $125,000 for 2008.

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

(f) *Recovery of capitalized amounts*—(1) *In general*. Amounts that are capitalized under this section are recovered through depreciation, cost of goods sold, or by an adjustment to basis at the time the property is placed in service, sold, used, or otherwise disposed of by the taxpayer. Cost recovery is determined by the applicable Code and regulation provisions relating to the use, sale, or disposition of property.

(2) *Examples*. The following examples illustrate the rule of this paragraph (f)(1). Assume that X does not apply the *de minimis* rule under paragraph (d)(4) of this section.

Example 1. Recovery when property placed in service. X owns a 10-unit apartment building. The refrigerator in one of the apartments stops functioning and X purchases a new refrigerator to replace the old one. X pays for the acquisition, delivery, and installation of the new refrigerator to replace the old refrigerator. Assume that the refrigerator is the unit of property, as determined under §1.263(a)–3(d)(2), and is not a material or supply under §1.162–3. Under paragraph (d) of this section, X is required to capitalize the amounts paid for the acquisition, delivery, and installation of the refrigerator. Under this paragraph (f), the capitalized amounts are recovered through depreciation when the refrigerator is placed in service by X.

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

(g) [Reserved]

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

Par. 8. Section 1.263(a)–3 is revised to read as follows:

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

(a) *Overview*. This section provides rules for applying section 263(a) to amounts paid to improve tangible property. Paragraph (b) of this section provides definitions. Paragraph (c) of this section provides rules for coordinating this section with other provisions of the Internal Revenue Code (Code). Paragraph (d) of this section provides rules for determining the treatment of amounts paid to improve tangible property, including rules for determining the appropriate unit of property. Paragraph (e) of this section provides a safe harbor for routine maintenance costs. Paragraph (f) of this section provides rules for determining whether amounts paid result in betterments to the unit of property.

Paragraph (g) of this section provides rules for determining whether amounts paid restore the unit of property. Paragraph (h) of this section provides rules for amounts paid to adapt the unit of property to a new or different use. Paragraph (i) of this section provides an optional regulatory accounting method safe harbor. Paragraph (j) of this section provides an optional repair allowance. Paragraphs (k) through (m) of this section provide additional rules related to these provisions. Paragraph (n) of this section provides the applicability date of the rules in this section.

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

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

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

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

(4) *Applicable financial statement*. The *applicable financial statement* is the taxpayer's financial statement listed in paragraphs (b)(4)(i) through (iii) of this section that has the highest priority (including within paragraph (b)(4)(ii) of this section). The financial statements are, in descending priority—

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

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

(A) Credit purposes;

(B) Reporting to shareholders, partners, or similar persons; or

(C) Any other substantial non-tax purpose; or

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

(c) *Coordination with other provisions of the Internal Revenue Code*—(1) *In general*. Nothing in this section changes the treatment of any amount that is specifically provided for under any provision of the Code or regulations (other than section 162(a) or section 212 and the regulations under those sections). See, for example, §1.263A–1(e)(3), requiring taxpayers to capitalize costs that directly benefit or are incurred by reason of the performance of production or resale activities, including repair and maintenance costs allocable to property produced or acquired for resale.

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

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

(d) *Improved property*—(1) *Capitalization rule*. Except as provided in the optional regulatory accounting method in paragraph (i) of this section or under any repair allowance method published in accordance with paragraph (j) of this section, a taxpayer must capitalize the aggregate of related amounts paid to improve a unit of property, whether the improvements are made by the taxpayer or by a third party, and whether the taxpayer is an owner or lessee of the property. For purposes of this section, a unit of property includes units of property for which the acquisition or production costs were deducted as materials and supplies under §1.162–3(a)(1) or under the *de minimis* rule in §1.263(a)–2(d)(4). See section 263A for the costs required to be capitalized to property produced by the taxpayer or to property acquired for resale; section 1016 for adding capitalized amounts to the basis of the unit of property; and section 168 for the treatment of additions or improvements for depreciation purposes. For purposes of this section, a unit of property is improved if the amounts paid for activities performed after the property is placed in service by the taxpayer—

(i) Result in a betterment to the unit of property (see paragraph (f) of this section); or

(ii) Restore the unit of property (see paragraph (g) of this section); or

(iii) Adapt the unit of property to a new or different use (see paragraph (h) of this section).

(2) *Determining the appropriate unit of property*—(i) *In general*. The unit of property rules in this paragraph (d)(2) apply only for purposes of section 263(a) and §§1.263(a)–1, 1.263(a)–2, 1.263(a)–3, and 1.162–3(d). In general, the unit of property determination is based upon the functional interdependence standard provided in paragraph (d)(2)(iii)(A) of this section. However, special rules are provided for buildings (see paragraph (d)(2)(ii) of this section), plant property (see paragraph (d)(2)(iii)(B) of this section), and network assets (see paragraph (d)(2)(iii)(C) of this section). Additional rules are provided if a taxpayer has assigned different financial statement economic useful lives or MACRS classes or depreciation methods to components of property (see paragraph (d)(2)(iii)(D) of this section). Property that is aggregated and subject to a general asset account election or accounted for in a multiple asset account (that is, pooled) may not be treated as a single unit of property. In addition, an improvement to a unit of property as determined under this section, other than a leasehold improvement, is not a unit of property separate from the unit of property improved.

(ii) *Buildings and structural components*. In the case of a building (as defined in §1.48–1(e)(1)), the building and its structural components (as defined in §1.48–1(e)(2)) are a single unit of property. In the case of a leasehold improvement made by a lessee and that is section 1250 property, the leasehold improvement is a separate unit of property. In the case of a taxpayer that owns or occupies an individual unit in a building with multiple units (such as a condominium or cooperative), the unit of property is the individual unit owned and/or occupied by the taxpayer.

(iii) *Property other than buildings*—(A) *In general*. Except as provided in paragraphs (d)(2)(iii)(B), (C) and (D) of this section, in the case of real or personal property other than property described in para-

graph (d)(2)(ii) of this section, all the components that are functionally interdependent comprise a single unit of property. Components of property are functionally interdependent if the placing in service of one component by the taxpayer is dependent on the placing in service of the other component by the taxpayer.

(B) *Plant property*—(*1*) *Definition*. For purposes of this paragraph (d)(2) of this section, the term *plant property* means functionally interdependent machinery or equipment, other than network assets, used to perform an industrial process, such as manufacturing, generation, warehousing, distribution, automated materials handling in service industries, or other similar activities.

(*2*) *Unit of property for plant property*. In the case of plant property, a unit of property is comprised of each component (or group of components) within the unit of property determined under the general rule of paragraph (d)(2)(iii)(A) of this section that performs a discrete and major function or operation within the functionally interdependent machinery or equipment.

(C) *Network assets*—(*1*) *Definition*. For purposes of this paragraph (d)(2), the term *network assets* means railroad track, oil and gas pipelines, water and sewage pipelines, power transmission and distribution lines, and telephone and cable lines that are owned or leased by taxpayers in each of those respective industries. The term includes, for example, trunk and feeder lines, pole lines, and buried conduit. It does not include property that would be included as a structural component of a building under paragraph (d)(2)(ii) of this section, nor does it include separate property that is adjacent to, but not part of a network asset, such as bridges, culverts, or tunnels.

(*2*) [Reserved]

(D) *Additional rules*. Notwithstanding the unit of property determination under paragraphs (d)(2)(iii)(A), (B), and (C) of this section, a component (or a group of components) of a unit property must be treated as a separate unit of property if—

(*1*) At the time the unit of property (as determined under paragraphs (d)(2)(iii)(A), (B), and (C) of this section) is placed in service by the taxpayer (without regard to subsequent improvements), the taxpayer has recorded on its books and records for financial or regulatory accounting purposes an economic useful life for the component that is different from the economic useful life of the unit of property of which the component is a part; or

(*2*) The taxpayer has properly treated the component as being within a different class of property under section 168(e) (MACRS classes) than the class of the unit of property of which the component is a part or, the taxpayer, at the time the component was placed in service by the taxpayer, has properly depreciated the component using a different depreciation method under section 167 or section 168 than the depreciation method of the unit of property of which the component is a part.

(iv) *Examples*. The rules of this paragraph (d)(2) are illustrated by the following examples, in which it is assumed that the taxpayer has not made a general asset account election with regard to property or accounted for property in a multiple asset account.

