Part I

Section 263.–Capital Expenditures

26 CFR 1.263(a)-1: Capital expenditures; in general.
(Also §§ 162, 165, 167, 263A; 1.165-3, 1.167(a)-8, 1.167(a)-11, 1.263A-1)

Rev. Rul. 2000-7

ISSUE

If the retirement and removal of a depreciable asset occurs in connection with the installation or production of a replacement asset, are the costs incurred in removing the retired asset required to be capitalized under § 263(a) or 263A as part of the cost of the replacement asset?

FACTS

The assets of *X,* a telephone company, include telephone poles *A* and *B*. *X* placed Pole *A* in service in 1979 on land it owned. *X* placed Pole *B* in service in 1982 on land owned by *Y* under the terms of an easement permitting *X* to have one pole on *Y*'s land. In 2000, *X* undertakes a project to replace telephone poles in the service area in which Pole *A* is situated. As part of that project, *X* incurs costs in 2000 in removing and discarding Pole *A* and installing a new telephone pole, Pole *C*, in the same location. *X* also undertakes a second project to replace telephone poles in the service area in which Pole *B* is situated. *X* installs a new telephone pole, Pole *D*, on *Y*'s land, but not in the same location as Pole *B*. As part of this second project and to comply with the easement, *X* incurs costs in 2000 in removing and discarding Pole *B*.

LAW AND ANALYSIS

Section 162 of the Internal Revenue Code and § 1.162-1 of the Income Tax Regulations generally 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 165 allows as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. For the allowance under § 165(a) of losses arising from the permanent withdrawal of depreciable property from use in a trade or business or in the production of income, § 1.165-2(c) cross references § 1.167(a)-8(a), which permits, in part, a loss from physical abandonment of retired property.

Under §§ 263(a) and 1.263(a)-1(a), no deduction is allowed for capital expenditures, such as amounts paid for new buildings or for permanent improvements or betterments made to increase the value of any property. Section 1.263(a)-2(a) provides that capital expenditures include the costs of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

Section 263A generally requires taxpayers that are producing real or tangible personal property to capitalize direct material costs, direct labor costs, and indirect costs that are properly allocable to the produced property. Section 263A(g)(1) provides that, for purposes of § 263A, the term “produce” includes construct, build, install, manufacture, develop, or improve. Under § 1.263A-1(e)(3)(i), indirect costs are allocable to produced property under § 263A when the costs directly benefit or are incurred by reason of the performance of production activities.

The costs of removing an asset have been historically allocable to the removed asset and, thus, generally deductible when the asset is retired and the costs are incurred. A deduction generally is allowed whether a taxpayer accounts for the retired asset in a single asset account or in a multiple asset account (*e.g.*, a general asset account or a mass asset account). *See* § 1.165-3(b); § 1.167(a)-1(c); § 1.167(a)-11(d)(3)(*x*); Rev. Rul. 74-455, 1974-2 C.B. 63; Rev. Rul. 75-150, 1975-1 C.B. 73. *But see* § 280B, requiring that the costs of demolishing buildings be added to the basis of the land, and § 1.165-3(a), requiring capitalization of demolition costs when the taxpayer acquires an asset with the intent to demolish it. *See, e.g.*, Wood County Telephone Co. v. Commissioner, 51 T.C. 72 (1968); Rev. Rul. 69-62, 1969-1 C.B. 58.

The removal costs of Poles *A* and *B* are not required to be capitalized under § 263(a). In both situations the removal costs are properly allocable to the retired poles, and thus do not relate to assets having a useful life in the taxpayer's business extending substantially beyond the taxable year in which the removal costs are incurred. The fact that Poles *A* and *B* are retired as part of a replacement project does not mean that the removal costs are required to be capitalized under § 263(a). Furthermore, the removal costs are not required to be capitalized under § 263A because the costs are incurred for the purpose of retiring Poles *A* and *B* and not by reason of the installation of Poles *C* and *D.* The analysis in this ruling does not apply to the removal of a component of a depreciable asset, the costs of which are either deductible or capitalizable based on whether replacement of the component constitutes a repair or an improvement. *See* §1.162-4 and § 1.263(a)-1(b).

HOLDING

If the retirement and removal of a depreciable asset occurs in connection with the installation or production of a replacement asset, the costs incurred in removing the retired asset are not required to be capitalized under § 263(a) or 263A as part of the cost of the replacement asset.

APPLICATION

Any change in a taxpayer's method of accounting to conform with this revenue ruling is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply. Except for assets for which depreciation is determined in accordance with § 1.167(a)-11 (ADR), the taxpayer's new method of treating removal costs for assets accounted for in a multiple asset account must be consistent with the taxpayer's method of treating salvage proceeds. *See* Rev. Rul. 74-455. (See sections 2.01 and 2.02 of the Appendix of Rev. Proc. 99-49, 1999-52 I.R.B. 725, for changing a taxpayer's present method of treating salvage proceeds.) A taxpayer wanting to change its method of accounting to conform with the holding in this revenue ruling must follow the automatic change in accounting method provisions of Rev. Proc. 99-49, except that the scope limitations in section 4.02 of Rev. Proc. 99-49 do not apply. However, if the taxpayer is under examination, before an appeals office, or before a federal court with respect to any income tax issue, the taxpayer must provide a copy of the Form 3115, Application for Change in Accounting Method, to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the Form 3115 with the national office. The Form 3115 must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate. In addition, if the asset is public utility property within the meaning of § 168(i)(10) or former § 167(l)(3)(A), the taxpayer must comply with the terms and conditions in section 2.01(3)(b)(vi) of the Appendix of Rev. Proc. 99-49.

EFFECT ON OTHER DOCUMENTS

Rev. Proc. 99-49 is modified and amplified to include this change in accounting method in the APPENDIX.

DRAFTING INFORMATION

The principal author of this revenue ruling is Beverly Katz of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling contact Ms. Katz on (202) 622-4950 (not a toll-free call).