

such estimated useful life, a change to a new and shorter estimated useful life computed in accordance with such showing will be permitted. No such change will be permitted merely because in the unsupported opinion of the taxpayer the property may become obsolete. For rules governing the allowance of a loss when the usefulness of depreciable property is suddenly terminated, see § 1.167(a)-8. If the estimated useful life and the depreciation rates have been the subject of a previous agreement, see section 167(d) and § 1.167(d)-1.

§ 1.167(a)-10 When depreciation deduction is allowable.

(a) A taxpayer should deduct the proper depreciation allowance each year and may not increase his depreciation allowances in later years by reason of his failure to deduct any depreciation allowance or of his action in deducting an allowance plainly inadequate under the known facts in prior years. The inadequacy of the depreciation allowance for property in prior years shall be determined on the basis of the allowable method of depreciation used by the taxpayer for such property or under the straight line method if no allowance has ever been claimed for such property. The preceding sentence shall not be construed as precluding application of any method provided in section 167(b) if taxpayer's failure to claim any allowance for depreciation was due solely to erroneously treating as a deductible expense an item properly chargeable to capital account. For rules relating to adjustments to basis, see section 1016 and the regulations thereunder.

(b) The period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service. A proportionate part of one year's depreciation is allowable for that part of the first and last year during which the asset was in service. However, in the case of a multiple asset account, the amount of depreciation may be determined by using what is commonly described as an "averaging convention", that is, by using an assumed timing of additions and retirements. For example, it might be assumed that all addi-

tions and retirements to the asset account occur uniformly throughout the taxable year, in which case depreciation is computed on the average of the beginning and ending balances of the asset account for the taxable year. See example (3) under paragraph (b) of § 1.167(b)-1. Among still other averaging conventions which may be used is the one under which it is assumed that all additions and retirements during the first half of a given year were made on the first day of that year and that all additions and retirements during the second half of the year were made on the first day of the following year. Thus, a full year's depreciation would be taken on additions in the first half of the year and no depreciation would be taken on additions in the second half. Moreover, under this convention, no depreciation would be taken on retirements in the first half of the year and a full year's depreciation would be taken on the retirements in the second half. An averaging convention, if used, must be consistently followed as to the account or accounts for which it is adopted, and must be applied to both additions and retirements. In any year in which an averaging convention substantially distorts the depreciation allowance for the taxable year, it may not be used.

§ 1.167(a)-11 Depreciation based on class lives and asset depreciation ranges for property placed in service after December 31, 1970.

(a) *In general*—(1) *Summary*. This section provides an asset depreciation range and class life system for determining the reasonable allowance for depreciation of designated classes of assets placed in service after December 31, 1970. The system is designed to minimize disputes between taxpayers and the Internal Revenue Service as to the useful life of property, and as to salvage value, repairs, and other matters. The system is optional with the taxpayer. The taxpayer has an annual election. Generally, an election for a taxable year must apply to all additions of eligible property during the taxable year of election, but does not apply to additions of eligible property in any other taxable year. The taxpayer's election, made with the return

for the taxable year, may not be revoked or modified for any property included in the election. Generally, the taxpayer must establish vintage accounts for all eligible property included in the election, must determine the allowance for depreciation of such property in the taxable year of election, and in subsequent taxable years, on the basis of the asset depreciation period selected and must apply the first-year convention specified in the election to determine the allowance for depreciation of such property. This section also contains special provisions for the treatment of salvage value, retirements, and the costs of the repair, maintenance, rehabilitation or improvement of property. In general, a taxpayer may not apply any provision of this section unless he makes an election and thereby consents to, and agrees to apply, all the provisions of this section. A taxpayer who elects to apply this section does, however, have certain options as to the application of specified provisions of this section. A taxpayer may elect to apply this section for a taxable year only if for such taxable year he complies with the requirements of paragraph (f)(4) of this section.

(2) *Definitions.* For the meaning of certain terms used in this section, see paragraphs (b)(2) (“eligible property”), (b)(3) (“vintage account” and “vintage”), (b)(4) (“asset depreciation range”, “asset guideline class”, “asset guideline period”, and “asset depreciation period”), (b)(5)(iii)(c) (“used property”), (b)(6)(i) (“public utility property”), (c)(1)(iv) (“original use”), (c)(1)(v) (“unadjusted basis” and “adjusted basis”), (c)(2)(ii) (“modified half-year convention”), (c)(2)(iii) (“half-year convention”), (d)(1)(i) (“gross salvage value”), (d)(1)(ii) (“salvage value”), (d)(2)(iii) (“repair allowance”, “repair allowance percentage”, and “repair allowance property”), (d)(2)(vi) (“excluded addition”), (d)(2)(vii) (“property improvement”), (d)(3)(ii) (“ordinary retirement” and “extraordinary retirement”), (d)(3)(vi) (“special basis vintage account”), and (e)(1) (“first placed in service”) of this section.

(b) *Reasonable allowance using asset depreciation ranges*—(1) *In general.* The

allowance for depreciation of eligible property (as defined in subparagraph (2) of this paragraph) to which the taxpayer elects to apply this section shall be determined as provided in paragraph (c) of this section and shall constitute the reasonable allowance for depreciation of such property under section 167(a).

(2) *Definition of eligible property.* For purposes of this section, the term “eligible property” means tangible property which is subject to the allowance for depreciation provided by section 167(a) but only if—

(i) An asset guideline class and asset guideline period are in effect for such property for the taxable year of election (see subparagraph (4) of this paragraph);

(ii) The property is first placed in service (as described in paragraph (e)(1) of this section) by the taxpayer after December 31, 1970 (but see subparagraph (7) of this paragraph for special rule where there is a mere change in the form of conducting a trade or business); and

(iii) The property is either—

(a) Section 1245 property as defined in section 1245(a)(3), or

(b) Section 1250 property as defined in section 1250(c).

See, however, subparagraph (6) of this paragraph for special rule for certain public utility property as defined in section 167(1)(3)(A). Property which meets the requirements of this subparagraph is eligible property even if depreciation with respect to such property, determined in accordance with this section, is allocated to or otherwise required to be reflected in the cost of a capitalized item. The term “eligible property” includes any property which meets the requirements of this subparagraph, whether such property is new property, “used property” (as described in subparagraph (5)(iii)(c) of this paragraph), a “property improvement” (as described in paragraph (d)(2)(vii) of this section), or an “excluded addition” (as described in paragraph (d)(2)(vi) of this section). For the treatment of expenditures for the repair, maintenance, rehabilitation or improvement of certain property, see paragraph (d)(2) of this section.

(3) *Requirement of vintage accounts*—(i) *In general.* For purposes of this section, a “vintage account” is a closed-end depreciation account containing eligible property to which the taxpayer elects to apply this section, first placed in service by the taxpayer during the taxable year of election. The “vintage” of an account refers to the taxable year during which the eligible property in the account is first placed in service by the taxpayer. Such an account will consist of an asset, or a group of assets, within a single asset guideline class established pursuant to subparagraph (4) of this paragraph and may contain only eligible property. Each item of eligible property to which the taxpayer elects to apply this section, first placed in service by the taxpayer during the taxable year of election (determined without regard to a convention described in paragraph (c)(2) of this section) shall be placed in a vintage account of the taxable year of election. For rule regarding “special basis vintage accounts” for certain property improvements, see paragraph (d)(2)(viii) and (3)(vi) of this section. Any number of vintage accounts of a taxable year may be established. More than one account of the same vintage may be established for different assets of the same asset guideline class. See paragraph (d)(3)(xi) of this section for special rule for treatment of certain multiple asset and item accounts.

(ii) *Special rule.* Section 1245 property may not be placed in a vintage account with section 1250 property. Property the original use of which does not commence with the taxpayer may not be placed in a vintage account with property the original use of which commences with the taxpayer. Property described in section 167(f)(2) may not be placed in a vintage account with property not described in section 167(f)(2). Property described in section 179(d)(1) for which the taxpayer elects the allowance for the first taxable year in accordance with section 179(c) may not be placed in a vintage account with property not described in section 179(d)(1) or for which the taxpayer does not elect such allowance for the first taxable year. For special rule for property acquired in a transaction to which section 381(a) applies, see paragraph

(e)(3)(i) of this section. For additional rules with respect to accounting for eligible property, see paragraph (e) of this section.

(4) *Asset depreciation ranges and periods*—(i) *Selection of asset depreciation period.* The taxpayers books and records must specify for each vintage account of the taxable year of election—

(a) In the case of vintage account for property in an asset guideline class for which no asset depreciation range is in effect for the taxable year, the asset depreciation period (which shall be equal to the asset guideline period for the assets in such account), or

(b) In the case of a vintage account for property in an asset guideline class for which an asset depreciation range is in effect for the taxable year, the asset depreciation period selected by the taxpayer from the asset depreciation range for the assets in such account.

Unless otherwise expressly provided in the establishment thereof, for purposes of this section, the term “asset guideline class” means a category of assets (including “subsidiary assets”) for which a separate asset guideline period is in effect for the taxable year as provided in subdivision (ii) of this subparagraph. The “asset depreciation range” is a period of years which extends from 80 percent of the asset guideline period to 120 percent of such period, determined in each case by rounding any fractional part of a year to the nearer of the nearest whole or half year. Except as provided in paragraph (e)(3)(iv) of this section, in the case of an asset guideline class for which an asset depreciation range is in effect, any period within the asset depreciation range for the assets in a vintage account which is a whole number of years or a whole number of years plus a half year, may be selected. The term “asset depreciation period” means the period selected from the asset depreciation range, or if no asset depreciation range is in effect for the class, the asset guideline period. The “asset guideline period” is established in accordance with subdivision (ii) of this subparagraph and is the class life

under section 167(m). See Revenue Procedure 72-10 for special rules for section 1250 property and property predominately used outside the United States. In general, an asset guideline period, but no asset depreciation range, is in effect for such property.

(ii) *Establishment of asset guideline classes and periods.* The asset guideline classes and the asset guideline periods, and the asset depreciation ranges determined from such periods, in effect for taxable years ending before the effective date of the first supplemental asset guideline classes, asset guideline periods, and asset depreciation ranges, established pursuant to this section are set forth in Revenue Procedure 72-10. Asset guideline classes and periods, and asset depreciation ranges, will from time to time be established, supplemented, and revised with express reference to this section, and will be published in the Internal Revenue Bulletin. The asset guideline classes, the asset guideline periods, and the asset depreciation ranges determined from such periods in effect as of the last day of a taxable year of election shall apply to all vintage accounts of such taxable year, except that neither the asset guideline period nor the lower limit of the asset depreciation range for any such account shall be longer than the asset guideline period or the lower limit of the asset depreciation range, as the case may be, for such account in effect as of the first day of the taxable year (or as of such later time in such year as an asset guideline class first established during such year becomes effective). Generally, the reasonable allowance for depreciation of property for any taxable year in a vintage account shall not be changed to reflect any supplement or revision of the asset guideline classes or periods, and asset depreciation ranges, for the taxable year in which the account is established, which occurs after the end of such taxable year. However, if expressly provided in such a supplement or revision, the taxpayer may, at his option in the manner specified therein, apply the revised or supplemented asset guideline classes or periods and asset depreciation ranges to such property for such taxable year and succeeding taxable years.

(iii) *Applicable guideline classes and periods in special situations.* (a) An electric or gas utility which would in accordance with Revenue Procedure 64-21 be entitled to use a composite guideline class basis for applying Revenue Procedure 62-21 may, solely with respect to property for which an asset depreciation range is in effect for the taxable year, elect to apply this section on the basis of a composite asset guideline class and asset guideline period determined by applying the provisions of Revenue Procedure 64-21 to such property. The asset depreciation range for such a composite asset guideline class shall be determined by reference to the composite asset guideline period at the beginning of the first taxable year to which the taxpayer elects to apply this section and shall not be changed until such time as major variations in the asset mix or the asset guideline classes or periods justify some other composite asset guideline period. Except as provided in paragraph (d)(2)(iii) of this section with respect to buildings and other structures, for the purposes of this section, all property in the composite asset guideline class shall be treated as included in a single asset guideline class. If the taxpayer elects to apply this subdivision, the election shall be made on the tax return filed for the first taxable year for which the taxpayer elects to apply this section. An election to apply this subdivision for any taxable year shall apply to all succeeding taxable years to which the taxpayer elects to apply this section, except to the extent the election to apply this subdivision is with the consent of the Commissioner terminated with respect to a succeeding taxable year and all taxable years thereafter.

(b) For purposes of this section, property shall be included in the asset guideline class for the activity in which the property is primarily used. See paragraph (e)(3)(iii) of this section for rule for leased property. Property shall be classified according to primary use even though the activity in which such property is primarily used is insubstantial in relation to all the taxpayer's activities. No change in the classification of property shall be made because of a change in primary use

after the end of the taxable year in which property is first placed in service, including a change in use which results in section 1250 property becoming section 1245 property.

(c) An incorrect classification or characterization by the taxpayer of property for the purposes of this section (such as under (b) of this subdivision or under subparagraph (2) or (3) (ii) of this paragraph) shall not cause or permit a revocation of the election to apply this section for the taxable year in which such property was first placed in service. The classification or characterization of such property shall be corrected. All adjustments necessary to the correction shall be made, including adjustments of unadjusted basis, adjusted basis, salvage value, the reserve for depreciation of all vintage accounts affected, and the amount of depreciation allowable for all taxable years for which the period for assessment of tax prescribed in section 6501 has not expired. If because of incorrect classification or characterization property included in an election to apply this section was not placed in a vintage account and no asset depreciation period was selected for the property or the property was placed in a vintage account but an asset depreciation period was selected from an incorrect asset depreciation range, the taxpayer shall place the property in a vintage account and select an asset depreciation period for the account from the correct asset depreciation range.

(d) Generally, except as provided in subparagraph (5)(v)(a) of this paragraph, a taxpayer may not compute depreciation for eligible property first placed in service during the taxable year under a method of depreciation not described in section 167(b) (1), (2), or (3). (If the taxpayer computes depreciation with respect to such property under section 167(k), or amortizes such property, the property must be excluded from the election to apply this section.) (See subparagraph (5)(v) (b) of this paragraph.) However, if the taxpayer establishes to the satisfaction of the Commissioner that a method of depreciation not described in section 167(b) (1), (2), (3), or (k) was adopted for property in the asset guideline class on the basis of a good faith mistake as to

the proper asset guideline class for the property, then, unless the requirements of subparagraph (5)(v) (a) of this paragraph are met, the taxpayer must terminate (as of the beginning of the taxable year) such method of depreciation with respect to all eligible property in the asset guideline class which was first placed in service during the taxable year. In such event, the taxpayer's election to apply this section shall include eligible property in the asset guideline class without regard to subparagraph (5)(v)(a) of this paragraph. The provisions of (c) of this subdivision shall apply to the correction in the classification of the property.

(e) If the provisions of section 167(j) apply to require a change in the method of depreciation with respect to an item of section 1250 property in a multiple asset vintage account, the asset shall be removed from the account and placed in a separate item vintage account. The unadjusted basis of the asset shall be removed from the unadjusted basis of the vintage account as of the first day of the taxable year in which the change in method of depreciation is required and the depreciation reserve established for the account shall be reduced by the depreciation allowable for the property computed in the manner prescribed in paragraph (c)(1)(v)(b) of this section for determination of the adjusted basis of property. See paragraph (d)(3)(vii)(e) of this section for treatment of salvage value when property is removed from a vintage account.