Example 1. Buildings and structural components; plant property. X owns a building containing various types of manufacturing equipment that are not structural components of the building. Because the property is a building, as defined in §1.48–1(e)(1), the unit of property for the building must be determined under paragraph (d)(2)(ii) of this section. Under the rules of that paragraph, X must treat the building and all its structural components as a single unit of property. In addition, because the manufacturing equipment contained within the building constitutes property other than a building, the units of property for the manufacturing equipment are initially determined under the general rule in paragraph (d)(2)(iii)(A) of this section and are therefore comprised of all the components that are functionally interdependent. Moreover, because the manufacturing equipment is plant property, under paragraph (d)(2)(iii)(B) of this section, the units of property under the general rule are further divided into smaller units of property by determining the components (or groups of components) that perform discrete and major functions within the plant. Finally, X must apply the additional rules in paragraph (d)(2)(iii)(D) of this section to determine whether any of the units of property determined under paragraphs (d)(2)(iii)(A) and (B) of this section contain components that must be treated as separate units of property.

Example 2. Buildings and structural components; property other than plants. X, a manufacturer, owns a building adjacent to its manufacturing facility that contains office space and related facilities for X's employees that manage and administer X's manufacturing operations. The office building contains equipment, such as desks, chairs, computers, telephones, and bookshelves, that are not structural components of the building. Because the office building is a building, as defined in §1.48–1(e)(1), the unit of property for the building must be determined under paragraph (d)(2)(ii) of this section. Under the rules of that paragraph, X must treat the office building and all its structural components as a single unit of property. In addition, because the equipment contained within the office building constitutes property other than a building, the units of property for the office equipment are initially determined under the general rule in paragraph (d)(2)(iii)(A) of this section and are comprised of the groups of components that are functionally interdependent. X then must apply the additional rules in paragraph (d)(2)(iii)(D) of this section to determine whether any of the units of property determined under paragraph (d)(2)(iii)(A) of this section contain components that must be treated as separate units of property.

Example 3. Plant property; discrete and major function. X is an electric utility company that operates a power plant to generate electricity. The power plant includes a structure that is not a building under §1.48–1(e)(1), four pulverizers that grind coal, one boiler that produces steam, one turbine that converts the steam into mechanical energy, and one generator that converts mechanical energy into electrical energy. In addition, the turbine contains a series of blades that cause the turbine to rotate when affected by the steam. When X placed the plant into service, X recorded all the components of the plant as having the same economic useful life on its books and records for financial and regulatory accounting purposes. X also treated all the components of the plant as being within the same class of property under section 168(e) and has depreciated all the components using the same depreciation methods. Because the plant is composed of real and personal tangible property other than a building, the unit of property for the generating equipment is initially determined under the general rule in paragraph (d)(2)(iii)(A) of this section and is comprised of all the components that are functionally interdependent. Under this rule, the initial unit of property is the entire plant because the components of the plant are functionally interdependent. However, because the power plant is plant property under paragraph (d)(2)(iii)(B) of this section, the initial unit of property is further divided into smaller units of property by determining the components (or groups of components) that perform discrete and major functions within the plant. Under this paragraph, X must treat the structure, the boiler, the turbine, and the generator each as a separate unit of property, and each of the four pulverizers as a separate unit of property because each of these components performs a discrete and major function within the power plant. X is not required to treat components, such as the turbine blades, as separate units of property because each of these components does not perform a discrete and major function within the plant.

Example 4. Plant property; discrete and major function. X is engaged in a uniform and linen rental business that operates a plant to treat and launder items used in its business. Within the plant, X utilizes an assembly line-like process that incorporates many different machines and equipment to launder and prepare the items to be returned to customers. X utilizes two laundering lines in its plant, each of which can operate independently. One line is used for uniforms and another line is used for linens. Both lines incorporate several sorters, boilers, washers, dryers, ironers, folders, and waste water treatment systems. Because the laundering equipment contained within the plant is personal property, the unit of property

for the laundering equipment is initially determined under the general rule in paragraph (d)(2)(iii)(A) of this section and is comprised of all the components that are functionally interdependent. Under this rule, the initial units of property are each laundering line because each line is functionally independent and is comprised of components that are functionally interdependent. However, because each line is comprised of plant property under paragraph (d)(2)(iii)(B) of this section, the initial units of property are further divided into smaller units of property by determining the components (or groups of components) that perform discrete and major functions within the line. Under paragraph (d)(2)(iii)(B) of this section, X must treat each sorter, boiler, washer, dryer, ironer, folder, and waste water treatment system in each line as a separate unit of property because each of these components performs a discrete and major function within the line. Finally, X must apply the additional rules in paragraph (d)(2)(iii)(D) of this section to determine whether any of the units of property determined under paragraph (d)(2)(iii)(B) of this section contain components that must be treated as separate units of property.

Example 5. Plant property; industrial process. X operates a restaurant that prepares and serves food to retail customers. Within its restaurant, X has a large piece of equipment that uses an assembly line-like process to prepare and cook tortillas that X serves to its customers. Because the tortilla-making equipment is personal property, the unit of property for the equipment is initially determined under the general rule in paragraph (d)(2)(iii)(A) of this section and is comprised of all the components that are functionally interdependent. Under this rule, the initial unit of property is the entire tortilla-making equipment because the various components of the equipment are functionally interdependent. Although the equipment is used to perform a manufacturing process, the equipment is not being used in an industrial process, as it performs a small-scale function as part of X's retail restaurant operations. Therefore, the equipment is not plant property under paragraph (d)(2)(iii)(B) of this section. Finally, X must apply the additional rules in paragraph (d)(2)(iii)(D) of this section to determine whether the equipment contains components that must be treated as separate units of property.

Example 6. Personal property. X owns locomotives that it uses in its railroad business. Each locomotive consists of various components, such as an engine, generators, batteries and trucks. X acquired a locomotive with all its components and recorded all the components as having the same economic useful life on its books and records for financial and regulatory accounting. X also treated all the components of the locomotive as being within the same class of property under section 168(e) and has depreciated all the components using the same depreciation methods. Because X's locomotive is property other than a building, the initial unit of property is determined under paragraph (d)(2)(iii)(A) of this section. Under this paragraph, the locomotive is a single unit of property because it consists entirely of components that are functionally interdependent. Because the additional rules under paragraph (d)(2)(iii)(D) of this section do not apply under these facts, the locomotive is a single unit of property.

Example 7. Personal property. X is engaged in the business of transporting freight throughout the United States. To conduct its business, X owns a fleet of tractors and trailers. Each tractor and trailer is comprised of various components, including tires. X purchases a truck trailer with all of its components, including 16 tires. At the time the trailer was placed in service by X, X treated the trailer and the tires as being within the same class of property under section 168(e) and has depreciated all the components using the same depreciation methods. However, on its books and records for financial accounting purposes, X recorded economic useful lives for the tires that were different from the economic useful life that it recorded for the trailer. Because X's trailer is property other than a building, the initial units of property for the trailer are determined under the general rule in paragraph (d)(2)(iii)(A) of this section and are comprised of all the components that are functionally interdependent. Under this rule, the truck trailer, including its 16 tires, is a single unit of property because the trailer and the tires are functionally interdependent (that is, the placing in service of the tires is dependent upon the placing in service of the trailer). X then must apply the additional rules in paragraph (d)(2)(iii)(D) of this section to determine whether the initial unit of property determined under paragraph (d)(2)(iii)(A) of this section contains components that must be treated as separate units of property. Under paragraph (d)(2)(iii)(D)(*1*) of this section, because X recorded on its books and records economic useful lives for the tires that are different from the economic useful lives that it recorded for the trailer, the tires must be treated as separate units of property.

Example 8. Personal property. X provides legal services to customers. X purchased a laptop computer and a printer to be used by its employees in providing services. When X placed the computer and printer into service, X recorded both items and all their components as having the same economic useful life on its books and records for financial accounting purposes. X also treated the computer and printer and all their components as being within the same class of property under section 168(e) and has depreciated all the components using the same depreciation methods. Because the computer and printer are property other than a building, the initial units of property are determined under the general rule in paragraph (d)(2)(iii)(A) of this section and are comprised of the components that are functionally interdependent. Under this paragraph (d)(2)(iii)(A), the computer and the printer are separate units of property because the computer and the printer are not components that are functionally interdependent (that is, the placing in service of the computer is not dependent on the placing in service of the printer). The additional rules in paragraph (d)(2)(iii)(D) of this section do not apply under these facts. Accordingly, the computer and the printer each constitute separate units of property.

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

(4) *Repairs and maintenance performed during an improvement*—(i) *In general.* A taxpayer must capitalize all the direct costs of an improvement and all the indirect costs (including otherwise deductible repair costs) that directly benefit or are incurred by reason of an improvement in accordance with the rules under section 263A. Repairs and maintenance that do not directly benefit or are not incurred by reason of an improvement are not required to be capitalized under section 263(a), regardless of whether they are made at the same time as an improvement.

