

**Office of Chief Counsel
Internal Revenue Service
memorandum**

Number: **201213023**

Release Date: 3/30/2012

CC:ITA:B03: Lewis Saideman
POSTF-105182-11

UICL: 162.00-00
263.03-00

date: December 21, 2011

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subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

A =

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D =

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F =

G =

H =

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ISSUE

Whether amounts incurred by Taxpayer for slot machine conversions must be capitalized under § 263(a) of the Internal Revenue Code?

CONCLUSION

Under the facts presented in this case, amounts incurred by Taxpayer for slot machine conversions are not required to be capitalized under § 263(a).

FACTS

Taxpayer operates numerous casinos in multiple gaming jurisdictions. Taxpayer offers two types of electronic gaming machines (“slot machines”) for the entertainment of the patrons of its casinos: reel machines and video machines. Reel machines display game symbols and pay lines on three, four, or five spinning reels. Multiple reels produce a greater number of symbols and potential winning combinations that result in payout to the patron. Video machines display game symbols and pay lines on one or more video screens and can be set to offer more combinations of winning symbols or pay lines than reel machines.

Taxpayer purchases all slot machines from third parties. The retail price of a new slot machine generally ranges from \$A to \$B depending on the manufacturer, the type of machine purchased, the quantity purchased, and any incentives or discounts offered by the manufacturer. Taxpayer represents that the commercial life of a reel machines may exceed C years and the commercial life of a video machine may exceed D years. Taxpayer characterizes all of its slot machines as 7-year property under MACRS.

Each slot machine contains one or more erasable programmable read-only memory controller chip (“EPROM”), which stores a pseudorandom number generator and other software used to establish the unique characteristics, as well as the graphics and sounds, used to define the game. Examples of EPROMs include basic input /output system (“BIOS”) chips, jurisdiction chips, reel controller units, game personality chips, and bill acceptors. The manufacturer delivers each slot machine with a complete set of installed EPROMs, which designates the theme and terms of play for the specific game.

The terms of play defined for a particular game include the number and denominations of wagers allowed per play, the number of winning results per play, the probability of achieving a winning result per play, the amount of the payout per winning result, and the choices available to the player. These terms of play factor into the computation of the theoretical payout percentage of the game, inversely known as the “hold rate.” For example, if a game is programmed to return 95% of amounts wagered by players over an infinite number of plays, it is said to have a theoretical payout percentage of 95% or a hold rate of 5%. The theoretical payout percentage or hold rate of the slot machines can be changed by changing the pay table, which can be accomplished without

changing the theme or game. To change the pay table, Taxpayer replaces one or more of the EPROMs that control the slot machine game characteristics.

The amount of revenue generated by a slot machine is a function of the theoretical payout percentage and the number of plays experienced over a specified period. The level of play of a particular slot machine will depend on a number of factors including the machine's location on the casino floor, promotions and advertising of the machine, the game's theme, and the condition of the overall economy. Some slot machines enjoy play from regular customers (e.g., video poker) such that they do not experience a decrease in revenue over time. For other slot machines, the level of revenue generated and the number of plays experienced relative to other machines in similar locations will decline over the operating life of the slot machine. This decline is generally attributable to the declining popularity of the particular game. In addition, some games never achieve the range of revenue initially anticipated by Taxpayer.

The process of changing the game offered by the slot machine to a different game or games, or the process of changing the manner of playing the slot machine, is called a "slot conversion." Slot machines that undergo slot conversions are not in disrepair and perform according to the design specifications designated by the manufacturer. A particular slot machine may undergo more than one slot conversion over its expected commercial life or may experience none at all. The decision to perform a slot conversion is elective. In contrast, all slot machines will require some regular maintenance and repair, which may include the replacement of bulbs, buttons, panels, power supply, and screens, as necessary. Moreover, some slot machines are not capable of being converted. If a casino wishes to change the particular game, these slot machines must be replaced.