(iv) *Examples.* The principles of this subparagraph may be illustrated by the following examples:

Example (1). Corporation X purchases a bulldozer for the use in its construction business. The bulldozer is first placed in service in 1972. Since the bulldozer is tangible property for which an asset guideline class and period have been established, the bulldozer is eligible property. The bulldozer is in asset guideline class 15.1 of Revenue Procedure 72-10, and the asset depreciation range is 4-6 years.

Example (2). In 1972, corporation Y first places in service a factory building. Since the factory building is tangible property for which an asset guideline class and period have been established, it is eligible property. The factory building is in asset guideline class 65.11 of Revenue Procedure 72-10. Since no asset depreciation range is in effect for

the asset guideline class, the asset depreciation period is the asset guideline period of 45 years. (See subparagraph (5)(vi) of this paragraph for election to exclude certain section 1250 property during transition period.)

Example (3). In January of 1971, corporation Y, a calendar year taxpayer, pays or incurs \$2,000 for the rehabilitation and improvement of machine A which was first placed in service in 1969. On January 1, 1971, corporation Y first placed in service machines B and C, each with an unadjusted basis of \$10,000. Machines B and C are eligible property. Machine A would be eligible property but for the fact it was first placed in service prior to January 1, 1971 (that is, machine A is eligible property determined without regard to subparagraph (2)(ii) of this paragraph). Corporation Y elects to apply this section for the taxable year, and adopts the modified half-year convention described in paragraph (c)(2)(ii) of this section, but does not elect to apply the asset guideline class repair allowance described in paragraph (d)(2)(iii) of this section. Machines A, B, and C are in asset guideline class 24.4 under Revenue Procedure 72-10 for which the asset depreciation range is 8 to 12 years. The \$2,000 expended on machine A substantially increases its capacity and is a capital expenditure under sections 162 and 263. The \$2,000 is a property improvement (as defined in paragraph (d)(2)(vii)(b) of this section) which is eligible property. However, corporation Y by mistake treats the property improvement of \$2,000 as a deductible repair. Also by mistake, corporation Y includes machine B in asset guideline class 24.3 under Revenue Procedure 72-10 for which the asset depreciation range is 5 to 7 years. Corporation Y establishes vintage accounts for 1971, and computes depreciation for 1971 and 1972 as follows:

	Dec. 31, 1972, reserve for depreciation	Dec. 31, 1972, adjusted basis
Vintage account for machine B, with an asset depreciation period of 5 years and an unadjusted basis of \$10,000 for which corporation Y adopts the straight line method	\$4,000	\$6,000
Vintage account for machine C, with an asset depreciation period of 8 years and an unadjusted basis of \$10,000 for which corporation Y adopts the straight line method	2,500	7,500

After audit in 1973 of corporation Y's taxable years 1971 and 1972, it is determined that the \$2,000 paid in 1971 for the rehabilitation and improvement of machine A is a capital expenditure and that machine B is in asset guideline class 24.4. The incorrect classification is corrected. Corporation Y places ma-

chine B and the property improvement in a vintage account of 1971 and on its tax return filed for 1973 selects an asset depreciation period of 8 years for that account. Giving effect to the correction in classification of the property in accordance with subdivision (iii) (c) of this subparagraph, at the end of 1972 the unadjusted basis, reserve for depreciation, and adjusted basis of the vintage account for machine B and the property improvement with respect to machine A are \$12,000, \$3,000, and \$9,000, respectively. Corporation Y's deduction of the \$2,000 property improvement in 1971 as a repair expense under section 162 is disallowed. For 1971 and 1972 depreciation deductions are disallowed in the amount of \$500 each year (that is, \$750 excess annual depreciation on machine B minus \$250 annual depreciation on the property improvement).

Example (4). (a) In 1971, Corporation X, a calendar year taxpayer, first places in service machines A through M, all of which are eligible property. All the machines except machine A are in asset guideline class 24.3 under Revenue Procedure 72-10. Machine A is in asset guideline class 24.4 under Revenue Procedure 72-10. Machine B has an unadjusted basis equal to 80 percent of the total unadjusted basis of machines B through M. By good faith mistake as to proper classification, corporation X includes both machine A and machine B in asset guideline class 24.4. Corporation X consistently uses the machine hour method of depreciation on all property in asset guideline class 24.4, and for 1971 computes depreciation for machines A and B under that method. Corporation X elects to apply this section for 1971 on the assumption that the election includes machines C through M which are in asset guideline class 24.3. In 1973, upon audit of corporation X's taxable years 1971 and 1972, it is determined that machine B is included in asset guideline class 24.3 and that since for 1971 corporation X computed depreciation on machine B under the machine hour method, in accordance with subparagraph (5)(v) (a) of this paragraph, all property in asset guideline class 24.3 (machines B through M) is excluded from corporation X's election to apply this section for 1971. Although corporation X has consistently used the machine hour method for asset guideline class 24.4, corporation X has not in the past used the machine hour method for machines of the type and function of machines C through M which are in asset guideline class 24.3. Both machine A and machine B are used in connection with the manufacture of wood products. There is reasonable basis for corporation X having assumed that machine B is in asset guideline class 24.4 along with machine A to which it is similar. Corporation X establishes to the satisfaction of the Commissioner that it used the machine hour method for machine B on the basis of a good faith

mistake as to the proper classification of the machine. Corporation X may, at its option (see subparagraph (5)(v) of this paragraph), terminate the machine hour method of depreciation for machine B as of the beginning of 1971, and in that event corporation X's election to apply this section for 1971 will apply to machines B through M without regard to subparagraph (5)(v)(a) of this paragraph. The adjustments provided in subdivision (iii)(c) of this subparagraph will be made as a result of the correction in classification of property. If corporation X does not terminate the machine hour method with respect to machine B, machines B through M must be excluded from the election to apply this section (see subparagraph (5)(v) of this paragraph).

(b) The facts are the same as in (a) of this example except that machine B has an unadjusted basis equal to only 65 percent of the total unadjusted basis of machines B through M.

In this case, corporation X must either terminate the machine hour method of depreciation with respect to asset B (since the provisions of subparagraph (5)(v) of this paragraph do not permit the exclusion of the property from the election to apply this section) or otherwise comply with the provisions of subparagraph (5)(v) of this paragraph. (See paragraph (c)(1)(iv) for limitation on methods which may be adopted for property included in the election to apply this section.)

(5) *Requirements of election*—(i) *In general.* Except as otherwise provided in paragraph (d)(2) of this section dealing with expenditures for the repair, maintenance, rehabilitation or improvement of certain property, no provision of this section shall apply to any property other than eligible property to which the taxpayer elects in accordance with this section, to apply this section. For the time and manner of election, and certain conditions to an election, see paragraph (f) of this section. Except as otherwise provided in subparagraph (4)(iii) of this paragraph, subdivision (v) of this subparagraph and in subparagraph (6)(iii) of this paragraph, a taxpayer's election to apply this section may not be revoked or modified after the last day prescribed for filing the election. Thus, for example, after such day, a taxpayer may not cease to apply this section to property included in the election, establish different vintage accounts for the taxable year of election, select a different period from the asset depreciation range for any such account, or

adopt a different first-year convention for any such account.

(ii) *Property required to be included in election.* Except as otherwise provided in subdivision (iii) of this subparagraph dealing with certain "used property", in subdivision (iv) of this subparagraph dealing with "section 38 property", in subdivision (v) of this subparagraph dealing with property subject to special depreciation or amortization, in subdivision (vi) of this subparagraph dealing with certain section 1250 property, in subdivision (vii) of this subparagraph dealing with certain subsidiary assets, and in paragraph (e)(3)(i) and (iv) of this section dealing with transactions to which section 381(a) applies, if the taxpayer elects to apply this section to any eligible property first placed in service by the taxpayer during the taxable year of election, the election shall apply to all such eligible property, whether placed in service in a trade or business or held for production of income.

(iii) *Special 10 percent used property rule.* (a) If (1) the unadjusted basis of eligible used section 1245 property (as defined in (c) of this subdivision) first placed in service by the taxpayer during the taxable year of election, for which no specific used property asset guideline class (as defined in (c) of this subdivision) is in effect for the taxable year, exceeds (2) 10 percent of the unadjusted basis of all eligible section 1245 property first placed in service during the taxable year of election, the taxpayer may exclude all (but not less than all) the property described in (a)(1) of this subdivision from the election to apply this section.

(b) If (1) the unadjusted basis of eligible used section 1250 property first placed in service by the taxpayer during the taxable year of election, for which no specific used property asset guideline class is in effect for the taxable year, exceeds (2) 10 percent of the unadjusted basis of all eligible section 1250 property first placed in service during the taxable year of election, the taxpayer may exclude all (but not less than all) the property described in (b)(1) of this subdivision from the election to apply this section.

(c) For the purposes of this section, the term “used property” means property the original use of which does not commence with the taxpayer. Solely for the purpose of determining whether the 10 percent rule of this subdivision is satisfied, (1) eligible used property first placed in service during the taxable year and excluded from the election to apply this section pursuant to subdivision (v)(a) of this subparagraph and (2) eligible property acquired during the taxable year in a transaction to which section 381(a) applies, shall all be treated as used property regardless of whether such property would be treated as new property under section 167(c) and the regulations thereunder. The term “specific used property asset guideline class” means a class established in accordance with subparagraph (4) of this paragraph solely for used property primarily used in connection with the activity to which the class relates.

(iv) *Property subject to investment tax credit.* The taxpayer may exclude from an election to apply this section all, or less than all, units of eligible property first placed in service during the taxable year which is—

(a) “Section 38 property” as defined in section 48(a) which meets the requirements of section 49 and which is not property described in section 50, or

(b) Property to which section 47(a)(5)(B) applies which would be section 38 property but for section 49 and which is placed in service to replace section 38 property (other than property described in section 50) disposed of prior to August 15, 1971.

(v) *Property subject to special method of depreciation or authorization.* (a) In the case of eligible property first placed in service in a taxable year of election (and not otherwise properly excluded from an election to apply this section) the taxpayer may not compute depreciation for any of such property in the asset guideline class under a method not described in section 167(b) (1), (2), (3), or (k) unless he (1) computes depreciation under a method or methods not so described for eligible property first placed in service in the taxable year in the asset guideline class with an unadjusted basis at least equal to 75 percent of the unadjusted basis of all

eligible property first placed in service in the taxable year in the asset guideline class and (2) agrees to continue to depreciate such property under such method or methods until the consent of the Commissioner is obtained to a change in method. The consent of the Commissioner must be obtained by filing Form 3115 with the Commissioner of Internal Revenue, Washington, D.C. 20224, within the first 180 days of the taxable year for which the change is desired. If for the taxable year of election the taxpayer computes depreciation under any method not described in section 167(b) (1), (2), (3), or (k) for any eligible property (other than property otherwise properly excluded from an election to apply this section) first placed in service during the taxable year, an election to apply this section for the taxable year shall not include such property or any other eligible property in the same asset guideline class as such property. With respect to a taxable year beginning before January 1, 1973, if the taxpayer has adopted a method of depreciation which is not permitted under this subdivision, the taxpayer may under this section adopt a method of depreciation permitted under this subdivision or otherwise comply with the provisions of this subdivision.

(b) An election to apply this section shall not include eligible property for which, for the taxable year of election, the taxpayer computes depreciation under section 167(k), or computes amortization under section 169, 184, 185, 187, 188, or paragraph (b) of § 1.162-11. If the taxpayer has elected to apply this section to eligible property described in section 167(k), 169, 184, 185, or 187 and the taxpayer thereafter computes depreciation or amortization for such property for any taxable year in accordance with section 167(k), 169, 184, 185, or 187, then the election to apply this section to such property shall terminate as of the beginning of the taxable year for which depreciation or amortization is computed under such section. Application of this section to the property for any period prior to the termination date will not be affected by the termination. The unadjusted basis of the property shall be removed as of the termination date from the

unadjusted basis of the vintage account. The depreciation reserve established for the account shall be reduced by the depreciation allowable for the property, computed in the manner prescribed in paragraph (c)(1)(v)(b) of this section for determination of the adjusted basis of the property. See paragraph (d)(3)(vii)(e) of this section for treatment of salvage value when property is removed from a vintage account.

(vi) *Certain section 1250 property.* (a) The taxpayer may exclude from an election to apply this section all, or less than all, items of eligible section 1250 property first placed in service during the taxable year of election provided that—

(1) The item is first placed in service before the earlier of the effective date of the first supplemental asset guideline class including such property established in accordance with subparagraph (4)(ii) of this paragraph, or January 1, 1974, and

(2) The taxpayer establishes that a useful life shorter than the asset guideline period in effect on January 1, 1971, for such item of property is justified for such taxable year.

A useful life shorter than the asset guideline period in effect on January 1, 1971, will be considered justified only if such life is justified in accordance with the provisions of Revenue Procedure 62-21 (including all modifications, amendments or supplements thereto as of January 1, 1971), determined without application of the minimal adjustment rule in section 4, part II, of Revenue Procedure 65-13. If an item of section 1250 property is excluded from an election to apply this section pursuant to this subdivision, any elevator or escalator which is a part of such item shall also be excluded from the election.

(b) If the taxpayer excludes an item of section 1250 property from an election to apply this section in accordance with this subdivision, the useful life justified under Revenue Procedure 62-21 in accordance with this subdivision for the taxable year of exclusion will be treated as justified for such item of section 1250 property for the taxable year of the exclusion and all subsequent taxable years.

(vii) *Subsidiary assets.* The taxpayer may exclude from an election to apply this section all (but not less than all) subsidiary assets first placed in service during the taxable year of election in an asset guideline class, provided that—

(a) The unadjusted basis of eligible subsidiary assets first placed in service during the taxable year in the class is as much as 3 percent of the unadjusted basis of all eligible property first placed in service during the taxable year in the class, and

(b) Such subsidiary assets are first placed in service by the taxpayer before the earlier of (1) the effective date of the first supplemental asset guideline class including such subsidiary assets established in accordance with subparagraph (4)(ii) of this paragraph, or (2) January 1, 1974.

For purposes of this subdivision the term “subsidiary assets” includes jigs, dies, molds, returnable containers, glassware, silverware, textile mill cam assemblies, and other equipment included in group 1, class 5, of Revenue Procedure 62-21, which is usually and property accounted for separately from other property and under a method of depreciation not expressed in terms of years.

(6) *Special rule for certain public utility property—*(i) *Requirement of normalization in certain cases.* Under section 167(1), in the case of public utility property (as defined in section 167(1)(3)(A)), if the taxpayer—

(a) Is entitled to use a method of depreciation other than a “subsection (1) method” of depreciation (as defined in section 167(1)(3)(F)) only if it uses the “normalization method of accounting” (as defined in section 167(1)(3)(G)) with respect to such property, or

(b) Is entitled for the taxable year to use only a “subsection (1) method” of depreciation, such property shall be eligible property (as defined in subparagraph (2) of this paragraph) only if the taxpayer normalizes the tax deferral resulting from the election to apply this section.

(ii) *Normalization.* The taxpayer will be considered to normalize the tax deferral resulting from the election to apply this section only if it computes

its tax expense for purposes of establishing its cost of service for rate-making purposes and for reflecting operating results in its regulated books of account using a period for depreciation no less than the lesser of—

(a) 100 percent of the asset guideline period in effect in accordance with subparagraph (4)(ii) of this paragraph for the first taxable year to which this section applies, or

(b) The period for computing its depreciation expense for ratemaking purposes and for reflecting operating results in its regulated books of account, and makes adjustments to a reserve to reflect the deferral of taxes resulting from the election to apply this section. A determination whether the taxpayer is considered to normalize (within the meaning of the preceding sentence) the tax deferral resulting from the election to apply this section shall be made in a manner consistent with the principles for determining whether a taxpayer is using the “normalization method of accounting” (within the meaning of section 167(1)(3)(G)). [Removed] See § 1.167(1)-1(h).