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

(5) *Aggregate of related amounts.* For purposes of paragraph (d)(1) of this section, the aggregate of related amounts paid to improve a unit of property may be incurred over a period of more than one taxable year. Whether amounts are related to the same improvement depends on the facts and circumstances of the activities being performed and whether the costs are incurred by reason of a single improvement or directly benefit a single improvement.

(e) *Safe harbor for routine maintenance*—(1) *In general.* An amount paid for routine maintenance performed on a unit of property is deemed to not improve that unit of property. Routine maintenance is the recurring activities that a taxpayer expects to perform as a result of the taxpayer's use of the unit of property to keep the unit of property in its ordinarily efficient operating condition. Routine maintenance activities include, for example, the inspection, cleaning, and testing of the unit of property, and the replacement of parts of the unit of property with comparable and commercially available and reasonable replacement parts. The activities are routine only if, at the time the unit of property is placed in service by the taxpayer, the taxpayer reasonably expects to perform the activities more than once during the class life (as defined in paragraph (e)(4) of this section) of the unit of property. Among the factors to be con-

sidered in determining whether a taxpayer is performing routine maintenance are the recurring nature of the activity, industry practice, manufacturers' recommendations, the taxpayer's experience, and the taxpayer's treatment of the activity on its applicable financial statement (as defined in paragraph (b)(4) of this section). With respect to a taxpayer that is a lessor of a unit of property, the taxpayer's use of the unit of property includes the lessee's use of the unit of property.

(2) *Exceptions*. Routine maintenance does not include the following—

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

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

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

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

(3) *Rotable or temporary spare parts*. For purposes of paragraph (e)(1) of this section, amounts paid for routine maintenance include routine maintenance performed on (and with regard to) rotable and temporary spare parts. But see §1.162–3(b), which provides that rotable and temporary spare parts are used or consumed by the taxpayer in the taxable year in which the taxpayer disposes of the part.

(4) *Class life*. The class life of a unit of property is the recovery period prescribed for the property under section 168(g)(2) and (3) for purposes of the alternative depreciation system, regardless of whether the property is depreciated under section 168(g). For purposes of determining class life under this paragraph (e), section 168(g)(3)(A) (relating to tax-exempt use property subject to lease) does not apply.

(5) *Examples*. The following examples illustrate the rules of this paragraph (e).

Example 1. Routine maintenance on rotable component. (i) X is a commercial airline engaged in the business of transporting passengers and freight throughout the United States and abroad. To conduct its business, X owns or leases various types of aircraft. As a condition of maintaining its airworthiness certification for these aircraft, X is required by the Federal Aviation Administration (FAA) to establish and adhere to a continuous maintenance program for each aircraft within its fleet. These programs, which are designed by X and the aircraft's manufacturer and approved by the FAA, are incorporated into each aircraft's maintenance manual. The maintenance manuals require a variety of periodic maintenance visits at various intervals. One type of maintenance visit is an engine shop visit (ESV), which X expects to perform on its aircraft engines approximately every 4 years in order to keep its aircraft in its ordinarily efficient operating condition. In 2004, X purchased a new aircraft and four new engines to use in that aircraft and later, in other aircraft in its fleet. The aircraft engines are rotable spare parts because they are removable from the aircraft, and repaired and reinstalled on other aircraft or stored for later installation on other aircraft. See §1.162–3(b) (treatment of materials and supplies). In 2008, X performs its first ESV on the aircraft engines. The ESV includes disassembly, cleaning, inspection, repair, replacement, reassembly, and testing of the engine and its component parts. During the ESV, the engine is removed from the aircraft and shipped to an outside vendor who performs the ESV. If inspection or testing discloses a discrepancy in a part's conformity to the specifications in X's maintenance program, the part is repaired, or if necessary, replaced with a comparable and commercially available and reasonable replacement part. After the ESVs, the engines are returned to X to be reinstalled on another aircraft or stored for later installation. Assume the unit of property for X's aircraft is the entire aircraft, including the aircraft engines, and that the class life for X's aircraft is 12 years. Assume that none of the exceptions set out in paragraph (e)(2) of this section applies to the costs of performing the ESVs.

(ii) Because the ESVs involve the recurring activities that X expects to perform as a result of its use of the aircraft to keep the aircraft in ordinarily efficient operating condition, and consist of maintenance activities that X expects to perform more than once during the 12 year class life of the aircraft, X's ESVs are within the routine maintenance safe harbor under paragraph (e) of this section. Accordingly, the amounts paid by X for the ESVs are deemed not to improve the aircraft and are not required to be capitalized under paragraph (d)(1) of this section. For the treatment of costs to acquire the engines, see §1.162–3.

Example 2. Routine maintenance after economic useful life. Assume the same facts as in *Example 1*, except that X incurs costs to perform an ESV on one of its aircraft engines in 2024, after the end of the economic useful life that X anticipated for the aircraft. Because this ESV involves the same routine maintenance activities that were performed on aircraft engines in *Example 1*, this ESV also is within the routine maintenance safe harbor under paragraph (e) of this section. Accordingly, the amounts paid by X for this ESV, even though performed after the economic useful life of the aircraft, are deemed not to improve the aircraft and are not required to be capitalized under paragraph (d)(1) of this section.

Example 3. Routine maintenance resulting from prior owner's use. (i) In January 2008, X purchases a used machine for use its manufacturing operations. Assume that the machine is the unit of property and has a class life of 10 years. The machine is fully operational at the time it is purchased by X and is immediately placed in service in X's business. At the time it is placed in service by X, X expects to perform manufacturer recommended scheduled maintenance on the machine approximately every three years. The scheduled maintenance includes the cleaning and oiling of the machine, the inspection of parts for defects, and the replacement of minor items such as springs, bearings, and seals with comparable and commercially available and reasonable replacement parts. At the time the machine is purchased, it is approaching the end of a three-year scheduled maintenance period. As a result, in February 2008, X incurs costs to perform the manufacturer recommended scheduled maintenance. Assume that none of the exceptions set out in paragraph (e)(2) of this section apply to the amounts paid for the scheduled maintenance.

(ii) The majority of the costs incurred by X do not qualify under the routine maintenance safe harbor in paragraph (e) of this section because the costs were primarily incurred as a result of the prior owner's use of the property and not X's use. The condition of the machine at the time that it was placed in service by X was that of a machine nearing the end of a scheduled maintenance period. Accordingly, the amounts paid by X for the scheduled maintenance resulting from the prior owner's use of the property must be capitalized if those amounts result in a betterment under paragraph (f) of this section, including the amelioration of a material condition or defect, or otherwise result in an improvement under paragraph (d)(1) of this section. See also section 263A requiring taxpayers to capitalize the direct and allocable share of indirect costs of property produced or acquired for resale.

Example 4. Routine maintenance resulting from new owner's use. Assume the same facts as in *Example 3*, except that after X incurs costs for the maintenance in 2008, X continues to operate the machine in its manufacturing business. In 2011, X incurs costs to perform the next scheduled manufacturer recommended maintenance on the machine. Assume that the scheduled maintenance activities performed are the same as those performed in *Example 3* and that none of the exceptions set out in paragraph (e)(2) of this section apply to the amounts paid for the scheduled maintenance. Because the scheduled maintenance performed in 2011 involves the recurring activities that X performs as a result of its use of the machine, keeps the machine in an ordinarily efficient operating condition, and consists of maintenance activities that X expects to perform more than once during the 10 year class life of the machine, X's scheduled maintenance costs are within the routine maintenance safe harbor under paragraph (e) of this section. Accordingly, the amounts paid by X for the scheduled maintenance in 2011 are deemed not to improve the machine and are not required to be capitalized under paragraph (d)(1) of this section. However, because the amounts paid for the scheduled maintenance are incurred by reason of X's manufacturing operations, X is required to capitalize the amounts

paid for the maintenance to products produced by X. See §1.263A–1(e)(3)(ii).