When Taxpayer observes that the daily revenue generated by a slot machine on the casino floor drops below the range of anticipated revenue, the slot machine is designated as an underperforming machine and becomes a candidate for a slot conversion. Taxpayer regularly performs slot conversions on underperforming slot machines with the express objective of bringing the level of daily revenues generated by the slot machine back to within the range of wins expected considering the particular casino property and the location of the machine on the casino floor. Taxpayer may also perform slot conversions to change the configuration of the slot machine. For example, a slot machine may undergo a slot conversion to change from accepting and dispensing coins or tokens to accepting and dispensing tickets or vouchers. This type of slot machine conversion is primarily done to decrease operating costs. The slot machines offered by Taxpayer are designed so that the particular game or theme utilized by the slot machine to attract play can be easily changed or updated after the slot machine has been placed in service on the casino floor. Taxpayer performs slot conversions on approximately E% percent of its slot machines each year.

To perform a slot conversion, Taxpayer first purchases a slot conversion kit from the manufacturer. The kit includes all parts necessary to complete the conversion,

including EPROMs, reel tapes, glass, video screens, and decals. The EPROMs contain firmware (programming instructions) burned onto the EPROM itself. The new EPROM will frequently possess increased functionality (compared to the old EPROM) to support the new firmware. For example, the new EPROM may have a larger memory capacity, superior graphics capability, enhanced audio effects, or additional functions, such as more player panel switches and options, player tracking, and statistical data accumulation and accounting.

A slot machine conversion is a multi-step process. Before performing the slot machine conversion, the machine is taken "offline," which entails disconnecting it from the system. The length of time that the slot machine is offline during the slot conversion procedure depends on the regulatory review and certification procedures in the specific gaming jurisdiction but typically lasts one to three days. During this time, the slot machine is either physically removed from the casino floor or otherwise blocked to prevent patrons from using it. Slot conversions of reel machines typically require: (1) turning off the machine; (2) opening the main door of the slot machine; (3) removing the light bulb, bulb fixture screws, and bulb fixture; (4) removing the top glass; (5) installing the new upper glass; (6) removing the belly glass; (7) installing the new lower glass; (8) laying out the reel strips (in order); (9) installing the reel strips in the reel basket; (10) removing the coin hopper and coin tray; (11) removing the main system processor board; (12) removing the reel EPROM controller chip; (13) installing the new reel EPROM controller chip; (14) removing the game EPROM controller chip; (15) installing the new game EPROM controller chip; (16) installing (returning) the main system processor board; (17) installing (returning) the coin hopper and coin tray; (18) turning the machine on; (19) initializing the slot machine; and (20) closing the main door of the slot machine. Slot conversions of video machines require the same steps except steps 8, 9, 12, and 13. In addition, video machine conversions may also include the replacement of the video display screens. The process takes approximately 2 hours for both types of machines.

Taxpayer's total cost of a typical slot conversion performed on a reel machine, including the EPROMs, ranges from \$F to \$G per machine. Taxpayer's cost of a typical slot conversion performed on a video machine, including the EPROM, ranges from \$H to \$I per machine.

Taxpayer's slot machine technician employees generally perform the slot conversions as part of their regular duties. The time and expense incurred by Taxpayer's employees to perform the slot conversions is not tracked separately from their other duties. However, Taxpayer accounts for its slot conversion kit acquisition costs for financial statement reporting purposes by capitalizing the acquisition costs and recovering these costs over J years. According to information provided by a slot machine manufacturer, the economic useful life of a conversion kit is generally 9 to 24 months.

LAW AND ANALYSIS

Section 162 of the Code and § 1.162-1(a) of the Income Tax Regulations allow a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 1.162-4 allows a deduction for the cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its useful life, but keep it in an ordinarily efficient operating condition.

Section 263(a) and § 1.263(a)-1(a) provide that no deduction is allowed for any amount paid out for permanent improvements or betterments made to increase the value of any property or for any amount expended in restoring property or for making good the exhaustion thereof for which an allowance has been made in the form of a deduction for depreciation, amortization, or depletion.