(iii) *Failure to normalize.* If a taxpayer, which has elected to apply this section to any eligible public utility property and is required under subdivision (i) of this subparagraph to normalize the tax deferral resulting from the election to apply this section to such property, fails to normalize such tax deferral, the election to apply this section to such property shall terminate as of the beginning of the taxable year for which the taxpayer fails to normalize such tax deferral. Application of this section to such property for any period prior to the termination date will not be affected by the termination. The unadjusted basis of the property shall be removed as of the termination date from the unadjusted basis of the vintage account. The depreciation reserve established for the account shall be reduced by the depreciation allowable for the property, computed in the manner prescribed in paragraph (c)(1)(v)(b) of this section for determination of the adjusted basis of the property. See paragraph (d)(3)(vii)(e) of this section for treatment of salvage value when property is removed from a vintage account.

(iv) *Examples.* The principles of this subparagraph may be illustrated by the following examples:

Example (1). Corporation A is a gas pipeline company, subject to the jurisdiction of the Federal Power Commission, which is entitled under section 167(1) to use a method of depreciation other than a “subsection (1) method” of depreciation (as defined in section 167(1)(3)(F)) only if it uses the “normalization method of accounting” (as defined in section 167(1)(3)(G)). Corporation A elects to apply this section for 1972 with respect to all eligible property. In 1972, corporation A places in service eligible property with an unadjusted basis of \$2 million. One hundred percent of the asset guideline period for such property is 22 years and the asset depreciation range is from 17.5 years to 26.5 years. The taxpayer uses the double declining balance method of depreciation, selects an asset depreciation period of 17.5 years and applies the half-year convention (described in paragraph (c)(2)(iii) of this section). The depreciation allowable under this section with respect to such property in 1972 is \$114,285. The taxpayer will be considered to normalize the tax deferral resulting from the election to apply this section and to use the “normalization method of accounting” (within the meaning of section 167(1)(3)(G)) if it computes its tax expense for purposes of determining its cost of service for rate making purposes and for reflecting operating results in its regulated books of account using a “subsection (1) method” of depreciation, such as the straight line method, determined by using a depreciation period of 22 years (that is, 100 percent of the asset guideline period). A depreciation allowance computed in this manner is \$45,454. The difference in the amount determined under this section (\$114,285) and the amount used in computing its tax expense for purposes of estimating its cost of service for rate making purposes and for reflecting operating results in its regulated books of account (\$45,454) is \$68,831. Assuming a tax rate of 48 percent, the deferral of taxes resulting from an election to apply this section and using a different method of depreciation for tax purposes from that used for establishing its cost of service for rate making purposes and for reflecting operating results in its regulated books of account is 48 percent of \$68,831, or \$33,039, which amount should be added to a reserve to reflect the deferral of taxes resulting from the election to apply this section and from the use of a different method of depreciation in computing the allowance for depreciation under section 167 from that used in computing its depreciation expense for purposes of establishing its cost of service for rate making purposes and for reflecting operating results in its regulated books of account.

Example (2). Corporation B, a telephone company subject to the jurisdiction of the Federal Communications Commission used a “flow-through method of accounting” (as defined in section 167(1)(3)(H)) for its “July 1969 accounting period” (as defined in section 167(1)(3)(I)) with respect to all of its pre-1970 public utility property and did not make an election under section 167(1)(4)(A). Thus, corporation B is entitled under section 167(1) to use a method of depreciation other than a “subsection (1) method” with respect to certain property without using the “normalization method of accounting.” In 1972, corporation B makes an election to apply this section with respect to all eligible property. Corporation B is not required to normalize the tax deferral resulting from the election to apply this section in the case of property for which it is not required to use the “normalization method of accounting” under section 167(1).

Example (3). Assume the same facts as in example (2) except that corporation B made a timely election under section 167(1)(4)(A) that section 167(1)(2)(C) not apply with respect to property which increases the productive or operational capacity of the taxpayer. Corporation B must normalize the tax deferral resulting from the election to apply this section with respect to such property.

(7) *Mere change in form of conducting a trade or business.* Property which was first placed in service by the transferor before January 1, 1971, shall not be eligible property if such property is first placed in service by the transferee after December 31, 1970, by reason of a mere change in the form of conducting a trade or business in which such property is used. A mere change in the form of conducting a trade or business in which such property is used will be considered to have occurred if—

(i) The transferor (or in a case where the transferor is a partnership, estate, trust, or corporation, the partners, beneficiaries, or shareholders) of such property retains a substantial interest in such trade or business, or

(ii) The basis of such property in the hands of the transferee is determined in whole or in part by reference to the basis of such property in the hands of the transferor.

For purposes of this subparagraph, a transferor (or in a case where the transferor is a partnership, estate, trust, or corporation, the partners, beneficiaries, or shareholders) shall be considered as having retained a substantial interest in the trade or busi-

ness only if, after the change in form, his (or their) interest in such trade or business is substantial in relation to the total interest of all persons in such trade or business. This subparagraph shall apply to property first placed in service prior to January 1, 1971, held for the production of income (within the meaning of section 167(a)(2)) as well as to property used in a trade or business. The principles of this subdivision may be illustrated by the following examples:

Example (1). Corporation X and corporation Y are includible corporations in an affiliated group as defined in section 1504(a). In 1971 corporation X sells property to corporation Y for cash. The property would meet the requirements of subparagraph (2) of this paragraph for eligible property except that it was first placed in service by corporation X in 1970. After the transfer, the property is first placed in service by corporation Y in 1971. The property is not eligible property because of the mere change in the form of conducting a trade or business.

Example (2). In 1971, in a transaction to which section 351 applies, taxpayer B transfers to corporation W property which would meet the requirements of subparagraph (2) of this paragraph for eligible property except that the property was first placed in service by B in 1969. Corporation W first places the property in service in 1971. The property is not eligible property because of the mere change in the form of conducting a trade or business.

(c) *Manner of determining allowance*

—(1) *In general*—(i) *Computation of allowance.* (a) The allowance for depreciation of property in a vintage account shall be determined in the manner specified in this paragraph by using the method of depreciation adopted by the taxpayer for the account and a rate based upon the asset depreciation period for the account. (For limitations on methods of depreciation permitted with respect to property, see section 167 (c) and (j) and subdivision (iv) of this subparagraph.) In applying the method of depreciation adopted by the taxpayer, the annual allowance for depreciation of a vintage account shall be determined without adjustment for the salvage value of the property in such account except that no account may be depreciated below the reasonable salvage value of the account. (For rules regarding estimation and treatment of salvage value, see paragraph (d)(1) and

(3) (vii) and (viii) of this section.) Regardless of the method of depreciation adopted by the taxpayer, the depreciation allowable for a taxable year with respect to a vintage account may not exceed the amount by which (as of the beginning of the taxable year) the unadjusted basis of the account exceeds (1) the reserve for depreciation established for the account plus (2) the salvage value of the account. The unadjusted basis of a vintage account is defined in subdivision (v) of this subparagraph. The adjustments to the depreciation reserve are described in subdivision (ii) of this subparagraph.

(b) The annual allowance for depreciation of a vintage account using the straight line method of depreciation shall be determined by dividing the unadjusted basis of the vintage account (without reduction for salvage value) by the number of years in the asset depreciation period selected for the account. See subdivision (iii)(b) of this subparagraph for the manner of computing the depreciation allowance following a change from the declining balance method or the sum of the years-digits method to the straight line method.

(c) In the case of the sum of the years-digits method, the annual allowance for depreciation of a vintage account shall be computed by multiplying the unadjusted basis of the vintage account (without reduction for salvage value) by a fraction, the numerator of which changes each year to a number which corresponds to the years remaining in the asset depreciation period for the account (including the year for which the allowance is being computed) and the denominator of which is the sum of all the year's digits corresponding to the asset depreciation period for the account. See subdivision (iii)(c) of this subparagraph for the manner of computing the depreciation allowance following a change from the declining balance method to the sum of the years-digits method.

(d) The annual allowance for depreciation of a vintage account using a declining balance method is determined by applying a uniform rate to the excess of the unadjusted basis of the vintage account over the depreciation reserve established for that account. The

rate under the declining balance method may not exceed twice the straight line rate based upon the asset depreciation period for the vintage account.

(e) The allowance for depreciation under this paragraph shall constitute the amount of depreciation allowable under section 167. See section 179 for additional first-year allowance for certain property.

(ii) *Establishment of depreciation reserve.* The taxpayer must establish a depreciation reserve for each vintage account. The amount of the reserve for a guideline class must be stated on each income tax return on which depreciation with respect to such class is determined under this section. The depreciation reserve for a vintage account consists of the accumulated depreciation allowable under this section with respect to the vintage account, increased by the adjustments for ordinary retirements prescribed by paragraph (d)(3)(iii) of this section, by the adjustments for reduction of the salvage value of a vintage account prescribed by paragraph (d)(3)(vii)(d) of this section, and by the adjustments for transfers to supplies or scrap prescribed by paragraph (d)(3)(viii)(b) of this section, and decreased by the adjustments for extraordinary retirements and certain special retirements as prescribed by paragraph (d)(3) (iv) and (v) of this section, by the adjustments for the amount of the reserve in excess of the unadjusted basis of a vintage account prescribed by paragraph (d)(3)(ix)(a) of this section, and by the adjustments for property removed from a vintage account prescribed by paragraphs (b)(4)(iii)(e), (5)(v)(b) and (6)(iii) of this section. The adjustments to the depreciation reserve for ordinary retirements during the taxable year shall be made as of the beginning of the taxable year. The adjustments to the depreciation reserve for extraordinary retirements shall be made as of the date the retirement is treated as having occurred in accordance with the first-year convention (described in subparagraph (2) of this paragraph) adopted by the taxpayer for the vintage account. The adjustment to the depreciation reserve for reduction of salvage value and for transfers to supplies or scrap shall, in the case of an ordinary retirement,

be made as of the beginning of the taxable year, and in the case of an extraordinary retirement the adjustment for reduction of salvage value shall be made as of the date the retirement is treated as having occurred in accordance with the first-year convention (described in subparagraph (2) of this paragraph) adopted by the taxpayer for the vintage account. The adjustment to the depreciation reserve for property removed from a vintage account in accordance with paragraph (b)(4)(iii)(e), (5)(v)(b) and (6)(iii) of this section shall be made as of the beginning of the taxable year. The depreciation reserve of a vintage account may not be decreased below zero.

(iii) *Consent to change in method of depreciation.* (a) During the asset depreciation period for a vintage account, the taxpayer is permitted to change under this section from a declining balance method of depreciation to the sum of the years-digits method of depreciation and from a declining balance method of depreciation or the sum of the years-digits method of depreciation to the straight line method of depreciation with respect to such account. Except as provided in section 167(j)(2)(1), and paragraph (e)(3)(i) of this section, no other changes in the method of depreciation adopted for a vintage account will be permitted. The provisions of § 1.167(e)-1 shall not apply to any change in depreciation method permitted under this section. The change in method applies to all property in the vintage account and must be adhered to for the entire taxable year of the change.

(b) When a change is made to the straight line method of depreciation, the annual allowance for depreciation of the vintage account shall be determined by dividing the adjusted basis of the vintage account (without reduction for salvage value) by the number of years remaining (at the time as of which the change is made) in the asset depreciation period selected for the account. However, the depreciation allowable for any taxable year following a change to the straight line method may not exceed an amount determined by dividing the unadjusted basis of the vintage account (without reduction for salvage value) by the number of years

in the asset depreciation period selected for the account.

(c) When a change is made from the declining balance method of depreciation to the sum of the years-digits method of depreciation, the annual allowance for depreciation of a vintage account shall be determined by multiplying the adjusted basis of the account (without reduction for salvage value) at the time as of which the change is made by a fraction, the numerator of which changes each year to a number which corresponds to the number of years remaining in the asset depreciation period selected for the account (including the year for which the allowance is being computed), and the denominator of which is the sum of all the year's digits corresponding to the number of years remaining in the asset depreciation period at the time as of which the change is made.

(d) The number of years remaining in the asset depreciation period selected for an account is equal to the asset depreciation period less the number of years of depreciation previously allowed. For this purpose, regardless of the first year convention adopted by the taxpayer, it will be assumed that depreciation was allowed for one-half of a year in the first year.

(e) The taxpayer shall furnish a statement setting forth the vintage accounts for which the change is made with the income tax return filed for the taxable year of the change.

(f) The principles of this subdivision may be illustrated by the following examples:

Example (1). A, a calendar year taxpayer, places new section 1245 property in service in a trade or business as follows:

Asset	Placed in service	Unadjusted basis	Estimated salvage
X	Mar. 15, 1971	\$400	\$20
Y	June 13, 1971	500	50
Z	July 30, 1971	100	0

The property is eligible property and is properly included in a single vintage account. The asset depreciation range for such property is 5 to 7 years and the taxpayer selects an asset depreciation period of 5½ years and adopts the 200-percent declining balance method of depreciation. The taxpayer adopts

Internal Revenue Service, Treasury

§ 1.167(a)-11

the half-year convention described in subparagraph (2)(iii) of this paragraph. After 3 years, A changes from the 200-percent declin-

ing balance method to the straight line method of depreciation. Depreciation allowances would be as follows:

Year	Unadjusted basis	Rate	Depreciation	Reserve	Adjusted basis
1971	\$1,000	0.18182	\$181.82	\$181.82	\$818.18
1972	1,000	.36363	297.52	479.34	520.66
1973	1,000	.36363	189.33	668.67	331.33
1974	1,000	¹ .33333	110.44	779.11	220.89
1975	1,000	.33333	110.44	889.56	110.44
1976	1,000	.33333	² 40.44	930.00	70.00

¹ Rate applied to adjusted basis of the account (without reduction by salvage) at the time as of which the change is made to the straight line method.

² The allowable depreciation is limited by estimated salvage.

Example (2). The facts are the same as in example (1) except that A elects to use the modified half-year convention described in

subparagraph (2)(ii) of this paragraph. The depreciation allowances would be as follows:

Year	Unadjusted basis	Rate	Depreciation	Reserve	Adjusted basis
1971	\$1,000	¹ 0.36363	\$327.27	\$327.27	\$672.73
1972	1,000	.36363	244.63	571.90	428.10
1973	1,000	.36363	155.67	727.57	272.43
1974	1,000	.33333	90.81	818.38	181.62
1975	1,000	.33333	90.81	909.19	90.81
1976	1,000	.33333	² 20.81	930.00	70.00

¹ Rate applied to \$900, the amount of assets placed in service during the first half of the taxable year.

² The allowable depreciation is limited by estimated salvage.

Example (3). The facts are the same as in example (1) except that A adopted the sum of the years-digits method of depreciation and

does not change to the straight line method of depreciation. The depreciation allowances would be as follows:

Year	Unadjusted basis	Rate	Depreciation	Reserve	Adjusted basis
1971	\$1,000	¹ 2.75/18	\$152.78	\$152.78	\$847.22
1972	1,000	5/18	277.78	430.56	569.44
1973	1,000	4/18	222.22	652.78	347.22
1974	1,000	3/18	166.67	819.45	180.55
1975	1,000	2/18	² 110.55	930.00	70.00
1976	1,000	1/18	0.00	930.00	70.00
1977	1,000	0.25/18	0.00	930.00	70.00

¹ Rate is equal to one-half of 5.5/18. The denominator is equal to 5.5+4.5+3.5+2.5+1.5+0.5.