Example 5. Routine maintenance; replacement of substantial structural part. X is in the business of producing commercial products for sale. As part of the production process, X places raw materials into lined containers in which a chemical reaction is used to convert raw materials into the finished product. The lining is a substantial structural part of the container, and comprises 60% of the total physical structure of the container. Assume that each container, including its lining, is the unit of property and that a container has a class life of 12 years. At the time that X placed the container into service, X was aware that approximately every three years, X would be required to replace the lining in the container with comparable and commercially available and reasonable replacement materials. At the end of that period, the container will continue to function, but will become less efficient and the replacement of the lining will be necessary to keep the container in an ordinarily efficient operating condition. In 2003, X acquired 10 new containers and placed them into service. In 2006, 2009, 2011, and 2014, X pays amounts to replace the containers' linings with comparable and commercially available and reasonable replacement parts. Assume that none of the exceptions set out in paragraph (e)(2) of this section apply to the amounts paid for the replacement linings. Because the replacement of the linings involves recurring activities that X expects to perform as a result of its use of the containers to keep the containers in their ordinarily efficient operating condition, and consists of maintenance activities that X expects to perform more than once during the 12 year class lives of the containers, X's lining replacement costs are within the routine maintenance safe harbor under paragraph (e) of this section. Accordingly, the amounts paid by X for the replacement of the container linings are deemed not to improve the containers and are not required to be capitalized under paragraph (d)(1) of this section. However, because the amounts paid to replace the container linings are incurred by reason of X's manufacturing operations, X is required to capitalize the amounts paid for the replacements to products produced by X. See §1.263A–1(e)(3)(ii).

Example 6. Routine maintenance once during class life. X is a Class I railroad that owns a fleet of freight cars. Assume that a freight car, including all its components, is a unit of property and has a class life of 14 years. At the time that X places a freight car into service, X expects to perform cyclical reconditioning to the car every 8 to 10 years in order to keep the freight car in ordinarily efficient operating condition. During this reconditioning, X incurs costs to disassemble, inspect, and recondition and/or replace components of the freight car with comparable and commercially available and reasonable replacement parts. Ten years after the freight car is placed in service by X, X incurs costs to perform a cyclical reconditioning on the car. Because X expects to perform the reconditioning only once during the 14 year class life of the freight car, the costs incurred for reconditioning do not qualify for the routine maintenance safe harbor under paragraph (e) of this section. Accordingly, X must capitalize the amounts paid for the reconditioning of the freight car if these amounts result in an improvement under paragraph (d)(1) of this section.

Example 7. Routine maintenance on non-rotable part. X is a towboat operator that owns and leases a fleet of towboats. Each towboat is equipped with two diesel-powered engines. Assume that each towboat, including its engines, is the unit of property and that a towboat has a class life of 18 years. At the time that X places its towboats into service, X is aware that approximately every three to four years, X will need to perform scheduled maintenance on the two towboat engines to keep the engines in their ordinarily efficient operating condition. This maintenance is completed while the engines are attached to the towboat and involves the cleaning and inspecting of the engines to determine which parts are within acceptable operating tolerances and can continue to be used, which parts must be reconditioned to be brought back to acceptable tolerances, and which parts must be replaced. Engine parts replaced during these procedures are replaced with comparable and commercially available and reasonable replacement parts. Assume the towboat engines are not rotable spare parts under §1.162–3(b). In 2005, X acquired a new towboat, including its two engines, and placed the towboat into service. In 2009, X incurs amounts to perform scheduled maintenance on both engines in the towboat. Assume that none of the exceptions set out in paragraph (e)(2) of this section apply to the scheduled maintenance costs. The scheduled maintenance involves recurring activities that X expects to perform more than once during the 18 year class life of the towboat. Because this maintenance results from X's use of the towboat, and is performed to keep the towboat in an ordinarily efficient operating condition, the scheduled maintenance on X's towboat is within the routine maintenance safe harbor under paragraph (e) of this section. Accordingly, the amounts paid by X for the scheduled maintenance to its towboat engines in 2009 are deemed not to improve the towboat and are not required to be capitalized under paragraph (d)(1) of this section.

Example 8. Routine maintenance with betterments. Assume the same facts as *Example 7*, except that in 2013, X's towboat engines are due for another scheduled maintenance visit. At this time X decides to upgrade the engines to increase their horsepower and propulsion, which would permit the towboats to tow heavier loads. Accordingly, in 2013 X incurs costs to perform many of the same activities that it would perform during the typical scheduled maintenance activities such as cleaning, inspecting, reconditioning, and replacing minor parts, but at the same time, X incurs costs to upgrade certain engine parts to increase the towing capacity of the boats in excess of the capacity when the boats were placed in service by X. Both the scheduled maintenance procedures and the replacement of parts with new and upgraded parts are necessary to increase the horsepower of the engines and the towing capacity of the boat. Thus, the work done on the engines encompasses more than the recurring activities that X expected to perform as a result of its use of the towboats and did more than keep the towboat in its ordinarily efficient operating condition. In addition, the scheduled maintenance procedures directly benefit and are incurred by reason of the upgrades. Therefore, the amounts paid by X in 2013 for the maintenance and upgrade of the engines do not qualify for the routine maintenance safe harbor described under paragraph (e) of this section. These amounts must be capitalized if they result in a betterment under paragraph (f) of this section, including a material increase in the capacity of the towboat, or otherwise result in an improvement under paragraph (d)(1) of this section. See also section 263A requiring taxpayers to capitalize all the direct costs of an improvement to property and all the indirect costs that directly benefit or are incurred by reason of an improvement to property.

Example 9. Exceptions to routine maintenance. X owns and operates a farming and cattle ranch with an irrigation system that provides water for crops. Assume that each canal in the irrigation system is a single unit of property and has a class life of 20 years. When X placed the canals into service, X expected to have to perform major maintenance on the canals every 3 years to keep the canals in their ordinarily efficient operating condition. This maintenance included draining the canals, and then cleaning, inspecting, repairing, reconditioning or replacing parts of the canal with comparable and commercially available and reasonable replacement parts. X placed the canals into service in 2005 and did not perform any maintenance on the canals until 2010. At that time, the canals had fallen into a state of disrepair and no longer functioned for irrigation. In 2010, X paid amounts to drain the canals, and do extensive cleaning, repairing, reconditioning and replacing parts of the canals with comparable and commercially available and reasonable replacement parts. Although the work performed on X's canals was similar to the activities that X expected to perform, but did not perform, every three years, the costs of these activities do not fall within the routine maintenance safe harbor. Specifically, under paragraph (e)(2)(iv) of this section, routine maintenance does not include amounts paid to return a unit of property to its former ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use. Accordingly, amounts paid by X for work performed on the canals in 2010 must be capitalized if they result in improvements under paragraph (d)(1) of this section (for example, restorations under paragraph (g) of this section).

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

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

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

(iii) Results in a material increase in capacity (including additional cubic or square space), productivity, efficiency,

strength, or quality of the unit of property or the output of the unit of property.

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

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

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

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

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

(3) *Examples*. The following examples illustrate solely the rules of this paragraph (f). Even if capitalization is not required in an example under this paragraph (f), the amounts paid in the example may be subject to capitalization under a different provision of this section.

Example 1. Amelioration of pre-existing material condition or defect. In 2008, X purchases a store located on a parcel of land that contained underground gasoline storage tanks left by prior occupants. Assume that the parcel of land is the unit of property. The tanks had leaked, causing soil contamination. X is not aware of the contamination at the time of purchase. In 2009, X discovers the contamination and incurs costs to remediate the soil. The remediation costs incurred by X result in a betterment to the land under paragraph (f)(1)(i) of this section because the costs were incurred to ameliorate a material condition or defect that existed prior to the taxpayer's acquisition of the land.

Example 2. Not amelioration of pre-existing condition or defect. X owned a building that was constructed with insulation that contained asbestos. The health dangers of asbestos were not widely known when the building was constructed. In 2008, X determined that certain areas of asbestos-containing insulation had begun to deteriorate and could eventually pose a health risk to employees. Therefore, X decided to remove the asbestos-containing insulation from the building and replace it with new insulation that was safer to employees, but no more efficient or effective than the asbestos insulation. Assume the building and its structural components (including the asbestos insulation) is the unit of property. The amounts paid to remove and replace the asbestos insulation are not required to be capitalized as a betterment under paragraphs (f)(1)(i) and (f)(2)(i) of this section because the asbestos, although later determined to be unsafe under certain circumstances, was not an inherent and material defect to the property. In addition, the removal and replacement of the asbestos did not result in any material additions to the building or material increases in capacity, productivity, efficiency, strength or quality of the building or the output of the building under paragraphs (f)(1)(ii) and (f)(1)(iii) of this section.

Example 3. Not amelioration of pre-existing material condition or defect. (i) In January 2008, X purchases a used machine for use in its manufacturing operations. Assume that the machine is a unit of property and it has a class life of 10 years. The machine is fully operational at the time it is purchased by X and is immediately placed in service in X's business. At the time it is placed in service by X, X expects to perform manufacturer recommended scheduled maintenance on the machine every three years. The scheduled maintenance includes the cleaning and oiling of the machine, the inspection of parts for defects, and the replacement of minor items such as springs, bearings, and seals with comparable and commercially available and reasonable replacement parts. The scheduled maintenance does not result in any material additions or material increases in capacity, productivity, efficiency, strength or quality of the machine or the output of the machine. At the time the machine is purchased, it is approaching the end of a three-year scheduled maintenance period. As a result, in February 2008, X incurs costs to perform the manufacturer recommended scheduled maintenance to keep the machine in its ordinarily efficient operating condition.