Section 1.263(a)-1(b) provides that capital expenditures include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. The regulation further provides that amounts paid or incurred for incidental repairs and maintenance of property within the meaning of § 162 and § 1.162-4 are not capital expenditures under § 1.263(a)-1.

The United States Supreme Court has specifically recognized that the "decisive distinctions [between capital and ordinary expenditures] are those of degree and not of kind," and a careful examination of the particular facts of each case is required. Deputy v. du Pont, 308 U.S. 488, 496 (1940); Welch v. Helvering, 290 U.S. 111, 114 (1933).

Any properly performed maintenance, no matter how routine, could be considered to prolong the useful life and increase the value of the property if it is compared with the situation existing immediately prior to that maintenance. Consequently, the courts have articulated a number of ways to distinguish between deductible expenses and non-deductible capital improvements. For example, in Illinois Merchants Trust Co. v. Commissioner, 4 B.T.A. 103, 106 (1926), acq., 1926-2 C.B. 2, the court explained that repair and maintenance expenses are incurred for the purpose of keeping the property in an ordinarily efficient operating condition over its probable useful life for the uses for which the property was acquired. Capital expenditures, in contrast, are for replacements, alterations, improvements, or additions that appreciably prolong the life of the property, materially increase its value, or make it adaptable to a different use.

To determine whether costs incurred for work performed on property increase the value of the property or prolong its useful life, both the courts and the Service have frequently looked to the standard applied in Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333 (1962), nonacq. on other grounds, 1964-2 C.B. 8. In Plainfield-Union, the court allowed the taxpayer to currently deduct the costs incurred to clean a portion of its water

pipeline and to replace the tar lining in those pipes with a cement lining. These expenditures were necessary in order to restore the pipe's carrying capacity, which had decreased due to tuberculation of the pipe's tar lining. As part of its analysis, the court stated that any repair increases the value of a taxpayer's property as compared with the situation existing immediately before that repair. Accordingly, the court reasoned that the appropriate test for determining whether such cost constitutes a capital expenditure is if it "materially enhances the value, use, life expectancy, strength, or capacity" of the property "as compared with the status of the property prior to the condition necessitating the expenditure" ("the Plainfield-Union standard"). *Id.* at 338. Under this analysis, the court compared the status of the taxpayer's pipeline before the tuberculation to its status after the cleaning and relining. The court found that the taxpayer's expenditure had not materially enhanced the pipeline but rather had restored the capacity of the pipeline.

The courts and the Internal Revenue Service have consistently applied the Plainfield-Union standard to distinguish routine maintenance from capital improvements. *See, e.g., FedEx Corp. v. Commissioner*, 291 F. Supp. 2d 699 (W.D. Tenn. 2003), *aff'd*, 412 F.3d 617 (6th Cir. 2005) (holding taxpayer's costs for aircraft engine shop visits were deductible maintenance expenses because the work performed did not materially add to the value of the aircraft as compared to their condition immediately after the previous engine shop visit and did not appreciably prolong, but rather preserved, the aircraft's economic useful life); *Ingram Industries, Inc. v. Commissioner*, T.C. Memo. 2000-323 (finding work performed on towboat engines did not increase the value or prolong the useful life of the boat or the engines); Rev. Rul. 94-38, 1994-1 C.B. 35 (finding costs of soil remediation did not result in improvements to land because they restored soil and groundwater to condition that existed before contamination); Rev. Rul. 2001-4, 2001-1 C.B. 295 (finding that costs of heavy maintenance visits on aircraft airframes were not capital expenditures, in part, because they kept airframe in ordinarily efficient operating condition over its anticipated useful life for the uses for which it was acquired).

Under the facts provided, we find that that Taxpayer's costs incurred for slot machine conversions, whether performed on video or reel machines, generally do not rise to the level of a capital expenditure under § 263(a). Specifically, Taxpayer's slot machine conversions do not result in permanent improvements or betterments that materially increase the value of the machines or restore the machines under the standards provided in § 1.263(a)-1.