² The allowable depreciation is limited by estimated salvage.

Example (4). The facts are the same as in example (3) except that A elects to use the modified half-year convention described in

subparagraph (2) (ii) of this paragraph. The depreciation allowances would be as follows:

Year	Unadjusted basis	Rate	Depreciation	Reserve	Adjusted basis
1971	\$1,000	¹ 5.5/18	\$275.00	\$275.00	\$725.00
1972	1,000	5/18	277.78	552.78	447.22
1973	1,000	4/18	222.22	775.00	225.00
1974	1,000	3/18	² 155.00	930.00	70.00
1975	1,000	2/18	0.00	930.00	70.00
1976	1,000	1/18	0.00	930.00	70.00
1977	1,000	0.25/18	0.00	930.00	70.00

¹ Rate applied to \$900, the amount of assets placed in service during the first half of the taxable year.

² The allowable depreciation is limited by estimated salvage.

§ 1.167(a)-11

26 CFR Ch. I (4-1-02 Edition)

Example (5). The facts are the same as in example (2) except that after 2 years A changes from the 200-percent declining bal-

ance method to the sum of the years-digits method of depreciation. The depreciation allowances would be as follows:

Year	Unadjusted basis	Rate	Depreciation	Reserve	Adjusted basis
1971	\$1,000	0.36363	\$327.27	\$327.27	\$672.73
1972	1,000	.36363	244.63	571.90	428.10
1973	1,000	4/10	171.24	743.14	256.86
1974	1,000	3/10	128.43	871.57	128.43
1975	1,000	2/10	158.43	930.00	70.00
1976	1,000	1/10	0.00	930.00	70.00

¹ The allowable depreciation is limited by estimated salvage.

(iv) *Limitation on methods.* (a) The same method of depreciation must be adopted for all property in a single vintage account. Generally, the method of depreciation which may be adopted is subject to the limitations contained in section 167(c), (j) and (l).

(b) Except as otherwise provided in section 167(j) with respect to certain eligible section 1250 property—

(1) In the case of a vintage account for which the taxpayer has selected an asset depreciation period of 3 years or more and which only contains property the original use of which commences with the taxpayer, any method of depreciation described in section 167(b) (1), (2), or (3) may be adopted, but if the vintage account contains property the original use of which does not commence with the taxpayer, or if the asset depreciation period for the account is less than 3 years, a method of depreciation described in section 167(b) (2) or (3) may not be adopted for the account, and

(2) The declining balance method using a rate not in excess of 150 percent of the straight line rate based upon the asset depreciation period for the vintage account may be adopted for the account even if the original use of the property does not commence with the taxpayer provided the asset depreciation period for the account is at least 3 years.

(c) The term “original use” means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. (See §1.167(c)-1).

(v) *Unadjusted and adjusted basis.* (a) For purposes of this section, the unadjusted basis of an asset (including an “excluded addition” and a “property improvement” as described, re-

spectively, in paragraph (d)(2) (vi) and (vii) of this section) is its cost or other basis without any adjustment for depreciation or amortization (other than depreciation under section 179) but with other adjustments required under section 1016 or other applicable provisions of law. The unadjusted basis of a vintage account is the total of the unadjusted bases of all the assets in the account. The unadjusted basis of a “special basis vintage account” as described in paragraph (d)(3)(vi) of this section is the amount of the property improvement determined in paragraph (d)(2)(vii)(a) of this section.

(b) The adjusted basis of a vintage account is the amount by which the unadjusted basis of the account exceeds the reserve for depreciation for the account. The adjusted basis of an asset in a vintage account is the amount by which the unadjusted basis of the asset exceeds the amount of depreciation allowable for the asset under this section computed by using the method of depreciation and the rate applicable to the account. For purposes of this subdivision, the depreciation allowable for an asset shall include, to the extent identifiable, the amount of proceeds previously added to the depreciation reserve in accordance with paragraph (d)(3)(iii) of this section upon the retirement of any portion of such asset. (See paragraph (d)(3)(vi) of this section for election under certain circumstances to allocate adjusted basis of an amount of property improvement determined under paragraph (d)(2)(vii)(a) of this section.)

(2) *Conventions applied to additions and retirements—*(i) *In general.* The allowance for depreciation of a vintage account (whether an item account or a

multiple asset account) shall be determined by applying one of the conventions described in subdivisions (ii) and (iii) of this subparagraph. (For the manner of applying a convention in the case of taxable years beginning before and ending after December 31, 1970, see subparagraph (3) of this paragraph.) The same convention must be adopted for all vintage accounts of a taxable year, but the same convention need not be adopted for the vintage accounts of another taxable year. An election to apply this section must specify the convention adopted. (See paragraph (f) of this section for information required in making the election.) The convention adopted by the taxpayer is a method of accounting for purposes of section 446, but the consent of the Commissioner will be deemed granted to make an annual adoption of either of the conventions described in subdivisions (ii) and (iii) of this subparagraph.

(ii) *Modified half-year convention.* The depreciation allowance for a vintage account for which the taxpayer adopts the "modified half-year convention" shall be determined by treating: (a) All property in such account which is placed in service during the first half of the taxable year as placed in service on the first day of the taxable year; and (b) all property in such account which is placed in service during the second half of the taxable year as placed in service on the first day of the succeeding taxable year. The depreciation allowance for a vintage account for a taxable year in which there is an extraordinary retirement (as defined in paragraph (d) (3) (ii) of this section) of property first placed in service during the first half of the taxable year is determined by treating all such retirements from such account during the first half of the taxable year as occurring on the first day of the taxable year and all such retirements from such account during the second half of the taxable year as occurring on the first day of the second half of the taxable year. The depreciation allowance for a vintage account for a taxable year in which there is an extraordinary retirement (as defined in paragraph (d)(3)(ii) of this section) of property first placed in service during the second half of the taxable year is deter-

mined by treating all such retirements from such account during the first half of the taxable year as occurring on the first day of the second half of the taxable year and all such retirements in the second half of the taxable year as occurring on the first day of the succeeding taxable year.

(iii) *Half-year convention.* The depreciation allowance for a vintage account for which the taxpayer adopts the "half-year convention" shall be determined by treating all property in the account as placed in service on the first day of the second half of the taxable year and by treating all extraordinary retirements (as defined in paragraph (d)(3)(ii) of this section) from the account as occurring on the first day of the second half of the taxable year.

(iv) *Rules of application.* (a) The first-year convention adopted for a vintage account must be consistently applied to all additions to and all extraordinary retirements from such account. See paragraph (d)(3) (ii) and (iii) of this section for definition and treatment of ordinary retirements.

(b) If the actual number of months in a taxable year is other than 12 full calendar months, depreciation is allowed only for such actual number of months and the term "taxable year", for purposes of this subparagraph, shall mean only such number of months. In such event, the first half of such taxable year shall be deemed to expire at the close of the last day of a calendar month which is the closest such last day to the middle of such taxable year and the second half of such taxable year shall be deemed to begin the day after the expiration of the first half of such taxable year. If a taxable year consists of a period which includes only 1 calendar month, the first half of the taxable year shall be deemed to expire on the first day which is nearest to the midpoint of the month, and the second half of the taxable year shall begin the day after the expiration of the first half of the month.

(c) For purposes of this subparagraph, for property placed in service after November 14, 1979, other than depreciable property described in paragraph (c)(2)(iv)(e) of this section, the taxable year of the person placing such property in service does not include any

month before the month in which the person begins engaging in a trade or business or holding depreciable property for the production of income.

(d) For purposes of paragraph (c)(2)(iv)(c) of this section—

(1) For property placed in service after February 21, 1981, an employee is not considered engaged in a trade or business by virtue of employment.

(2) If a person engages in a small amount of trade or business activity after February 21, 1981, for the purpose of obtaining a disproportionately large depreciation deduction for assets for the taxable year in which they are placed in service, and placing those assets in service represents a substantial increase in the person's level of business activity, then for purposes of depreciating those assets the person will not be treated as beginning a trade or business until the increased amount of business activity begins. For property held for the production of income, the principle of the preceding sentence applies.

(3) A person may elect to apply the rules of § 1.167(a)-11 (c)(2)(iv)(d) as set forth in T.D. 7763 (“(d) rules in T.D. 7763”). This election shall be made by reflecting it under paragraph (f)(4) of this section in the books and records. If necessary, amended returns shall be filed.

(4) If an averaging convention was adopted in reliance on or in anticipation of the (d) rules in T.D. 7763, that convention may be changed without regard to paragraph (f)(3) of this section. Similarly, if an election is made under paragraph (c)(2)(iv)(d)(3) of this section to apply to the (d) rules in T.D. 7763, the averaging convention adopted for the taxable years for which the election is made may be changed. The change shall be made by filing a timely amended return for the taxable year for which the convention was adopted. Notwithstanding the three preceding sentences, if an averaging convention was adopted in reliance on or in anticipation of the (d) rules in T.D. 7763, and if an election is made to apply those rules, the averaging convention adopted cannot be changed except as provided in paragraph (f) of this section.

(e) The rules in paragraph (c)(2)(iv)(c) of this section do not apply to depre-

ciable property placed in service after November 14, 1979, and the rules in paragraph (c)(2)(iv)(d) of this section do not apply to depreciable property placed in service after February 21, 1981, with respect to which substantial expenditures were paid or incurred prior to November 15, 1979. For purposes of the preceding sentence, expenditures will not be considered substantial unless they exceed the lesser of 30 percent of the final cost of the property or \$10 million. Expenditures that are not includible in the basis of the depreciable property will be considered expenditures with respect to property if they are directly related to a specific project involving such property. For purposes of determining whether expenditures were paid or incurred prior to November 15, 1979, expenditures made by a person (transferor) other than the person placing the property in service (transferee) will be taken into account only if the basis of the property in the hands of the transferee is determined in whole or in part by reference to the basis in the hands of the transferor. The principle of the preceding sentence also applies if there are multiple transfers.

(v) *Mass assets.* In the case of mass assets, if extraordinary retirements of such assets in a guideline class during the first half of the taxable year are allocated to a particular vintage year for which the taxpayer applied the modified half-year convention, then that portion of the mass assets so allocated which bears the same ratio to the total number of mass assets so allocated as the mass assets in the same vintage and assets guideline class placed in service during the first half of that vintage year bear to the total mass assets in the same vintage and asset guideline class shall be treated as retired on the first day of the taxable year. The remaining mass assets which are subject to extraordinary retirement during the first half of the taxable year and which are allocated to that vintage year and assets guideline class shall be treated as retired on the first days of the second half of the taxable year. If extraordinary retirements of mass assets in a guideline class occur in the second half of the taxable year and are allocated to a particular vintage year for which the

taxpayer applied the modified half-year convention, then that portion of the mass assets so allocated which bears the same ratio to the total number of mass assets so allocated as the mass assets in the same vintage and asset guideline class first placed in service during the first half of that vintage year bear to the total mass assets in the same vintage and asset guideline class shall be treated as retired on the first day of the second half of the taxable year. The remaining mass assets which are subject to extraordinary retirements during the second half of the taxable year and which are allocated to that same vintage and asset guideline class shall be treated as retired on the first day of the succeeding taxable year. If the taxpayer has applied the half-year convention for the vintage year to which the extraordinary retirements are allocated, the mass assets shall be treated as retired on the first day of the second half of the taxable year.

(3) *Taxable years beginning before and ending after December 31, 1970.* In the case of a taxable year which begins before January 1, 1971, and ends after December 31, 1970, property first placed in service after December 31, 1970, but treated as first placed in service before January 1, 1971, by application of a convention described in subparagraph (2) of this paragraph shall be treated as provided in this subparagraph. The depreciation allowed (or allowable) for the taxable year shall consist of the depreciation allowed (or allowable) for the period before January 1, 1971, determined without regard to this section plus the amount allowable for the period after December 31, 1970, determined under this section. However, neither the modified half-year convention described in subparagraph (2)(ii) of this paragraph, nor the half-year convention described in subparagraph (2)(iii) of this paragraph may for any such taxable year be applied with respect to property placed in service after December 31, 1970, to allow depreciation for any period prior to January 1, 1971, unless such convention is consistent with the convention applied by the taxpayer with respect to property placed in service in such taxable year prior to January 1, 1971.

(4) *Examples.* The principles of this paragraph may be illustrated by the following examples:

Example (1). Taxpayer A, a calendar year taxpayer, places new property in service in a trade or business as follows:

Asset	Placed in service	Unadjusted basis
W	Apr. 1, 1971	\$5,000
X	June 30, 1971	8,000
Y	July 15, 1971	12,000

Taxpayer A adopts the modified half-year convention described in subparagraph (2) (ii) of this paragraph. Assets W, X, and Y are placed in a multiple asset account for which the asset depreciation range is 8 to 12 years. A selects 8 years, the minimum asset depreciation period with respect to such assets, and adopts the declining balance method of depreciation using a rate twice the straight line rate (computed without reduction for salvage). The annual rate under this method using a period of 8 years is 25 percent. The depreciation allowance for assets W and X for 1971 is \$3,250, a full year's depreciation under the modified half-year convention (that is, basis of \$13,000 (unreduced by salvage) multiplied by 25 percent). The depreciation allowance for asset Y for 1971 is zero under the modified half-year convention.

Example (2). The facts are the same as in example (1), except that the taxpayer adopts the half-year convention described in subparagraph (2) (iii) of this paragraph. The depreciation allowance with respect to asset Y is \$1,500 (that is the basis of \$12,000 multiplied by 25 percent, then multiplied by $\frac{1}{2}$). Assets W and X are also entitled to a depreciation allowance for only a half year. Thus, the depreciation allowance for assets W and X for 1971 is \$1,625 (that is, $\frac{1}{2}$ of the \$3,250 allowance computed in example (1)).

Example (3). Asset Z is placed in service by a calendar year taxpayer on December 1, 1971. The taxpayer places asset Z in an item account and adopts the sum of the years-digits method and the half year convention described in subparagraph (2) (iii) of this paragraph. The asset depreciation range for such asset is 4 to 6 years and the taxpayer selects an asset depreciation period of 5 years. The depreciation allowance for asset Z in 1971 is \$10,000 (that is, basis of \$60,000 (unreduced by salvage) multiplied by $\frac{5}{15}$, the appropriate fraction using the sum of the years-digits method then multiplied by $\frac{1}{2}$, since only one half year's depreciation is allowable under the convention).

Example (4). A is a calendar year taxpayer. All taxpayer A's assets are placed in service

§ 1.167(a)-11

in the first half of 1971. If the taxpayer selects the modified half-year convention described in subparagraph (2) (ii) of this paragraph, a full year's depreciation is allowable for all assets.

Example (5). (i) The taxpayer during his taxable year which begins April 1, 1970, and ends March 31, 1971, places new property in service in a trade or business as follows:

Asset	Placed in service	Unadjusted basis
A	Apr. 30, 1970	\$10,000
B	Dec. 15, 1970	10,000
C	Jan. 1, 1971	10,000

The taxpayer adopted a convention under § 1.167(a)-10(b) with respect to assets placed in service prior to January 1, 1971, which treats assets placed in service during the first half of the year as placed in service on the first day of such year and assets placed in service in the second half of the year as placed in service on the first day of the following year. If the taxpayer selects the half-year convention described in subparagraph (2) (iii) of this paragraph, one year's depreciation is allowable on asset A determined without regard to this section. No depreciation is allowable for asset B. No depreciation is allowable for asset C for the period prior to January 1, 1971. One-fourth year's depreciation is allowable on asset C determined under this section.