(ii) The majority of the costs incurred by X do not qualify under the routine maintenance safe harbor in paragraph (e) of this section because the costs were primarily incurred as a result of the prior owner's use of the property and not the taxpayer's use. The condition of the machine at the time that it was placed in service by X was that of a machine nearing the end of a scheduled maintenance period. Accordingly, the amounts paid by X for the scheduled maintenance resulting from the prior owner's use of the property ameliorate conditions or defects that existed prior to X's ownership of the machine. Nevertheless, considering the facts and circumstances under paragraph (f)(2)(i) of this section, including the purpose and minor nature of the work performed, those amounts do not ameliorate a material condition or defect under paragraph (f)(1)(i) of this section and accordingly do not result in a betterment that must be capitalized under this paragraph (f).

Example 4. Not amelioration of pre-existing material condition or defect. In 2008, X purchases a used ice resurfacing machine for use in the operation of its ice skating rink. To comply with local regulations, X is required to routinely monitor the air quality in the ice skating rink. One week after X places the machine into service, during a routine air quality check, X discovers that the operation of the machine is adversely affecting the air quality in the skating rink. As a result, X incurs costs to inspect and retune the machine, which includes replacing minor components of the engine, which had worn out prior to X's acquisition of the machine. Assume the resurfacing machine, including the engine, is the unit of property. The routine maintenance safe harbor in paragraph (e) of this section does not apply to the amounts paid because the activities performed do more than return the machine to the condition that existed at the time it was placed in service by X. The amounts paid by X to inspect, retune, and replace minor components of the ice resurfacing machine ameliorated a condition or defect that existed prior to X's acquisition of the equipment. Nevertheless, considering the facts and circumstances under paragraph (f)(2)(i) of this section, including the purpose and minor nature of the work performed, these amounts do not ameliorate a material condition or defect under paragraph (f)(1)(i) of this section, result in a material addition to the machine under paragraph (f)(1)(ii) of this section, or result in a material increase in the capacity, productivity, efficiency, strength or quality of the machine or the output of the machine. Accordingly, the amounts paid by X to inspect, retune, and replace minor components of the machine do not result in a betterment that must be capitalized under this paragraph (f).

Example 5. Amelioration of material condition or defect; increase in quality. (i) In January 2009, X acquires a building for use in its business of providing assisted living services. Before and after the purchase, the building functions as an assisted living facility. However, at the time of the purchase, X is aware that the building is in a condition that is below the standards that X requires for facilities used in its business. Beginning in 2009 and over the next two years, while X continues to use the building as an assisted living facility, X incurs costs for repairs,

maintenance, and the acquisition of new property to bring the facility into the high-quality condition for which X's facilities are known. The work includes repainting; replacing flooring materials, windows, and tiling and fixtures in bathrooms; replacing window treatments, furniture, and cabinets; and repairing or replacing roofing materials, heating and cooling systems. On its applicable financial statements, X capitalizes the costs of the repairs, maintenance, and acquisitions over the remaining economic useful life recorded for the building. Assume that the building, including its structural components, is a single unit of property and that each section 1245 property is a separate unit of property.

(ii) Considering the facts and circumstances under paragraph (f)(2)(i) of this section, including the purpose of the expenditures, the effect of the expenditures on the building, and the treatment of the expenditures in X's applicable financial statements, the amounts paid by X for repairs and maintenance to the building and its structural components ameliorated material conditions and defects that existed prior to X's acquisition of the building. In addition, these amounts materially increased the quality of the building as compared to the condition of the building when it was placed in service by X. Accordingly, the amounts paid by X for repairs and maintenance to the building and its structural components (that is, repainting, replacing windows, replacing bathroom fixtures, repairing and replacing roofing materials and heating and cooling systems) result in betterments that must be capitalized under this paragraph (f). Moreover, X is required to capitalize the amounts paid to acquire and install each section 1245 property, including the flooring materials, tiling, each window treatment, each item of furniture, and each cabinet, in accordance with §1.263(a)–2(d).

Example 6. Not a betterment. (i) X owns a nationwide chain of retail stores that sell a wide variety of items. To remain competitive in the industry, X periodically changes the layout and appearance of its stores. These changes include the reconfiguration of the stores to provide better exposure of the merchandise and cosmetic alterations to keep the store modern and attractive to customers. The work is not undertaken for the purpose of repairing damaged property but rather to renew the appearance of the property. X incurs costs to update 50 stores during the taxable year. In its applicable financial statement, X capitalizes all the costs of the updates over a 5 year period until which X anticipates it would have to update again. Assume that each store building, including its structural components, is a unit of property and that each section 1245 property within the store is a separate unit of property. Also assume that the work performed did not ameliorate any material conditions or defects that existed when X acquired the store buildings or result in any material additions to the store buildings.

(ii) Considering the facts and circumstances under paragraph (f)(2)(i) of this section, including the purpose of the expenditure, the nature of the work performed, and the treatment of the work on X's applicable financial statements, the amounts paid by X for updates to its store buildings (including their structural components) do not result in material increases in capacity, productivity, efficiency, strength or quality of the store buildings. Accordingly, the amounts paid by X for the updates on the store buildings (including their structural components) do not result in betterments that must be capitalized under this paragraph (f). However, X is required to capitalize the amounts paid to acquire and install each section 1245 property in accordance with §1.263(a)–2(d).

Example 7. Betterment; regulatory requirement. X owns a hotel in City that includes five foot high unreinforced terra cotta and concrete parapets with overhanging cornices around the entire roof perimeter. The parapets and cornices are in good condition. In 2008, City passes an ordinance setting higher safety standards for parapets and cornices because of the hazardous conditions caused by earthquakes. To comply with the ordinance, X replaces the old parapets and cornices with new ones made of glass fiber reinforced concrete, which makes them lighter and stronger than the original ones. They are attached to the hotel using welded connections instead of wire supports, making them more resistant to damage from lateral movement. Assume the hotel building and its structural components are the unit of property. The event necessitating the expenditure was the 2008 City ordinance. Prior to the ordinance, the old parapets and cornices were in good condition, but were determined by City to create a potential hazard. After the expenditure, the new parapets and cornices materially increased the structural soundness (that is, the strength) of the hotel building. Therefore, the amounts paid by X to replace the parapets and cornices must be capitalized because they resulted in a betterment to the hotel. City's requirement that X correct the potential hazard to continue operating the hotel is not relevant in determining whether the amount paid improved the hotel. See paragraph (d)(3) of this section.

Example 8. Not a betterment; regulatory requirement. X owns a meat processing plant. In 2008, X discovers that oil was seeping through the concrete walls of the plant, creating a fire hazard. Federal meat inspectors advise X that it must correct the seepage problem or shut down its plant. To correct the problem, X incurs costs to add a concrete lining to the walls from the floor to a height of about four feet and also to add concrete to the floor of the plant. Assume the plant building and its structural components are the unit of property. The event necessitating the expenditure was the seepage of the oil. Prior to the seepage, the plant did not leak and was functioning for its intended use. The expenditure did not result in a material addition or material increase in capacity, productivity, efficiency, strength or quality of the plant or its output compared to the condition of the plant prior to the seepage of the oil. Therefore, the amounts paid by X to correct the seepage do not result in a betterment to the plant. X is not required to capitalize as an improvement under this paragraph (f) amounts paid to correct the seepage problem. The Federal meat inspectors' requirement that X correct the seepage to continue operating the plant is not relevant in determining whether the amount paid improved the plant. See paragraph (d)(3) of this section.

Example 9. Not a betterment; replacement with same part. X owns a small retail shop. In 2008, a storm damages the roof of X's shop by displacing numerous wooden shingles. X decides to replace all the wooden shingles on the roof and hires a contractor to replace all the shingles on the roof with new wooden shingles. Assume the shop building and its structural components are the unit of property. The event necessitating the expenditure was the storm. Prior to the storm, the retail shop was functioning for its intended use. The expenditure did not result in a material addition, or material increase in the capacity, productivity, efficiency, strength or quality of the shop or the output of the shop compared to the condition of the shop prior to the storm. Therefore, the amounts paid by X to reshingle the roof with wooden shingles do not result in betterment to the shop building. X is not required to capitalize as an improvement under this paragraph (f) amounts paid to replace the shingles.