First, a slot machine conversion does not materially add value to a slot machine as compared to the value of the machine either when it is first placed on the casino floor or immediately after its last conversion. Taxpayer has stipulated that over the operating life of certain slot machines, the level of revenue or wins per unit and the number of plays experienced will decline because the particular game or theme declines in popularity. As a result, Taxpayer regularly performs conversions on its under-performing machines with the express objective of bringing the machine's revenue stream back to the level expected for its location on the casino floor and for the

particular casino property. While the conversion refreshes the appearance of the machine and updates the manner and modes of play to reflect current trends and standards, we do not believe this conversion materially enhances the machine's value in Taxpayer's business as compared to the machine's initial or pre-decline condition. Rather, the conversion restores the machine to an ordinarily efficient operating condition. Further, the costs of the conversions as compared to the replacement costs of the machines, the activities involved in the conversion process, and the routine nature of such conversions suggest that the conversions do not materially increase the value of the machines over their initial or pre-decline value. Accordingly, Taxpayer's conversion costs do not materially increase the value of the slot machines using the comparisons appropriate under § 1.263(a)-1.

Second, the slot machine conversions do not substantially prolong the useful life of the machines under § 1.263(a)-1. According to Taxpayer, the commercial life of its reel slot machines may exceed C years. In addition, the commercial life of Taxpayer's video machines may exceed D years. According to a slot machine manufacturer, the economic useful life of a slot machine conversion kit is 9 to 24 months. Under the facts provided, we find no indication that slot machine conversions prolong the useful lives of the machines substantially beyond the economic useful lives anticipated when Taxpayer places the slot machines into service. Neither do we find that the type of work performed on the machines constitutes a substantial replacement of property that would significantly extend the expected economic useful life.

Third, the slot machine conversions do not adapt the machines to a new or different use. Both before and after the conversions, the slot machines continue to offer games that provide the possibility of a payout to customers depositing money into the machines. The style and content of the games change, hopefully making the converted machines more attractive for marketing purposes, but their use in Taxpayer's business is consistent with the use anticipated for a slot machine when placed in service. Therefore, the amounts paid for the slot conversions do not adapt Taxpayer's property to a new or different use under § 1.263(a)-1.

The foregoing analysis does not change where Taxpayer performs a slot machine conversion to change the configuration of the machine from accepting and dispensing coins or tokens to accepting and dispensing tickets or vouchers in order to decrease operating costs. Both the courts and the Service have maintained that amounts paid solely to reduce or eliminate future costs may be deductible. See, e.g., T.J. Enterprises, Inc. v. Commissioner, 101 T.C. 581, 589 (1993) (holding that amounts paid to majority shareholder to compensate her for refraining from action that would cause a royalty rate increase were currently deductible); Rev. Rul. 95-32, 1995-1 C.B. 8 (holding that under specified circumstances expenditures incurred by a public utility for the implementation and operation of energy conservation and load management programs are currently deductible under § 162).

Based on the information provided, we conclude that the amounts incurred by Taxpayer for video and reel slot machine conversions are not capital expenditures under § 263(a) but are more in the nature of routine maintenance expenses deductible under § 162.

Please note that the Department of Treasury has published proposed regulations that clarify the application of §§162 and 263 to expenditures paid or incurred to repair, improve, or rehabilitate tangible property. See Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 73 FR 12838-01 (Mar. 10, 2008), 2008-1 C.B. 871. Final or temporary regulations pertaining to this subject have not yet been adopted. We express no opinion on how the expenditures at issue would be treated under new regulations.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

This Chief Counsel Advice addresses only the facts pertaining to Taxpayer and only the types of conversions for which adequate information was provided. This office does not opine on any situation outside the facts set out above.

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Please call Lewis Saideman at (202) 622-4950 if you have any further questions.