(ii) The facts are the same as in (i) of this example except that the taxpayer adopts the modified half-year convention described in subparagraph (2) (ii) of this paragraph for 1971. No depreciation is allowable for assets B and C which were placed in service in the second half of the taxable year.

Example (6). The taxpayer during his taxable year which begins August 1, 1970, and ends July 31, 1971, places new property in service in a trade or business as follows:

Asset	Placed in service
A	Aug. 1, 1970.
B	Jan. 15, 1971.
C	June 30, 1971.

The taxpayer adopted a convention under § 1.167(a)-10(b) with respect to assets placed in service prior to January 1, 1971, which treats all assets as placed in service at the mid-point of the taxable year. If the taxpayer selects the half-year convention described in subparagraph (2) (iii) of this paragraph, one-half year's depreciation is allowable for asset A determined without regard to this section. One-half year's depreciation is allowable for assets B and C determined under this section.

Example (7). X, a calendar year corporation, is incorporated on July 1, 1978, and begins engaging in a trade or business in September

1979. X purchases asset A and places it in service on November 20, 1979. Substantial expenditures were not paid or incurred by X with respect to asset A prior to November 15, 1979. For purposes of applying the conventions under this section to determine depreciation for asset A, the 1979 taxable year is treated as consisting of 4 months. The first half of the taxable year ends on October 31, 1979, and the second half begins on November 1, 1979. X adopts the half-year convention. Asset A is treated as placed in service on November 1, 1979.

Example (8). On January 20, 1982, A, B, and C enter an agreement to form partnership P for the purpose of purchasing and leasing a ship to a third party, Z. P uses the calendar year as its taxable year. On December 15, 1982, P acquires the ship and leases it to Z. For purposes of applying the conventions, P begins its leasing business in December 1982, and its taxable year begins on December 1, 1982. Assuming that P elects to apply this section and adopts the modified half-year convention, P depreciates the ship placed in service in 1982 for the 1-month period beginning December 1, 1982, and ending December 31, 1982.

Example (9). A and B form partnership P on December 15, 1981, to conduct a business of leasing small aircraft. P uses the calendar year as its taxable year. On January 15, 1982, P acquires and places in service a \$25,000 aircraft. P begins engaging in business with only one aircraft for the purpose of obtaining a disproportionately large depreciation deduction for aircraft that P plans to acquire at the end of the year. On December 10, 1982, P acquires and places in service 4 aircraft, the total purchase price of which is \$250,000. For purposes of applying the conventions to the aircraft acquired in December, P begins its leasing business in December 1982, and P's taxable year begins December 1, 1982, and ends December 31, 1982. Assuming that P elects to apply this section and adopts the modified half-year convention, P depreciates the aircraft placed in service in December 1982, for the 1-month period beginning December 1, 1982, and ending December 31, 1982. P depreciates the aircraft placed in service in January 1982, for the 12-month period beginning January 1, 1982, and ending December 31, 1982.

(d) *Special rules for salvage, repairs and retirements—(1) Salvage value—(i) Definition of gross salvage value.* "Gross salvage" value is the amount which is estimated will be realized upon a sale or other disposition of the property in the vintage account when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service, without reduction for the cost of removal,

dismantling, demolition or similar operations. If a taxpayer customarily sells or otherwise disposes of property at a time when such property is still in good operating condition, the gross salvage value of such property is the amount expected to be realized upon such sale or disposition, and under certain circumstances, as where such property is customarily sold at a time when it is still relatively new, the gross salvage value may constitute a relatively large proportion of the unadjusted basis of such property.

(ii) *Definition of salvage value.* “Salvage value” means gross salvage value less the amount, if any, by which the gross salvage value is reduced by application of section 167(f). Generally, as provided in section 167(f), a taxpayer may reduce the amount of gross salvage value of a vintage account by an amount which does not exceed 10 percent of the unadjusted basis of the personal property (as defined in section 167(f)(2)) in the account. See paragraph (b)(3)(ii) of this section for requirement of separate vintage accounts for personal property described in section 167(f)(2).

(iii) *Estimation of salvage value.* The salvage value of each vintage account of the taxable year shall be estimated by the taxpayer at the time the election to apply this section is made, upon the basis of all the facts and circumstances existing at the close of the taxable year in which the account is established. The taxpayer shall specify the amount, if any, by which gross salvage value taken into account is reduced by application of section 167(f). See paragraph (f)(2) of this section for requirement that the election specify the estimated salvage value for each vintage account of the taxable year of election. The salvage value estimated by the taxpayer will not be redetermined merely as a result of fluctuations in price levels or as a result of other facts and circumstances occurring after the close of the taxable year of election. Salvage value for a vintage account need not be established or increased as a result of a property improvement as described in subparagraph (2) (vii) of this paragraph. The taxpayer shall maintain records reasonably sufficient to determine facts

and circumstances taken into account in estimating salvage value.

(iv) *Salvage as limitation on depreciation.* In no case may a vintage account be depreciated below a reasonable salvage value after taking into account any reduction in gross salvage value permitted by section 167(f).

(v) *Limitation on adjustment of reasonable salvage value.* The salvage value established by the taxpayer for a vintage account will not be redetermined if it is reasonable. Since the determination of salvage value is a matter of estimation, minimal adjustments will not be made. The salvage value established by the taxpayer will be deemed to be reasonable unless there is sufficient basis in the facts and circumstances existing at the close of the taxable year in which the account is established for a determination of an amount of salvage value for the account which exceeds the salvage value established by the taxpayer for the account by an amount greater than 10 percent of the unadjusted basis of the account at the close of the taxable year in which the account is established. If the salvage value established by the taxpayer for the account is not within the 10 percent range, or if the taxpayer follows the practice of understating his estimates of gross salvage value to take advantage of this subdivision, and if there is a determination of an amount of salvage value for the account which exceeds the salvage value established by the taxpayer for the account, an adjustment will be made by increasing the salvage value established by the taxpayer for the account by an amount equal to the difference between the salvage value as determined and the salvage value established by the taxpayer for the account. For the purposes of this subdivision, a determination of salvage value shall include all determinations at all levels of audit and appellate proceedings, and as well as all final determinations within the meaning of section 1313(a) (1). This subdivision shall apply to each such determination. (See example (3) of subdivision (vi) of this subparagraph.)

(vi) *Examples.* The principles of this subparagraph may be illustrated by the

following examples in which it is assumed that the taxpayer has not followed a practice of understating his estimates of gross salvage value:

Example (1). Taxpayer B elects to apply this section to assets Y and Z, which are placed in a multiple asset vintage account of 1971 for which the taxpayer selects an asset depreciation period of 8 years. The unadjusted basis of asset Y is \$50,000 and the unadjusted basis of asset Z is \$30,000. B estimates a gross salvage value of \$55,000. The property qualifies under section 167(f) (2) and B reduces the amount of salvage taken into account by \$8,000 (that is, 10 percent of \$30,000 under section 167(f)). Thus, B establishes a salvage value of \$47,000 for the account. Assume that there is not sufficient basis for determining a salvage value for the account greater than \$52,000 (that is, \$60,000 minus the \$8,000 reduction under section 167(f)). Since the salvage value of \$47,000 established by B for the account is within the 10 percent range, it is reasonable. Salvage value for the account will not be redetermined.

Example (2). The facts are the same as in example (1) except that B estimates a gross salvage value of \$50,000 and establishes a salvage value of \$42,000 for the account (that is, \$50,000 minus the \$8,000 reduction under section 167(f)). There is sufficient basis for determining an amount of salvage value greater than \$50,000 (that is, \$58,000 minus the \$8,000 reduction under section 167(f)). The salvage value of \$42,000 established by B for the account can be redetermined without regard to the limitation in subdivision (v) of this subparagraph, since it is not within the 10 percent range. Upon audit of B's tax return for a taxable year for which the redetermination would affect the amount of depreciation allowable for the account, salvage value is determined to be \$52,000 after taking into account the reduction under section 167(f). Salvage value for the account will be adjusted to \$52,000.

Example (3). The facts are the same as in example (1) except that upon audit of B's tax return for a taxable year the examining officer determines the salvage value to be \$58,000 (that is, \$66,000 minus the \$8,000 reduction under section 167(f)), and proposes to adjust salvage value for the vintage account to \$58,000 which will result in disallowing an amount of depreciation for the taxable year. B does not agree with the finding of the examining officer. After receipt of a "30-day letter", B waives a district conference and initiates proceedings before the Appellate Division. In consideration of the case by the Appellate Division it is concluded that there is not sufficient basis for determining an amount of salvage value for the account in excess of \$55,000 (that is \$63,000 minus the \$8,000 reduction under section 167(f)). Since

the salvage of \$47,000 established by B for the account is within the 10 percent range, it is reasonable. Salvage value for the account will not be redetermined.

Example (4). Taxpayer C elects to apply this section to factory building X which is placed in an item vintage account of 1971. The unadjusted basis of factory building X is \$90,000. C estimates a gross salvage value for the account of \$10,000. The property does not qualify under section 167(f)(2). C establishes a salvage value of \$10,000 for the account. Assume that there is not sufficient basis for determining a salvage value for the account greater than \$18,000. Since the salvage value of \$10,000 established by B for the account is within the 10 percent range, it is reasonable. Salvage value for the account will not be redetermined.

(2) *Treatment of repairs—(i) In general.*

(a) Sections 162, 212, and 263 provide general rules for the treatment of certain expenditures for the repair, maintenance, rehabilitation or improvement of property. In general, under those sections, expenditures which substantially prolong the life of an asset, or are made to increase its value or adapt it to a different use are capital expenditures. If an expenditure is treated as a capital expenditure under section 162, 212, or 263, it is subject to the allowance for depreciation. On the other hand, in general, expenditures which do not substantially prolong the life of an asset or materially increase its value or adapt it for a substantially different use may be deducted as an expense in the taxable year in which paid or incurred. Expenditures, or a series of expenditures, may have characteristics both of deductible expenses and capital expenditures. Other expenditures may have the characteristics of capital expenditures, as in the case of an "excluded addition" (as defined in subdivision (vi) of this subparagraph). This subparagraph provides a simplified procedure for determining whether expenditures with respect to certain property are to be treated as deductible expenses or capital expenditures.

(b) [Reserved]

(ii) *Election of repair allowance.* In the case of an asset guideline class which consists of "repair allowance property" as defined in subdivision (iii) of this subparagraph, subject to the provisions of subdivision (v) of this subparagraph, the taxpayer may elect to apply the asset guideline class repair allowance

described in subdivision (iii) of this subparagraph for any taxable year ending after December 31, 1970, for which the taxpayer elects to apply this section.

(iii) *Repair allowance for an asset guideline class.* For a taxable year for which the taxpayer elects to apply this section, the "repair allowance" for an asset guideline class which consists of "repair allowance property" is an amount equal to—

(a) The average of (1) the unadjusted basis of all "repair allowance property" in the asset guideline class at the beginning of the taxable year, less in the case of such property in a vintage account the unadjusted basis of all such property retired in an ordinary retirement (as described in subparagraph (3)(ii) of this paragraph) in prior taxable years, and (2) the unadjusted basis of all "repair allowance property" in the asset guideline class at the end of the taxable year, less in the case of such property in a vintage account the unadjusted basis of all such property retired in an ordinary retirement (including ordinary retirements during the taxable year), multiplied by—

(b) The repair allowance percentage in effect for the asset guideline class for the taxable year.

In applying the assets guideline class repair allowance to buildings which are section 1250 property, for the purpose of this subparagraph each building shall be treated as in a separate asset guideline class. If two or more buildings are in the same asset guideline class determined without regard to the preceding sentence and are operated as an integrated unit (as evidenced by their actual operation, management, financing and accounting), they shall be treated as a single building for this purpose. The "repair allowance percentages" in effect for taxable years ending before the effective date of the first supplemental repair allowance percentages established pursuant to this section are set forth in Revenue Procedure 72-10. Repair allowance percentages will from time to time be established, supplemented and revised with express reference to this section. These repair allowance percentages will be published in the Internal Revenue Bulletin. The repair allowance

percentages in effect on the last day of the taxable year shall apply for the taxable year, except that the repair allowance percentage for a particular taxable year shall not be less than the repair allowance percentage in effect on the first day of such taxable year (or as of such later time in such year as a repair allowance percentage first established during such year becomes effective). Generally, the repair allowance percentages for a taxable year shall not be changed to reflect any supplement or revision of the repair allowance percentages after the end of such taxable year. However, if expressly provided in such a supplement or revision of the repair allowance percentages, the taxpayer may, at his option in the manner specified therein, apply the revised or supplemented repair allowance percentages for such taxable year and succeeding taxable years. For the purposes of this section, "repair allowance property" means eligible property determined without regard to paragraph (b)(2)(ii) of this section (that is, without regard to whether such property was first placed in service by the taxpayer before or after December 31, 1970) in an asset guideline class for which a repair allowance percentage is in effect for the taxable year. The determination whether property is repair allowance property shall be made without regard to whether such property is excluded, under paragraph (b)(5) of this section, from an election to apply this section. Property in an asset guideline class for which the taxpayer elects to apply the asset guideline class repair allowance described in this subdivision, which results from expenditures in the taxable year of election for the repair, maintenance, rehabilitation, or improvement of property in an asset guideline class shall not be "repair allowance property" for such taxable year but shall be for each succeeding taxable year provided such property is a property improvement as described in subdivision (vii) (a) of this subparagraph and is in an asset guideline class for which a repair allowance percentage is in effect for such succeeding taxable year.

(iv) *Application of asset guideline class repair allowance.* In accordance with the principles of sections 162, 212, and

263, if the taxpayer pays or incurs any expenditures during the taxable year for the repair, maintenance, rehabilitation or improvement of eligible property (determined without regard to paragraph (b)(2)(ii) of this section), the taxpayer must either—

(a) If such property is repair allowance property and if the taxpayer elects to apply the repair allowance for the asset guideline class, treat an amount of all such expenditures in such taxable year with respect to all such property in the asset guideline class which does not exceed in total the repair allowance for that asset guideline class as deductible repairs, and treat the excess of all such expenditures with respect to all such property in the asset guideline class in the manner described for a property improvement in subdivision (viii) of this subparagraph, or

(b) If such property is not repair allowance property or if the taxpayer does not elect to apply the repair allowance for the asset guideline class, treat each of such expenditures in such taxable year with respect to all such property in the asset guideline class as either a capital expenditure or as a deductible repair in accordance with the principles of sections 162, 212, and 263 (without regard to (a) of this subdivision), and treat the expenditures which are required to be capitalized under sections 162, 212, and 263 (without regard to (a) of this subdivision) in the manner described for a property improvement in subdivision (viii) of this subparagraph.

For the purposes of (a) of this subdivision, expenditures for the repair, maintenance, rehabilitation or improvement of property do not include expenditures for an excluded addition or for which a deduction is allowed under section 167(k). (See subdivision (viii) of this subparagraph for treatment of an excluded addition.) The taxpayer shall elect each taxable year whether to apply the repair allowance and treat expenditures under (a) of this subdivision, or to treat expenditures under (b) of this subdivision. The treatment of expenditures under this subdivision for a taxable year for all asset guideline classes shall be specified in the books and records of the taxpayer for the tax-

able year. The taxpayer may treat expenditures under (a) of this subdivision with respect to property in one asset guideline class and treat expenditures under (b) of this subdivision with respect to property in some other asset guideline class. In addition, the taxpayer may treat expenditures with respect to property in an asset guideline class under (a) of this subdivision in one taxable year, and treat expenditures with respect to property in that asset guideline class under (b) of this subdivision in another taxable year.