Example 10. Not a betterment; replacement with comparable part. Assume the same facts as in *Example 9*, except that wooden shingles are not available on the market. X decides to replace all the wooden shingles with comparable asphalt shingles. The amounts paid by X to reshingle the roof with asphalt shingles do not result in a betterment to the shop, even though the asphalt shingles may be stronger than the wooden shingles. Because the wooden shingles could not practicably be replaced with new wooden shingles, the replacement of the old shingles with comparable asphalt shingles does not, by itself, result in an improvement to the shop. X is not required to capitalize as an improvement under this paragraph (f) amounts paid to replace the shingles.

Example 11. Betterment; replacement with improved parts. Assume the same facts as in *Example 9*, except that, instead of replacing the wooden shingles with asphalt shingles, X decides to replace all the wooden shingles with shingles made of lightweight composite materials that are maintenance-free and do not absorb moisture. The new shingles have a 50-year warranty and a Class A fire rating. The expenditure for these shingles resulted in a material increase in the quality of the shop building as compared to the condition of the shop building prior to the storm. X must capitalize amounts paid to reshingle the roof as an improvement under this paragraph (f) because they result in a betterment to the shop.

Example 12. Material increase in capacity. X owns a factory building with a storage area on the second floor. In 2008, X replaces the columns and girders supporting the second floor to permit storage of supplies with a gross weight 50 percent greater than the previous load-carrying capacity of the storage area. Assume the factory building and its structural components are the unit of property. X must capitalize as an improvement amounts paid for the columns and girders because they result in a material increase in the load-carrying capacity of the building. The comparison rule in paragraph (f)(2)(iii) of this section does not apply to these amounts paid because the expenditure was not necessitated by a particular event.

Example 13. Material increase in capacity. In 2008, X purchases harbor facilities consisting of a slip for the loading and unloading of barges and a channel leading from the slip to the river. At the time of purchase, the channel is 150 feet wide, 1,000 feet long, and 10 feet deep. To allow for ingress and egress and for the unloading of its barges, X needs to deepen the channel to a depth of 20 feet. X hires a contractor to dredge the channel to the required depth. Assume the channel is the unit of property. X must capitalize as an improvement amounts paid for the dredging because it resulted in a material increase in

the capacity of the channel. The comparison rule in paragraph (f)(2)(iii) of this section does not apply to these amounts paid because the expenditure was not necessitated by a particular event.

Example 14. Not a material increase in capacity. Assume the same facts as in *Example 13*, except that the channel was susceptible to siltation and, by 2009, the channel depth had been reduced to 18 feet. X hired a contractor to redredge the channel to a depth of 20 feet. The event necessitating the expenditure was the siltation of the channel. Both prior to the siltation and after the redredging, the depth of the channel was 20 feet. Therefore, the amounts paid by X for redredging the channel did not result in a material addition to the unit of property or a material increase in the capacity, productivity, efficiency, strength or quality of the unit of property or the output of the unit of property. X is not required to capitalize as a betterment under paragraph (f) of this section amounts paid to redredge the channel.

Example 15. Not a material increase in capacity. X owns a building used in its trade or business. The first floor has a drop-ceiling. X decides to remove the drop-ceiling and repaint the original ceiling. Assume the building and its structural components are the unit of property. The removal of the drop-ceiling does not create additional capacity in the building that was not there prior to the removal. Therefore, the amounts paid by X to remove the drop-ceiling and repaint the original ceiling did not result in a material addition or a material increase to the capacity, productivity, efficiency, strength or quality of the unit of property or output of the unit of property. X is not required to capitalize as a betterment under this paragraph (f) amounts paid related to removing the drop-ceiling. The comparison rule in paragraph (f)(2)(iii) of this section does not apply to these amounts paid because the expenditure was not necessitated by a particular event.

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

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

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

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

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

(v) Results in the rebuilding of the unit of property to a like-new condition after the end of its economic useful life (see paragraph (g)(2) of this section); or

(vi) Is for the replacement of a major component or a substantial structural part of the unit of property (see paragraph (g)(3) of this section).

(2) *Rebuild to like-new condition*—(i) *In general.* For purposes of paragraph (g)(1)(v) of this section, the following definitions apply:

(A) *Like-new condition.* A unit of property is rebuilt to a like-new condition if it is brought to the status of new, rebuilt, remanufactured, or similar status under the terms of any Federal regulatory guideline or the manufacturer's original specifications.

(B) *Economic useful life.* The economic useful life of a unit of property is not necessarily the useful life inherent in the property but is the period over which the property may reasonably be expected to be useful to the taxpayer or, if the taxpayer is engaged in a trade or business or an activity for the production of income, the period over which the property may reasonably be expected to be useful to the taxpayer in its trade or business or for the production of income, as applicable. See §1.167(a)–1(b) for the factors to be considered in determining this period.

(ii) *Exception.* An amount paid is not required to be capitalized under paragraph (g)(1)(v) of this section if it is paid during the recovery period prescribed in section 168(c) (taking into account the applicable convention) for the property, regardless of whether the property is depreciated under section 168(a).

(3) *Replacement of a major component or a substantial structural part*—(i) *In general.* For purposes of paragraph (g)(1)(vi) of this section, the replacement of a major component or a substantial structural part means the replacement of—

(A) A part or a combination of parts of the unit of property, the cost of which comprises 50 percent or more of the replacement cost of the unit of property; or

(B) A part or a combination of parts of the unit of property that comprise 50 percent or more of the physical structure of the unit of property.

(ii) *Exception.* An amount paid is not required to be capitalized under paragraph (g)(1)(vi) of this section if it is paid during the recovery period prescribed in section 168(c) (taking into account the applicable convention) for the property, regardless of whether the property is depreciated under section 168(a).

(4) *Examples.* The following examples illustrate solely the rules of this paragraph (g). Even if capitalization is not required in an example under the cited subparagraph under this paragraph (g), the amounts paid in the example may be subject to capitalization under a different provision of this section, or under a different subparagraph in this paragraph (g).

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

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

Example 3. Restoration after casualty loss. X owns an office building that it uses in its trade or business. A storm damages the office building at a time when the building has an adjusted basis of $500,000. X deducts under section 165 a casualty loss in the amount of $50,000 and properly reduces its basis in the office building to $450,000. X hires a contractor to repair the damage to the building and pays the contractor $50,000 for the work. Under paragraph (g)(1)(iii) of this section, X must capitalize the $50,000 amount paid to the contractor because X properly adjusted its basis as a result of a casualty loss under section 165.

Example 4. Restoration after casualty event. Assume the same facts as in *Example 3*, except that X receives insurance proceeds of $50,000 after the casualty to compensate for its loss. X cannot deduct a

casualty loss under section 165 because its loss was compensated by insurance. However, X properly reduces its basis in the property by the amount of the insurance proceeds. Under paragraph (g)(1)(iii) of this section, X must capitalize the $50,000 amount paid to the contractor because X has properly taken a basis adjustment relating to a casualty event described in section 165.

Example 5. Restoration of property in a state of disrepair. X owns and operates a farm with several barns and outbuildings. One of the outbuildings is not used or maintained by X on a regular basis and falls into a state of disrepair. The outbuilding previously was used for storage but can no longer be used for that purpose because the building is not structurally sound. X decides to restore the outbuilding and incurs costs to shore up the walls and replace the siding. Under paragraph (g)(1)(iv) of this section, X must capitalize the amounts paid to restore the outbuilding because they return the outbuilding to its ordinarily efficient operating condition after it had deteriorated to a state of disrepair and was no longer functional for its intended use.

Example 6. Rebuild of property to like-new condition before end of economic useful life. X is a Class I railroad that owns a fleet of freight cars. Freight cars have a recovery period of 7 years under section 168(c) and an economic useful life of 30 years. Every 8 to 10 years, X rebuilds its freight cars. Ten years after the freight car is placed in service by X, X performs a rebuild, which includes a complete disassembly, inspection, and reconditioning and/or replacement of components of the suspension and draft systems, trailer hitches, and other special equipment. X modifies the car to upgrade various components to the latest engineering standards. The freight car essentially is stripped to the frame, with all of its substantial components either reconditioned or replaced. The frame itself is the longest-lasting part of the car and is reconditioned. The walls of the freight car are replaced or are sandblasted and repainted. New wheels are installed on the car. All the remaining components of the car are restored before they are reassembled. At the end of the rebuild, the freight car has been restored to a rebuilt condition under the manufacturer's specifications. Assume the freight car is the unit of property. X is not required to capitalize under paragraph (g)(1)(v) of this section the amounts paid to rebuild the freight car because, although the amounts paid restore the freight car to a like-new condition, the amounts were not paid after the end of the economic useful life of the freight car.

Example 7. Rebuild of property to like-new condition after end of economic useful life. Assume the same facts as in *Example 6*, except that X rebuilds the freight car 40 years after it is placed in service by X. Under paragraph (g)(1)(v) of this section, X must capitalize the amounts paid to rebuild the freight car because the amounts paid restore the freight car to a like-new condition after the end of the economic useful life of the freight car.

Example 8. Replacement of major component. X is a common carrier that owns a fleet of petroleum hauling trucks. X replaces the existing engine, cab, and petroleum tank with a new engine, cab, and tank. The new engine and cab cost $25,000; the new tank costs $10,000. The cost of a new tractor is $50,000 and the cost of a new trailer is $30,000. Assume the tractor of the truck (which includes the cab and the engine) is a separate unit of property from the rest of the truck, and that the trailer (which contains the petroleum tank) is a separate unit of property from the rest of the truck. Also assume that X replaced the components after the end of the recovery periods under section 168(c) for the tractor and the trailer. The amounts paid for the new engine and cab comprise 50% of the cost of a new tractor and must be capitalized under paragraph (g)(1)(vi) of this section. The amounts paid for the new petroleum tank do not comprise 50% or more of the cost of a new trailer; however, the tank comprises more than 50% of the physical structure of the trailer. Therefore, the amounts paid for the new tank also must be capitalized under paragraph (g)(1)(vi) of this section.

Example 9. Repair performed during a restoration. Assume the same facts as in *Example 8*, except that, at the same time the engine and cab of the tractor are replaced, X paints the cab of the tractor with its company logo and fixes a broken taillight on the tractor. The repair of the broken taillight and the painting of the cab generally are deductible expenses under §1.162–4. However, under paragraph (d)(4)(i) of this section, a taxpayer must capitalize all the direct costs of an improvement and all the indirect costs that directly benefit or are incurred by reason of an improvement in accordance with the rules under section 263A. Repairs and maintenance that do not directly benefit or are not incurred by reason of an improvement are not required to be capitalized under section 263(a), regardless of whether they are made at the same time as an improvement. Therefore, all amounts paid that directly benefit or are incurred by reason of the tractor restoration must be capitalized, including amounts paid for activities that usually would be deductible maintenance expenses, such as the painting of the cab. Amounts paid to repair the broken taillight, however, are not incurred by reason of the restoration of the tractor, nor do the amounts paid directly benefit the tractor restoration, despite that the repair was performed at the same time as the restoration. Thus, X must capitalize to the restoration of the tractor the amounts paid to paint the cab, but X is not required to capitalize to the restoration of the tractor the amounts paid to repair the broken taillight.

Example 10. Not a replacement of substantial structural part. X owns a large retail store. X discovers a leak in the roof of the store and hires a contractor to inspect and fix the roof. The contractor discovers that a major portion of the sheathing and rafters has rotted, and recommends the replacement of the entire roof. X pays the contractor to replace the roof. Assume the store and its structural components are the unit of property and that the roof does not comprise 50% or more of the physical structure of the store. Also assume the cost of the roof does not comprise 50% or more of the cost to acquire a new store. Consequently, the new roof is not a major component or substantial structural part of the store. Therefore, X is not required to capitalize under paragraph (g)(1)(vi) of this section the amounts paid to replace the roof.

Example 11. Related amounts to replace major component. (i) X owns a retail gasoline station, consisting of a paved area used for automobile access to the pumps and parking areas, a building used to market gasoline, and a canopy covering the gasoline pumps. The premises also consist of underground storage tanks (USTs) that are connected by piping to the pumps and are part of the machinery used in the immediate retail sale of gas. To comply with regulations issued by the Environmental Protection Agency, X is required to remove and replace leaking USTs. In 2008, X hires a contractor to perform the removal and replacement, which consists of removing the old tanks and installing new tanks with leak detection systems. The removal of the old tanks includes removing the paving material covering the tanks, excavating a hole large enough to gain access to the old tanks, disconnecting any strapping and pipe connections to the old tanks, and lifting the old tanks out of the hole. Installation of the new tanks includes placement of a liner in the excavated hole, placement of the new tanks, installation of a leak detection system, installation of an overfill system, connection of the tanks to the pipes leading to the pumps, backfilling of the hole, and replacement of the paving. Assume the new tanks comprise 50% or more of the physical structure of the gasoline distribution system. X also is required to pay a permit fee to the county to undertake the installation of the new tanks.

(ii) X pays the permit fee to the county on October 15, 2008. The contractor performs all of the required work and, on November 1, 2008, bills X for the costs of removing the old USTs. On November 15, 2008, the contractor bills X for the remainder of the work. Assume the gasoline distribution system is the unit of property. The USTs are major components of the gasoline distribution system. Therefore, under paragraphs (d)(5) and (g)(1)(vi) of this section, X must capitalize as an improvement to the distribution system the aggregate of related amounts paid to replace the USTs, which related amounts include the amount paid to the county, the amount paid to remove the old USTs, and the amount paid to install the new USTs (regardless that the amounts were separately invoiced and paid to two different parties).

Example 12. Minor part replacement; coordination with section 263A. X is in the business of smelting aluminum. X's aluminum smelting facility includes a plant where molten aluminum is poured into molds and allowed to solidify. Because of the potential of fire from a molten metal explosion, the plant's roof must be made of fire-resistant material. The roof must also be without leaks because rain water hitting the molten aluminum could cause an explosion. During 2008, X removed and replaced a major portion of the plant's roof decking and roofing material. Assume the plant building and its structural components are the unit of property and that the portion of the roof that is replaced is not a major component or substantial structural part of the building. X is not required to capitalize under paragraph (g)(1)(vi) of this section the amounts paid to remove and replace the roof decking and materials. However, under section 263A, all direct and indirect costs, including otherwise deductible costs, that directly benefit or are incurred by reason of X's manufacturing activities must be capitalized to the property produced by X. Therefore, because the amounts paid for the roof decking and materials are incurred by reason of X's manufacturing operations, the amounts paid must be capitalized under section 263A to the property produced by X.

(h) *Capitalization of amounts to adapt property to a new or different use*—(1) *In general.* Taxpayers must capitalize amounts paid to adapt a unit of property

to a new or different use. In general, an amount is paid to adapt a unit of property to a new or different use if the adaptation is not consistent with the taxpayer's intended ordinary use of the unit of property at the time originally placed in service by the taxpayer.

(2) *Examples.* The following examples illustrate solely the rules of this paragraph (h). Even if capitalization is not required in an example under this paragraph (h), the amounts paid in the example may be subject to capitalization under a different provision of this section.

Example 1. New or different use. X is a manufacturer and owns a manufacturing facility that it has used for manufacturing since 1970, when it was placed in service by X. Assume the manufacturing facility is a unit of property. In 2008, X incurred costs to convert its manufacturing facility into a showroom for its business. To convert the facility, X replaces various structural components to provide a better layout for the showroom and its offices. X also rewires and repaints the building as part of the conversion. None of the materials used, such as the wiring, are better than existing materials in the building. Under this paragraph (h), the amounts paid by X to convert the manufacturing facility into a showroom are paid to adapt the building to a new or different use because the conversion is not consistent with X's intended ordinary use of the property at the time it was placed in service. Therefore, X is required to capitalize these amounts under paragraph (h)(1) of this section.

Example 2. Not a new or different use. X owns a building, which is a unit of property, consisting of twenty retail spaces. The space was designed to be reconfigured; that is, adjoining spaces could be combined into one space. In 2008, one of the tenants expanded its occupancy to include two adjoining retail spaces. To facilitate the new lease, X incurred costs to remove the walls between the three retail spaces. Under this paragraph (h), the amounts paid by X to convert three retail spaces into one larger space for an existing tenant do not adapt X's building to a new or different use because the combination of retail spaces is consistent with X's intended, ordinary use of the building. Therefore, the costs are not required by this paragraph (h) to be capitalized.

Example 3. Not a new or different use. X owns a building, which is a unit of property, consisting of twenty retail spaces. X decides to sell the building. In anticipation of selling the building, X repaints the interior walls and refinishes the hardwood floors. Preparing the building for sale does not constitute a new or different use for the building. Therefore, amounts paid in preparing the building for sale are not required by this paragraph (h) to be capitalized.