(v) *Special rules for repair allowance.*
(a) The asset guideline class repair allowance described in subdivision (iii) of this subparagraph shall apply only to expenditures for the repair, maintenance, rehabilitation or improvement of repair allowance property (as described in subdivision (iii) of this subparagraph). The taxpayer may apply the asset guideline class repair allowance for the taxable year only if he maintains books and records reasonably sufficient to determine:

(1) The amount of expenditures paid or incurred during the taxable year for the repair, maintenance, rehabilitation or improvement of repair allowance property in the asset guideline class, and

(2) The expenditures (and the amount thereof) with respect to such property which are for excluded additions (such as whether the expenditure is for an additional identifiable unit of property, or substantially increases the productivity or capacity of an existing identifiable unit of property or adapts it for a substantially different use).

In general, such books and records shall be sufficient to identify the amount and nature of expenditures with respect to specific items of repair allowance property or groups of similar properties in the same asset guideline class. However, in the case of such expenditures with respect to property, part of which is in one asset guideline class and part in another, or part of which is repair allowance property and part of which is not, and in comparable circumstances involving property in the same asset guideline class, to the extent books and records are not maintained identifying such expenditures with specific items of property or

groups of similar properties and it is not practicable to do so, the total amount of such expenditures which is not specifically identified may be allocated by any reasonable method consistently applied. In any case, the cost of repair, maintenance, rehabilitation or improvement of property performed by production personnel may be allocated by any reasonable method consistently applied and if performed incidental to production and not substantial in amount, no allocation to repair, maintenance, rehabilitation or improvement need be made. The types of expenditures for which specific identification would ordinarily be made include: Substantial expenditures such as for major parts or major structural materials for which a work order is or would customarily be written; expenditures for work performed by an outside contractor; or expenditures under a specific down time program. Types of expenditures for which specific identification would ordinarily be impractical include: General maintenance costs of machinery, equipment, and plant in the case of a taxpayer having assets in more than one class (or different types of assets in the same class) which are located together and generally maintained by the same work crew; small supplies which are used with respect to various classes or types of property; labor costs of personnel who work on property in different classes, or different types of property in the same class, if the work is performed on a routine, as needed, basis and the only identification of the property repaired is by the personnel. Factors which will be taken into account in determining the reasonableness of the taxpayer's allocation of expenditures include prior experience of the taxpayer; relative bases of the assets in the guideline class; types of assets involved; and relationship to specifically identified expenditures.

(b) If for the taxable year the taxpayer elects to deduct under section 263(e) expenditures with respect to repair allowance property consisting of railroad rolling stock (other than a locomotive) in a particular asset guideline class, the taxpayer may not, for such taxable year, use the asset guideline class repair allowance described in

subdivision (iii) of this subparagraph for any property in such asset guideline class.

(c)(1) If the taxpayer repairs, rehabilitates or improves property for sale or resale to customers, the asset guideline class repair allowance described in subdivision (iii) of this subparagraph shall not apply to expenditures for the repair, maintenance, rehabilitation or improvement of such property, or (2) if a taxpayer follows the practice of acquiring for his own use property (in need of repair, rehabilitation or improvement to be suitable for the use intended by the taxpayer) and of making expenditures to repair, rehabilitate or improve such property in order to take advantage of this subparagraph, the asset guideline class repair allowance described in subdivision (iii) of this subparagraph shall not apply to such expenditures. In either event, such property shall not be "repair allowance property" as described in subdivision (iii) of this subparagraph.

(vi) *Definition of excluded addition.* The term "excluded addition" means—

(a) An expenditure which substantially increases the productivity of an existing identifiable unit of property over its productivity when first acquired by the taxpayer;

(b) An expenditure which substantially increases the capacity of an existing identifiable unit of property over its capacity when first acquired by the taxpayer;

(c) An expenditure which modifies an existing identifiable unit of property for a substantially different use;

(d) An expenditure for an identifiable unit of property if (1) such expenditure is for an additional identifiable unit of property or (2) such expenditure (other than an expenditure described in (e) of this subdivision) is for replacement of an identifiable unit of property which was retired;

(e) An expenditure for replacement of a part in or a component or portion of an existing identifiable unit of property (whether or not such part, component or portion is also an identifiable unit of property) if such part, component or portion is for replacement of a part, component or portion which was retired in a retirement upon which gain or loss is recognized (or would be

recognized but for a special non-recognition provision of the Code or § 1.1502-13).

(f) In the case of a building or other structure (in addition to (b), (c), (d), and (e) of this subdivision which also apply to such property), an expenditure for additional cubic or linear space; and

(g) In the case of those units of property of pipelines, electric utilities, telephone companies, and telegraph companies consisting of lines, cables and poles (in addition to (a) through (e) of this subdivision which also apply to such property), an expenditure for replacement of a material portion of the unit of property.

Except as provided in (d) and (e) of this subdivision, notwithstanding any other provision of this subdivision, the term "excluded addition" does not include any expenditure in connection with the repair, maintenance, rehabilitation or improvement of an identifiable unit of property which does not exceed \$100. For this purpose all related expenditures with respect to the unit of property shall be treated as a single expenditure. For the purposes of (a), and (b) of this subdivision, an increase in productivity or capacity is substantial only if the increase is more than 25 percent. An expenditure which merely extends the productive life of an identifiable unit of property is not an increase in productivity within the meaning of (a) of this subdivision. Under (g) of this subdivision a replacement is material only if the portion replaced exceeds 5 percent of the unit of property with respect to which the replacement is made. For the purposes of this subdivision, a unit of property generally consists of each operating unit (that is, each separate machine or piece of equipment) which performs a discrete function and which the taxpayer customarily acquires for original installation and retires as a unit. The taxpayer's accounting classification of units of property will generally be accepted for purposes of this subdivision provided the classifications are reasonably consistent with the preceding sentence and are consistently applied. In the case of a building the unit of property generally consists of the building as well as its structural components;

except that each building service system (such as an elevator, an escalator, the electrical system, or the heating and cooling system) is an identifiable unit for the purpose of (a), (b), (c), and (d) of this subdivision. However, both in the case of machinery and equipment and in the case of a building, for the purpose of applying (d)(1) of this subdivision a unit of property may consist of a part in or a component or portion of a larger unit of property. In the case of property described in (g) of this subdivision (such as a pipeline), a unit of property generally consists of each segment which performs a discrete function either as to capacity, service, transmission or distribution between identifiable points. Thus, for example, under this subdivision in the case of a vintage account of five automobiles each automobile is an identifiable unit of property (which is not merely a part in or a component or portion of larger unit of property within the meaning of (e) of this subdivision). Accordingly, the replacement of one of the automobiles (which is retired) with another automobile is an excluded addition under (d)(2) of this subdivision. Also the purchase of a sixth automobile is an expenditure for an additional identifiable unit of property and is an excluded addition under (d)(1) of this subdivision. An automobile air conditioner is also an identifiable unit of property for the purposes of (d)(1) of this subdivision, but not for the purposes of (d)(2) of this subdivision. Accordingly, the addition of an air conditioner to an automobile is an excluded addition under (d)(1) of this subdivision, but the replacement of an existing air conditioner in an automobile is not an excluded addition under (d)(2) of this subdivision (since it is merely the replacement of a part in an existing identifiable unit of property). The replacement of the air conditioner may, however, be an excluded addition under (e) of this subdivision, if the air conditioner replaced was retired in a retirement upon which gain or loss was recognized. The principles of this subdivision may be further illustrated by the following examples in which it is assumed (unless otherwise stated) that (e) of this subdivision does not apply:

Example (1). For the taxable year, B pays or incurs only the following expenditures: (1) \$5,000 for general maintenance of repair allowance property (as described in subdivision (iii) of this subparagraph) such as inspection, oiling, machine adjustments, cleaning, and painting; (2) \$175 for replacement of bearings and gears in an existing lathe; (3) \$125 for replacement of an electric starter (of the same capacity) and certain electrical wiring in an automatic drill press; (4) \$300 for modification of a metal fabricating machine (including replacement of certain parts) which substantially increases its capacity; (5) \$175 for repair of the same metal fabricating machine which does not substantially increase its capacity; (6) \$800 for the replacement of an existing lathe with a new lathe; and (7) \$65 for the repair of a drill press. Expenditures (1) through (3) are expenditures for the repair, maintenance, rehabilitation or improvement of property to which B can elect to apply the asset guideline class repair allowance described in subdivision (iii) of this subparagraph. Expenditure (4) is an excluded addition under (b) of this subdivision. Expenditure (5) is not an excluded addition. Expenditure (6) is an excluded addition under (d)(2) of this subdivision. Without regard to (a), (b), and (c) of this subdivision, expenditure (7) is not an excluded addition since the expenditure does not exceed \$100.

Example (2). Corporation M operates a steel plant which produces rails, blooms, billets, special bar sections, reinforcing bars, and large diameter line pipe. During the taxable year, corporation M: (1) relines an openhearth furnace; (2) places in service 20 new ingot molds; (3) replaces one reversing roll in the blooming mill; (4) overhauls the rail and billet mill with no increase in capacity; (5) replaces a roll stand in the 20-inch bar mill; and (6) overhauls the 11-inch bar mill and reducing stands increasing billet speed from 1,800 feet per minute to 2,300 feet per minute. Assume that each expenditure exceeds \$100. Expenditure (1) is not an excluded addition. Expenditure (2) is an excluded addition under (d)(1) of this subdivision. Expenditure (3) is not an excluded addition since the expenditure for the reversing roll merely replaces a part in an existing identifiable unit of property. Expenditure (4) is not an excluded addition. Expenditure (5) is an excluded addition under (d)(2) of this subdivision since the roll stand is not merely a part of an existing identifiable unit of property. Expenditure (6) is an excluded addition under (a) of this subdivision since it increases the billet speed by more than 25 percent.

Example (3). For the taxable year, corporation X pays or incurs the following expenditures: (1) \$1,000 for two new temporary partition walls in the company's offices; (2) \$1,400 for repainting the exterior of a terminal building; (3) \$300 for repair of the roof of a

warehouse; (4) \$150 for replacement of two window frames and panes in the warehouse; and (5) \$100 for plumbing repair. Expenditure (1) is an excluded addition under (d)(1) of this subdivision. None of the other expenditures are excluded additions.

Example (4). For the taxable year, corporation Y pays or incurs the following expenditures: (1) \$10,000 for expansion of a loading dock from 600 square feet to 750 square feet; (2) \$600 for replacement of two roof girders in a factory building; and (3) \$9,500 for replacement of columns and girders supporting the floor of a second story loft storage area within the factory building in order to permit storage of supplies with a gross weight 50 percent greater than the previous capacity of the loft. Expenditure (1) is an excluded addition under (f) of this subdivision. Expenditure (2) is not an excluded addition. Expenditure (3) is an excluded addition under (b) of this subdivision.

Example (5). Corporation A has an office building with an unadjusted basis of \$10 million. The building has 10 elevators, five of which are manually operated and five of which are automatic. During 1971, corporation A:

(1) Replaces the five manually operated elevators with highspeed automatic elevators at a cost of \$400,000;

(2) Replaces the cable in one of the existing automatic elevators at a cost of \$1,700. The replacements of the elevators are excluded additions under (d)(2) of this subdivision. The replacement of the cable is not an excluded addition.

Example (6). Taxpayer W, a cement manufacturer, engages in the following modification and maintenance activities during the taxable year: (1) Replaces eccentric-bearing, spindle, and wearing surface in a gyratory crusher; (2) places in service a new apron feeder and hammer mill; (3) replaces four buckets on a chain bucket elevator; (4) relines refractory surface in the burning zone of a rotary kiln; (5) installs additional new dust collectors; and (6) Replaces two 16-inch x 90-foot belts on his conveyer system. Assume that there is no increase in productivity or capacity and that each expenditure exceeds \$100. Expenditure (1) is not an excluded addition. Expenditure (2) an excluded addition under (d)(1) of this subdivision. Expenditures (3) and (4) are not excluded additions. Expenditures (5) is an excluded addition under (d)(1) of this subdivision. Expenditure (6) is not an excluded addition.

Example (7). Corporation X, a gas pipeline company, has, in addition to others, the following units of property: (1) A gathering pipeline for a field consisting of 25 gas wells; (2) the main transmission line between compressor stations (that is, in the case of a 500-mile main transmission line with a compressor station every 100 miles, each one hundred miles section between compressor

stations is a separate unit of property); (3) a lateral transmission line from the main transmission line to a city border station; (4) a medium pressure distribution line to the northern portion of the city; and (5) a low pressure distribution line serving a group of approximately 200 residential customers off the medium pressure distribution line. In 1971, corporation X pays or incurs the following expenditures in connection with the repair, maintenance, rehabilitation or improvement of repair allowance property: (1) replaces a meter on a gas well; (2) in connection with the repair and rehabilitation of a unit of property consisting of a 2-mile gathering pipeline, replaces a 3,000-foot section of the gathering line; (3) in connection with the repair of leaks in a unit of property consisting of a 100-mile gas transmission line (that is, the 100 miles between compressor stations), replaces a 2,000-foot section of pipeline at one point; and (4) at another point replaces a 7-mile section of the same 100-mile gas transmission line. Assume that none of these expenditures substantially increases capacity and that each expenditure exceeds \$100. Expenditure (1) is an excluded addition under (d) of this subdivision. Expenditure (2) is an excluded addition under (g) of this subdivision since the portion replaced is more than 5 percent of the unit of property. Expenditure (3) is not an excluded addition. Expenditure (4) is an excluded addition under (g) of this subdivision.

Example (8). Taxpayer Y, an electric utility company, has in addition to others, the following units of property: (1) A high voltage transmission circuit from the switching station (at the generating station) to the transmission station; (2) a series of 100 poles (fully dressed) supporting the circuit in (1); (3) a high voltage circuit from the transmission station to the distribution substation; (4) a high voltage distribution circuit (either radial or looped) from the distribution substation; (5) a transformer on a distribution pole; (6) a circuit breaker on a distribution pole; and (7) all 220 (and lower) volt circuit (including customer service connections) off the distribution circuit in (4). In 1971, taxpayer Y pays or incurs the following expenditures for the repair, maintenance, rehabilitation or improvement of repair allowance property: (1) Replaces 25 adjacent poles in a unit of property consisting of the 300 poles supporting a radial distribution circuit from a distribution substation; (2) replaces a transformer on one of the poles in (1); (3) replaces a cross-arm on one of the poles in (1); (4) replaces a 200-foot section of a 2-mile radial distribution circuit serving 100 residential customers; and (5) replaces a 2,000-foot section on a 10-mile high voltage circuit from a transmission station to a distribution substation which was destroyed by a casualty which taxpayer Y treated as an extraordinary retirement under paragraph

(d)(3)(ii) of this section. Expenditure (1) is an excluded addition under (g) of this subdivision. Expenditure (2) is an excluded addition under (d)(2) of this subdivision. Expenditures (3) and (4) are not excluded additions. Expenditure (5) is an excluded addition under (e) of this subdivision.