Example 4. New or different use. Since 1930, X has owned a parcel of land on which it previously operated a manufacturing facility. Assume that the land is the unit of property. During the course of X's operation of the manufacturing facility, the land became contaminated with wastes from its manufacturing processes. In 1995, X discontinued manufacturing operations at the site. In 2008, X decides to sell the property to a developer that intends to use the property for residential housing. In anticipation of selling the land, X pays amounts to clean up the land to a standard that is required for the land to be used for residential purposes. In addition, X pays amounts to regrade the land so that it can be used for residential purposes. Amounts paid by X to clean up wastes that were discharged in the course of X's manufacturing operations do not adapt the land to a new or different use, regardless of the extent to which the land was cleaned. However, amounts to regrade the land so that it can be used for residential purposes adapts the land to a new or different use that is inconsistent with X's intended ordinary use of the property at the time it was placed in service. Accordingly, the amounts paid by X to regrade the land must be capitalized under paragraph (h)(1) of this section.

(i) *Optional regulatory accounting method*—(1) *In general.* This paragraph (i) provides an optional simplified method (the regulatory accounting method) for regulated taxpayers to determine whether amounts paid to repair, maintain, or improve tangible property are to be treated as deductible expenses or capital expenditures. A taxpayer that elects to use the regulatory accounting method described in paragraph (i)(3) of this section must use that method for property subject to regulatory accounting instead of determining whether amounts paid to repair, maintain, or improve property are capital expenditures or deductible expenses under the general principles of sections 162(a), 212, and 263(a). Thus, the capitalization rules in §1.263(a)–3(d) (and the routine maintenance safe harbor described in paragraph (e) of this section) do not apply to amounts paid to repair, maintain, or improve property subject to regulatory accounting by taxpayers that elect to use the regulatory accounting method under this paragraph (i). However, section 263A continues to apply to costs required to be capitalized to property produced by the taxpayer or to property acquired for resale.

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

(3) *Description of regulatory accounting method.* Under the regulatory accounting method, a taxpayer must follow its method of accounting for regulatory accounting purposes in determining whether an amount paid improves property under this section. Therefore, a taxpayer must capitalize for Federal income tax purposes an amount paid that is capitalized as an improvement for regulatory accounting purposes. A taxpayer must not capitalize for Federal income tax purposes under this section an amount paid that is not capitalized as an improvement for regulatory accounting purposes. A taxpayer that uses the regulatory accounting method must use that method for all of its tangible property that is subject to regulatory accounting rules. The method does not apply to tangible property that is not subject to regulatory accounting rules.

(4) [Reserved]

(5) *Examples.* The rules of this paragraph (i) are illustrated by the following examples.

Example 1. Taxpayer subject to regulatory accounting rules of FERC. X is an electric utility company that operates a power plant to generate electricity. X is subject to the regulatory accounting rules of FERC and X chooses to use the regulatory accounting method under this paragraph (i). X does not capitalize on its books and records for regulatory accounting purposes the cost of repairs made to its turbines. Under the regulatory accounting method, X must not capitalize for Federal income tax purposes amounts paid for repairs made to its turbines.

Example 2. Taxpayer not subject to regulatory accounting rules of FERC. X is an electric utility company that operates a power plant to generate electricity. X previously was subject to the regulatory accounting rules of FERC but, for various reasons, X is no longer required to use FERC's regulatory accounting rules. X cannot use the regulatory accounting method provided in this paragraph (i).

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

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

(j) *Repair allowance*. A taxpayer may use a repair allowance method of accounting that is identified in published guidance in the **Federal Register** or in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter).

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

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

(m) [Reserved]

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

Par. 9. Section 1.263A–1 is amended by adding paragraph (b)(14) as follows:

§1.263A–1 Uniform capitalization of costs.

* * * * *

(b) * * *

(14) *Property subject to de minimis rule*. Section 263A does not apply to the costs of property produced by a taxpayer to which the taxpayer properly applies the *de minimis* rule under §1.263(a)–2(d)(4). However, the cost of property to which a taxpayer properly applies the *de minimis* rule under §1.263(a)–2(d)(4) may be required to be capitalized to other property as a cost incurred by reason of the production of the other property that is subject to section 263A.

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Linda E. Stiff,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on March 7, 2008, 8:45 a.m., and published in the issue of the Federal Register for March 10, 2008, 73 F.R. 12837)

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations

Disclosure of Return Information in Connection With Written Contracts Among the IRS, Whistleblowers, and Legal Representatives of Whistleblowers

REG–114942–07

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In this issue of the Bulletin, the IRS is issuing temporary regulations (T.D. 9389) relating to the disclosure of return information, pursuant to section 6103(n), to whistleblowers and their legal representatives. The temporary regulations describe the circumstances by which an officer or employee of the Treasury Department may disclose return information to a whistleblower and, if applicable, the legal representative of the whistleblower, to the extent necessary in connection with a written contract among the IRS, the whistleblower and, if applicable, the legal representative of the whistleblower, for services relating to the detection of violations of the internal revenue laws or related statutes. The temporary regulations will affect officers and employees of the Treasury Department who disclose return information to whistleblowers, or their legal representatives, in connection with written contracts among the IRS, whistleblowers and, if applicable, their legal representatives, for services relating to the detection of violations of the internal revenue laws or related statutes. The temporary regulations will also affect any whistleblower, or legal representative of a whistleblower, who receives return information in connection with a written contract among the IRS, the whistleblower and, if applicable, the legal representative of the whistleblower, for services relating to the detection of violations of the internal revenue laws or related statutes.

DATES: Written or electronic comments and requests for a public hearing must be received by June 23, 2008.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG–114942–07), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–114942–07), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–114942–07).

FOR FURTHER INFORMATION CONTACT: Helene R. Newsome, 202–622–7950 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

Temporary regulations in this issue of the Bulletin amend the Procedure and Administration Regulations (26 CFR part 301) under section 6103(n) relating to the disclosure of return information in connection with written contracts among the IRS, whistleblowers and, if applicable, their legal representatives.

The Tax Relief and Health Care Act of 2006, Public Law 109–432 (120 Stat. 2958), (the Act) was enacted on December 20, 2006. Section 406 of the Act amends section 7623, concerning the payment of awards to whistleblowers, and establishes a Whistleblower Office within the IRS that has responsibility for the administration of a whistleblower program. The Whistleblower Office, in connection with administering a whistleblower program, will analyze information provided by a whistleblower, and either investigate the matter itself or assign it to the appropriate

IRS office for investigation. In analyzing information provided by a whistleblower, or investigating a matter, the Whistleblower Office may determine that it requires the assistance of the whistleblower, or the legal representative of the whistleblower. The legislative history of section 406 of the Act states that "[t]o the extent the disclosure of returns or return information is required [for the whistleblower or his or her legal representative] to render such assistance, the disclosure must be pursuant to an IRS tax administration contract." Joint Committee of Taxation, *Technical Explanation of H.R. 6408, The "Tax Relief and Health Care Act of 2006*," as Introduced in the House on December 7, 2006, at 89 (JCX–50–06), December 7, 2006. The legislative history further states that "[i]t is expected that such disclosures will be infrequent and will be made only when the assigned task cannot be properly or timely completed without the return information to be disclosed." *Id.*

Under section 6103(a), returns and return information are confidential unless the Internal Revenue Code (Code) authorizes disclosure. Section 6103(n) is the authority by which returns and return information may be disclosed pursuant to a tax administration contract. Section 6103(n) authorizes, pursuant to regulations prescribed by the Secretary, returns and return information to be disclosed to any person, including any person described in section 7513(a), for purposes of tax administration, to the extent necessary in connection with: (1) the processing, storage, transmission, and reproduction of returns and return information; (2) the programming, maintenance, repair, testing, and procurement of equipment; and (3) the providing of other services. These proposed regulations describe the circumstances, pursuant to section 6103(n), by which officers and employees of the Treasury Department may disclose return information to whistleblowers and, if applicable, their legal representatives, in connection with written contracts for services relating to the detection of violations of the internal revenue laws or related statutes.

The text of the temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains these proposed regulations.

Special Analyses

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

Comments and Request for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic and written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rule and how it may be made easier to understand. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by a person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place of the hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is Helene R. Newsome, Office of the Associate Chief Counsel (Procedure & Administration).

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 301 is proposed to be amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 is amended by adding an entry in numerical order to read as follows:

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

Section 301.6103(n)–2 also issued under 26 U.S.C. 6103(n); * * *

Par. 2. Section 301.6103(n)–2 is added to read as follows:

§301.6103(n)–2 Disclosure of return information in connection with written contracts among the IRS, whistleblowers, and legal representatives of whistleblowers.

[The text of this proposed section is the same as the text of §301.6103(n)–2T published elsewhere in this issue of the Bulletin].

Linda E. Stiff,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on March 24, 2008, 8:45 a.m., and published in the issue of the Federal Register for March 25, 2008, 73 F.R. 15687)

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
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T.D. —Treasury Decision.
TFE—Transferee.
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T.I.R.—Technical Information Release.
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