Example (9). Corporation Z, a telephone company, has in addition to others, the following units of property: (1) A buried feeder cable 3 miles in length off a local switching station; (2) a buried subfeeder cable 1 mile in length off the feeder cable in (1); (3) all the distribution cable (and customer service drops) off the subfeeder cable in (2); (4) the 300 poles (fully dressed) supporting the distribution cable in (3); (5) a 10-mile local trunk cable which interconnects two local tandem switching stations; (6) a toll connecting trunk cable from a local tandem switching station to a long distance tandem switching station; (7) a toll trunk cable 50 miles in length from the access point at one city to the access point at another city. In 1971, corporation Z pays or incurs the following expenditures in connection with the repair, maintenance, rehabilitation or improvement of repair allowance property: (1) replaces 100 feet of distribution cable in a unit of property consisting of 8 miles of local distribution cable (plus customer service drops); (2) replaces an amplifier in the distribution system; and (3) replaces 10 miles of a unit of property consisting of a toll trunk cable 50 miles in length. Expenditure (1) is not an excluded addition. Expenditure (2) is an excluded addition under (d)(2) of this subdivision. Expenditure (3) is an excluded addition under (g) of this subdivision.

(vii) *Definition of property improvement.* The term "property improvement" means—

(a) If the taxpayer treats expenditures for the asset guideline class under subdivision (iv) (a) of this subparagraph, the amount of all expenditures paid or incurred during the taxable year for the repair, maintenance, rehabilitation or improvement of repair allowance property in the asset guideline class, which exceeds the asset guideline class repair allowance for the taxable year; and

(b) If the taxpayer treats expenditures for the asset guideline class under subdivision (iv) (b) of this subparagraph, the amount of each expenditure paid or incurred during the taxable year for the repair, maintenance, rehabilitation or improvement of property which is treated under sections 162, 212, and 263 as a capital expenditure.

The term “property improvement” does not include any expenditure for an excluded addition.

(viii) *Treatment of property improvements and excluded additions.* If for the taxable year there is a property improvement as described in subdivision (vii) of this subparagraph or an excluded addition as described in subdivision (vi) of this subparagraph, the following rules shall apply—

(a) The total amount of any property improvement for the asset guideline class determined under subdivision (vii)(a) of this subparagraph shall be capitalized in a single “special basis vintage account” of the taxable year in accordance with the taxpayer’s election to apply this section for the taxable year (applied without regard to paragraph (b)(5)(v)(a) of this section). See subparagraph (3)(vi) of this paragraph for definition and treatment of a “special basis vintage account”.

(b) Each property improvement determined under subdivision (vii)(b) of this subparagraph, if it is eligible property, shall be capitalized in a vintage account of the taxable year in accordance with the taxpayer’s election to apply this section for the taxable year (applied without regard to paragraph (b)(5)(v)(a) of this section).

(c) Each excluded addition, if it is eligible property, shall be capitalized in a vintage account of the taxable year in accordance with the taxpayer’s election to apply this section for the taxable year.

For rule as to date on which a property improvement or an excluded addition is first placed in service, see paragraph (e)(1) (iii) and (iv) of this section.

(ix) *Examples.* The principles of this subparagraph may be illustrated by the following examples:

Example (1). For the taxable year 1972, B elects to apply this section. B has repair allowance property (as described in subdivision (iii) of this subparagraph) in asset guideline class 20.2 under Revenue Procedure 72-10 with an average unadjusted basis determined as provided in subdivision (iii) (a) of this subparagraph of \$100,000 and repair allowance property in asset guideline class 24.4 with an average unadjusted basis of \$300,000. The repair allowance percentage for asset guideline class 20.2 is 4.5 percent and for asset guideline class 24.4 is 6.5 percent. The two asset guideline class repair allowances for 1972 are

\$4,500 and \$19,500, respectively, determined as follows:

Asset Guideline Class 20.2	
\$100,000 average unadjusted basis multiplied by 4.5 percent	\$4,500
Asset Guideline Class 24.4	
\$300,000 average unadjusted basis multiplied by 6.5 percent	\$19,500

Example (2). The facts are the same as in example (1). During the taxable year 1972, B pays or incurs the following expenditures for the repair, maintenance, rehabilitation or improvement of repair allowance property in asset guideline class 20.2

General maintenance (including primarily labor costs)	\$3,000
Replacement of parts in several machines (including labor costs of \$1,650)	4,000
	7,000

In addition, in connection with the rehabilitation and improvement of two other machines B pays or incurs \$6,000 (including labor costs of \$2,000) which is treated as an excluded addition because the capacity of the machines was substantially increased. For 1972, B elects to apply this section and to apply the asset guideline class repair allowance to asset guideline class 20.2. Since the asset guideline class repair allowance is \$4,500, B can deduct \$4,500 in accordance with subdivision (iv) (a) of this subparagraph. B must capitalize \$2,500 in a special basis vintage account in accordance with subdivisions (vii) (a) and (viii) (a) of this subparagraph. Since the excluded addition is a capital item and is eligible property, B must also capitalize \$6,000 in a vintage account in accordance with subdivision (viii) (c) of this subparagraph. B selects from the asset depreciation range an asset depreciation period of 17 years for the special basis vintage account. B includes the excluded addition in a vintage account of 1972 for which he also selects an asset depreciation period of 17 years.

(3) *Treatment of retirements—(i) In general.* The rules of this subparagraph specify the treatment of all retirements from vintage accounts. The rules of § 1.167(a)-8 shall not apply to any retirement from a vintage account. An asset in a vintage account is retired when such asset is permanently withdrawn from use in a trade or business or in the production of income by the taxpayer. A retirement may occur as a result of a sale or exchange, by other act of the taxpayer amounting to a permanent disposition of an asset, or by physical abandonment of an asset. A

retirement may also occur by transfer of an asset to supplies or scrap.

(ii) *Definitions of ordinary and extraordinary retirements.* The term “ordinary retirement” means any retirement of section 1245 property from a vintage account which is not treated as an “extraordinary retirement” under this subparagraph. The retirement of an asset from a vintage account in a taxable year is an “extraordinary retirement” if—

(a) The asset is section 1250 property;

(b) The asset is section 1245 property which is retired as the direct result of fire, storm, shipwreck, or other casualty and the taxpayer, at his option consistently applied (taking into account type, frequency, and the size of such casualties) treats such retirements as extraordinary; or

(c)(i) The asset is section 1245 property which is retired (other than by transfer to supplies or scrap) in a taxable year as the direct result of a cessation, termination, curtailment, or disposition of a business, manufacturing, or other income producing process, operation, facility or unit, and (2) the unadjusted basis (determined without regard to subdivision (vi) of this subparagraph) of all such assets so retired in such taxable year from such account as a direct result of the event described in (c)(i) of this subdivision exceeds 20 percent of the unadjusted basis of such account immediately prior to such event.

For the purposes of (c) of this subdivision, all accounts (other than a special basis vintage account as described in subdivision (vi) of this subparagraph) containing section 1245 property of the same vintage in the same asset guideline class, and from which a retirement as a direct result of such event occurs within the taxable year, shall be treated as a single vintage account. See subdivision (xi) of this subparagraph for special rule for item accounts. The principles of this subdivision may be illustrated by the following examples:

Example (1). Taxpayer A is a processor and distributor of dairy products. Part of taxpayer A’s operation is a bottle washing facility consisting of machines X, Y, and Z, each of which is in an item vintage account of 1971. Each item vintage account has an unadjusted basis of \$1,000. Taxpayer A also

has a 1971 multiple asset vintage account consisting of machines E, S, and C. Machines E and S, used in processing butter, each has an unadjusted basis of \$10,000. Machine C used in capping bottles has an unadjusted basis of \$1,000. In 1975, taxpayer A changes to the use of paper milk cartons and disposes of all bottle washing machines (X, Y, and Z) as well as machine C which was used in capping bottles. The sales of machine C, X, Y, and Z are the direct result of the termination of a manufacturing process. However, since the total unadjusted basis of the eligible section 1245 property retired as a direct result of such event is only \$4,000 (which is less than 20 percent of the total unadjusted basis of machines E, S, C, X, Y, and Z, \$24,000) the sales are ordinary retirements. All the assets are in the same asset guideline class and are of the same vintage. Accordingly, machines E, S, C, X, Y, and Z are for this purpose treated as being in a single vintage account.

Example (2). The facts are the same as in example (1) except that in 1976, taxpayer A sells six of his 12 milk delivery trucks as a direct result of eliminating home deliveries to customers in the suburbs. Deliveries within the city require only six trucks. Each of the trucks has an unadjusted basis of \$3,000. Six of the taxpayer’s delivery trucks are in a multiple asset vintage account of 1974 and six are in a multiple asset vintage account of 1972. Neither account contains any other property. Four trucks are retired from the 1972 vintage account and two trucks are retired from the 1974 vintage account. The sales result from the curtailment of taxpayer A’s home delivery operation. The unadjusted basis of the four trucks retired from the 1972 vintage exceeds 20 percent of the total unadjusted basis of the affected account. The same is true for the two trucks retired from the 1974 vintage account. The sales of the trucks are extraordinary retirements.

(d) The asset is section 1245 property which is retired after December 30, 1980 by a charitable contribution for which a deduction is allowable under section 170.

(iii) *Treatment of ordinary retirements.* No loss shall be recognized upon an ordinary retirement. Gain shall be recognized only to the extent specified in this subparagraph. All proceeds from ordinary retirements shall be added to the depreciation reserve of the vintage account from which the retirement occurs. See subdivision (vi) of this subparagraph for optional allocation of basis in the case of a special basis vintage account. See subdivision (ix) of this subparagraph for recognition of

gain when the depreciation reserve exceeds the unadjusted basis of the vintage account. The amount of salvage value for a vintage account shall be reduced (but not below zero) as of the beginning of the taxable year by the excess of (a) the depreciation reserve for the account, after adjustment for depreciation allowable for such taxable year and all other adjustments prescribed by this section (other than the adjustment prescribed by subdivision (ix) of this subparagraph), over (b) the unadjusted basis of the account less the amount of salvage value for the account before such reduction. Thus, in the case of a vintage account with an unadjusted basis of \$1,000 and a salvage value of \$100, to the extent that proceeds from ordinary retirements increase the depreciation reserve above \$900, the salvage value is reduced. If the proceeds increase the depreciation reserve for the account to \$1,000, the salvage value is reduced to zero. The unadjusted basis of the asset retired in an ordinary retirement is not removed from the account and the depreciation reserve for the account is not reduced by the depreciation allowable for the retired asset. The previously unrecovered basis of the retired asset will be recovered through the allowance for depreciation with respect to the vintage account. See subdivision (v)(a) of this subparagraph for treatment of retirements on which gain or loss is not recognized in whole or in part. See subdivision (v)(b) of this subparagraph for treatment of retirements by disposition to a member of an affiliated group as defined in section 1504(a). See subdivision (v)(c) of this subparagraph for treatment of transfers between members of an affiliated group of corporations or other related parties as extraordinary retirements.

(iv) *Treatment of extraordinary retirements.* (a) Unless the transaction is governed by a special nonrecognition section of the Code such as 1031 or 337 or is one to which subdivision (v)(b) of this subparagraph applies, gain or loss shall be recognized upon an extraordinary retirement in the taxable year in which such retirement occurs subject to section 1231, section 165, and all other applicable provisions of law such as sections 1245 and 1250. If the asset

which is retired in an extraordinary retirement is the only or last asset in the account, the account shall terminate and no longer be an account to which this section applies. In all other cases, the unadjusted basis of the retired asset shall be removed from the unadjusted basis of the vintage account, and the depreciation reserve established for the account shall be reduced by the depreciation allowable for the retired asset computed in the manner prescribed in paragraph (c) (1)(v)(b) of this section for determination of the adjusted basis of the asset. See subdivision (ix) of this subparagraph for recognition of gain in the case of an account containing section 1245 property when the depreciation reserve exceeds the unadjusted basis of the vintage account. See subdivision (iii) of this subparagraph for reduction of salvage value for such an account when the depreciation reserve exceeds the unadjusted basis of the account minus salvage value. See subdivision (v)(b) of this subparagraph for treatment of retirements by disposition to a member of an affiliated group as defined in section 1504(a).

(b) The principles of this subdivision may be illustrated by the following examples:

Example (1). Corporation X has a multiple asset vintage account of 1971 consisting of assets K, R, A, and P all of which are section 1245 property. The unadjusted basis of the account is \$40,000. The unadjusted basis of asset A is \$10,000. When the reserve for depreciation for the account is \$20,000, asset A is sold in an extraordinary retirement for \$8,000 in cash. The \$10,000 unadjusted basis of asset A is removed from the account and the \$5,000 depreciation allowable for asset A is removed from the reserve for depreciation. Gain in the amount of \$3,000 (to which section 1245 applies) is recognized upon the sale of asset A.

Example (2). Corporation X has an item vintage account of 1972 consisting of residential apartment unit A. Unit A is section 1250 property. It is residential rental property and meets the requirements of section 167(j)(2). Corporation X adopts the declining balance method of depreciation using a rate twice the straight line rate. The asset depreciation period is 40 years. Unit A has an unadjusted basis of \$200,000. On June 30, 1974, when the reserve for depreciation for the account is \$19,500, unit A is sold for \$220,000. Since unit A is section 1250 property, the

sale is an extraordinary retirement in accordance with subdivision (ii)(a) of this subparagraph (without regard to subdivision (ii)(b) or (c) of this subparagraph). The adjusted basis of unit A is \$180,500. Gain in the amount of \$39,500 is recognized. The "additional depreciation" (as defined in section 1250(b)) for unit A is \$9,500. Accordingly, \$9,500 is in accordance with section 1250 treated as gain from the sale or exchange of an asset which is neither a capital asset nor property described in section 1231. The \$30,000 balance of the gain from the sale of unit A may be gain to which section 1231 applies.

(v) *Special rule for certain retirements.*

(a) In the case of an ordinary retirement on which gain or loss is in whole or in part not recognized because of a special nonrecognition section of the Code, such as 1031 or 337, no part of the proceeds from such retirement shall be added to the depreciation reserve of the vintage account in accordance with subdivision (iii) of this subparagraph. Instead, such retirement shall for all purposes of this section be treated as an extraordinary retirement.

(b) The provisions of §1.1502-13 shall apply to a retirement. In the case of an ordinary retirement to which the provisions of §1.1502-13 apply, no part of the proceeds from such retirement shall be added to the depreciation reserve of the vintage account in accordance with subdivision (iii) of this subparagraph. Instead, such retirement shall for all purposes of this section be treated as an extraordinary retirement.

(c) In a case in which property is transferred, in a transaction which would without regard to this subdivision be treated as an ordinary retirement, during the taxable year in which first placed in service to a person who bears a relationship described in section 179(d)(2) (A) or (B), such transfer shall for all purposes of this section be treated as an extraordinary retirement.

(d)(1) If, in the case of mass assets, it is impracticable for the taxpayer to maintain records from which he can establish the vintage of such assets as retirements occur, and if he adopts other reasonable recordkeeping practices, then the vintage of mass asset retirements may be determined by use of an appropriate mortality dispersion table.

Such a mortality dispersion table may be based upon an acceptable sampling of the taxpayer's actual experience or other acceptable statistical or engineering techniques. Alternatively, the taxpayer may use a standard mortality dispersion table prescribed by the Commissioner for this purpose. If the taxpayer uses such standard mortality dispersion table for any taxable year of election, it must be used for all subsequent taxable years of election unless the taxpayer obtains the consent of the Commissioner to change to another dispersion table or to actual identification of retirements. For information requirements regarding mass assets, see paragraph (f)(5) of this section.

(2) For purposes of this section, the term "mass assets" has the same meaning as when used in paragraph (e)(4) of §1.47-1.

(e) The principles of this subdivision may be illustrated by the following examples:

Example (1). Corporation X has a vintage account of 1971 consisting of machines A, B, and C, each with an unadjusted basis of \$1,000. The unadjusted basis of the account is \$3,000 and at the end of 1977 the reserve for depreciation is \$2,100. On January 1, 1978, machine A is transferred to corporation Y solely for stock in the amount of \$1,400 in a transaction to which section 351 applies. Since the adjusted basis of machine A is \$300, a gain of \$1,100 is realized, but no gain is recognized under section 351. Even though machine A was transferred in an ordinary retirement in accordance with (a) of this subdivision the rules for an extraordinary retirement are applied. The proceeds are not added to the reserve for depreciation for the account. Machine A is removed from the account, the unadjusted basis of the account is reduced by \$1,000, and the reserve for depreciation for the account is reduced by \$700.

Example (2). The facts are the same as in example (1) except that the consideration received for machine A is stock of corporation Y in the amount of \$1,200 and cash in the amount of \$200. The result is the same as in example (1) except that gain is recognized in the amount of \$200 all of which is gain to which section 1245 applies.

Example (3). The facts are the same as in example (1) except that machine A is sold for \$1,400 cash in an ordinary retirement and corporation X and corporation Y are includible corporations in an affiliated group as defined in section 1504(a) which files a consolidated return for 1978. Accordingly, (b) of this subdivision applies. The retirement is treated as an extraordinary retirement. Machine

Internal Revenue Service, Treasury

§ 1.167(a)-11

A is removed from the account, the unadjusted basis of the account is reduced by \$1,000, and the reserve for depreciation for the account is reduced by \$700. The gain of \$1,100 is deferred gain to which § 1.1502-13 applies.

(vi) *Treatment of special basis vintage accounts.* A "special basis vintage account" is a vintage account for an amount of property improvement determined under subparagraph (2) (vii)(a) of this paragraph. In general, reference in this section to a "vintage account" shall include a special basis vintage account. The unadjusted basis of a special basis vintage account shall be recovered through the allowance for depreciation in accordance with this section over the asset depreciation period for the account. Except as provided in this subdivision, the unadjusted basis, adjusted basis and reserve for depreciation of such account shall not be allocated to any specific asset in the asset guideline class, and the provisions of this subparagraph shall not apply to such account. However, in the event of a sale, exchange or other disposition of "repair allowance property" (as described in subparagraph (2)(iii) of this paragraph) in an extraordinary retirement as described in subdivision (ii) of this subparagraph (or if the asset is not in a vintage account, in an abnormal retirement as described in § 1.167(a)-8), the taxpayer may, if consistently applied to all such retirements in the taxable year and adequately identified in the taxpayer's books and records, elect to allocate the adjusted basis (as of the end of the taxable year) of all special basis vintage accounts for the asset guideline class to each such retired asset in the proportion that the adjusted basis of the retired asset (as of the beginning of the taxable year) bears to the adjusted basis of all repair allowance property in the asset guideline class at the beginning of the taxable year. The election to allocate basis in accordance with this subdivision shall be made on the tax return filed for the taxable year. The principles of this subdivision may be illustrated by the following example:

Example. In addition to other property, the taxpayer has machines A, B, and C all in the same asset guideline class and each with an

adjusted basis on January 1, 1977, of \$10,000. The adjusted basis on January 1, 1977, of all repair allowance property (as described in subparagraph (2)(iii) of this paragraph) in the asset guideline class is \$90,000. The machines are sold in an extraordinary retirement in 1977. The taxpayer is entitled to and does elect to allocate basis in accordance with this subdivision. There is also a 1972 special basis vintage account for the asset guideline class, as follows:

	Unadjusted basis	Reserve for depreciation	Dec. 31, 1977, adjusted basis
1972 special basis vintage account, for which the taxpayer selected an asset depreciation period of 10 years, adopted the straight line method, and used the half-year convention	\$2,000	\$1,100	\$900

By application of this subdivision, the adjusted basis of machines A, B, and C is increased to \$10,100 each (that is, $\$10,000 + \$90,000 \times \$900 = \100). The unadjusted basis, reserve for depreciation and adjusted basis of the special basis vintage account are reduced, respectively, by one-third (that is, $\$300 + \$900 = \frac{1}{3}$) in order to reflect the allocation of basis from the special basis vintage account.

(vii) *Reduction in the salvage value of a vintage account.* (a) A taxpayer may apply this section without reducing the salvage value for a vintage account in accordance with this subdivision or in accordance with subdivision (viii) of this subparagraph (relating to transfers to supplies or scrap). See subdivision (iii) of this subparagraph for reduction of salvage value in certain circumstances in the amount of proceeds from ordinary retirements.

(b) However, the taxpayer may, at his option, follow the consistent practice of reducing, as retirements occur, the salvage value for a vintage account by the amount of salvage value attributable to the retired asset, or the taxpayer may consistently follow the practice of so reducing the salvage value for a vintage account as extraordinary retirements occur while not reducing the salvage value for the account as ordinary retirements occur. If the taxpayer does not reduce the salvage value for a vintage account as ordinary retirements occur, the taxpayer

may be entitled to a deduction in the taxable year in which the last asset is retired from the account in accordance with subdivision (ix) (b) of this subparagraph.

(c) For purposes of this subdivision, the portion of the salvage value for a vintage account attributable to a retired asset may be determined by multiplying the salvage value for the account by a fraction, the numerator of which is the unadjusted basis of the retired asset and the denominator of which is the unadjusted basis of the account, or any other method consistently applied which reasonably reflects that portion of the salvage value for the account originally attributable to the retired asset.

(d) In the case of ordinary retirements the taxpayer may—

(1) In the case of retirements (other than by transfer to supplies or scrap) follow the consistent practice of reducing the salvage value for the account by the amount of salvage value attributable to the retired asset and not adding the same amount to the depreciation reserve for the account, and

(2) In the case of retirements by transfer to supplies or scrap, follow the consistent practice of reducing the salvage value for the account by the amount of salvage value attributable to the retired asset and not adding the same amount to the depreciation reserve for the account (in which case the basis in the supplies or scrap account of the retired asset will be zero) or follow the consistent practice of reducing the salvage value for the account by the amount of salvage value attributable to the retired asset and adding the same amount to the depreciation reserve for the account (up to an amount which does not increase the depreciation reserve to an amount in excess of the unadjusted basis of the account) in which case the basis in the supplies or scrap account of the retired asset will be the amount added to the depreciation reserve for the account.

Thus, for example, in the case of an ordinary retirement by transfer of an asset to supplies or scrap, the basis of the asset in the supplies or scrap account would either be zero or the amount added to the depreciation reserve of the vintage account from

which the retirement occurred. When the depreciation reserve for the account equals the unadjusted basis of the account no further adjustment to salvage value for the account will be made. See subdivision (viii) of this subparagraph for special optional rule for reduction of salvage value in the case of an ordinary retirement by transfer of an asset to supplies or scrap.

(e) In the event of a removal of property from a vintage account in accordance with paragraph (b)(4)(iii)(e), (5)(v)(b) or (6)(iii) of this section the salvage value for the account may be reduced by the amount of salvage value attributable to the asset removed determined as provided in (c) of this subdivision.

(viii) *Special optional adjustments for transfers to supplies or scrap.* If the taxpayer does not follow the consistent practice of reducing, as ordinary retirements occur, the salvage value for a vintage account in accordance with subdivision (vii) of this subparagraph, the taxpayer may (in lieu of the method described in subdivision (vii) (c) and (d) of this subparagraph) follow the consistent practice of reducing salvage value as ordinary retirements occur by transfer of assets to supplies or scrap and of determining the basis (in the supplies or scrap account) as assets retired in an ordinary retirement by transfer to supplies or scrap, in the following manner—

(a) The taxpayer may determine the value of the asset (not to exceed its unadjusted basis) by any reasonable method consistently applied (such as average cost, conditioned cost, or fair market value) if such method is adequately identified in the taxpayer's books and records.

(b) The value attributable to the asset determined in accordance with (a) of this subdivision shall be subtracted from the salvage value for the account (to the extent thereof) and the greater of (1) the amount subtracted from the salvage value for the vintage account and (2) the value of the asset determined in accordance with (a) of this subdivision, shall be added to the reserve for depreciation of this vintage account.

(c) The amount added to the reserve for depreciation of the vintage account

in accordance with (b) of this subdivision shall be treated as the basis of the retired asset in the supplies or scrap account.

If the taxpayer makes the adjustments in accordance with this subdivision, the reserve for depreciation of the vintage account may exceed the unadjusted basis of the account, and in that event gain will be recognized in accordance with subdivision (ix) of this subparagraph.

(ix) *Recognition of gain or loss in certain situations.* (a) In the case of a vintage account for section 1245 property, if at the end of any taxable year after adjustment for depreciation allowable for such taxable year and all other adjustments prescribed by this section, the depreciation reserve established for such account exceeds the unadjusted basis of the account, the entire amount of such excess shall be recognized as gain in such taxable year. Such gain—

(1) Shall constitute gain to which section 1245 applies to the extent that it does not exceed the total amount of depreciation allowances in the depreciation reserve at the end of such taxable year, reduced by gain recognized pursuant to this subdivision with respect to the account previously treated as gain to which section 1245 applies, and

(2) May constitute gain to which section 1231 applies to the extent that it exceeds such total amount as so reduced.

In such event, the depreciation reserve shall be reduced by the amount of gain recognized, so that after such reduction the amount of the depreciation reserve is equal to the unadjusted basis of the account.

(b) In the case of an account for section 1245 property, if at the time the last asset in the vintage account is retired the unadjusted basis of the account exceeds the depreciation reserve for the account (after all adjustments prescribed by this section), the entire amount of such excess shall be recognized in such taxable year as a loss under section 165 or as a deduction for depreciation under section 167. If the retirement of such asset occurs by sale or exchange on which gain or loss is recognized, the amount of such excess may constitute a loss subject to sec-

tion 1231. Upon retirement of the last asset in a vintage account, the account shall terminate and no longer be an account to which this section applies. See subdivision (xi) of this subparagraph for treatment of certain multiple asset and item accounts.

(c) The principles of this subdivision may be illustrated by the following example:

Example. The taxpayer has a vintage account for section 1245 property with an unadjusted basis of \$1,000 and a depreciation reserve of \$700 (of which \$600 represents depreciation allowances and \$100 represents the proceeds of ordinary retirements from the account). If \$500 is realized during the taxable year from ordinary retirements of assets from the account, the reserve is increased to \$1,200, gain is recognized to the extent of \$200 (the amount by which the depreciation reserve before further adjustment exceeds \$1,000) and the depreciation reserve is then decreased to \$1,000. The \$200 of gain constitutes gain to which section 1245 applies. If the amount realized from ordinary retirements during the year had been \$1,100 instead of \$500, the gain of \$800 would have consisted of \$600 of gain to which section 1245 applies and \$200 of gain to which section 1231 may apply.

(x) *Dismantling cost.* The cost of dismantling, demolishing, or removing an asset in the process of a retirement from the vintage account shall be treated as an expense deductible in the year paid or incurred, and such cost shall not be subtracted from the depreciation reserve for the account.

(xi) *Special rule for treatment of multiple asset and item accounts.* For the purposes of subdivision (ix)(b) of this subparagraph, all accounts (other than a special basis vintage account as described in subdivision (vi) of this subparagraph) of the same vintage in the same asset guideline class for which the taxpayer has selected the same asset depreciation period and adopted the same method of depreciation, and which contain only section 1245 property permitted by paragraph (b)(3)(ii) of this section to be included in the same vintage account, shall be treated as a single multiple asset vintage account.

(4) *Examples.* The principles of this paragraph may be illustrated by the following examples:

Example (1). (a) Taxpayer A has a multiple asset vintage account for selection 1245 property with an unadjusted basis of \$1,000. All the assets were first placed in service by A on January 15, 1971. This account contains all of A's assets in a single asset guideline class. A elects to apply this section for 1971 and adopts the modified half-year convention. A estimates a salvage value for the account of \$100 and this estimate is determined to be reasonable. (See subparagraph (1)(v) of this paragraph for limitation on adjustment of reasonable salvage value.) A adopts the straight line method of depreciation with respect to the account and selects a 10-year asset depreciation period. A does not follow a practice of reducing the salvage value for the account in the amount of salvage value attributable to each retired asset in accordance with subparagraph (3)(vii) of this paragraph. The depreciation allowance for each of the first 4 years is \$100, that is $\frac{1}{10}$ multiplied by the unadjusted basis of \$1,000, with reduction for salvage.

(b) In the fifth year of the asset depreciation period, three assets are sold in an ordinary retirement for \$300. Under paragraph (c)(1)(ii) of this section and subparagraph (3)(iii) of this paragraph, the proceeds of the retirement are added to the depreciation reserve as of the beginning of the fifth year. Accordingly, the reserve as of the beginning of the fifth year is \$700, that is, \$400 of depreciation as of the beginning of the year plus \$300 proceeds from ordinary retirements. The depreciation allowance for the fifth year is \$100, that is $\frac{1}{10}$ multiplied by the unadjusted basis of \$1,000, without reduction for salvage. Accordingly, the depreciation reserve at the end of the fifth year is \$800.

(c) In the sixth year, asset X is sold in an extraordinary retirement for \$30 and gain or loss is recognized. Under the first-year convention used by the taxpayer, the unadjusted basis of X, \$300, is removed from the unadjusted basis of the vintage account as of the beginning of the sixth year and the depreciation reserve as of the beginning of such year is reduced to \$650 by removing the depreciation applicable to asset X, \$150 (see subparagraph (3)(iv) of this paragraph). Since the depreciation reserve (\$650) exceeds the unadjusted basis of the account (\$700) minus salvage value (\$100) by \$50, under subparagraph (3)(iii) of this paragraph, salvage value is reduced by \$50. No depreciation is allowable for the sixth year.

(d) In the seventh year, an asset is sold in an ordinary retirement for \$110. This would increase the reserve as of the beginning of the seventh year to \$760 and under subparagraph (3)(iii) of this paragraph the salvage value is reduced to zero. Under subparagraph (3)(ix)(a) of this paragraph the depreciation reserve is then decreased to \$700 (the unadjusted basis of the account) and \$60 is reported as gain, without regard to the ad-

justed basis of the asset. No depreciation is allowable for the seventh year since the depreciation reserve (\$700) equals the unadjusted basis of the account (\$700).

(e)(1) In the eighth year, A elects to apply this section and to treat expenditures during the year for repair, maintenance, rehabilitation or improvement under subparagraph (2)(iii) and (iv)(a) of this paragraph (the "guideline class repair allowance"). This results in the treatment of \$300 as a property improvement for the asset guideline class. (See subparagraph (2)(vii) of this paragraph for definition of a property improvement.) The property improvement is capitalized in a special basis vintage account of the eighth taxable year (see subparagraph (2)(viii)(a) of this paragraph). A selects an asset depreciation period of 10 years and adopts the straight line method for the special basis vintage account. A adopts the modified half-year convention for the eighth year.

(2) In the eighth year, A sells asset Y in an ordinary retirement for \$175. Under paragraph (c)(1)(ii) of this section and subparagraph (3)(iii) of this paragraph, \$175 is added to the depreciation reserve for the account as of the beginning of the taxable year. Since the depreciation reserve for the account (\$875) exceeds the unadjusted basis of the account (\$700) by \$175, that amount of gain is recognized under subparagraph (3)(ix) of this paragraph. Upon recognition of gain in the amount of \$175, the depreciation reserve for the account is reduced to \$700.

(3) No depreciation is allowable in the eighth year for the vintage account since the depreciation reserve (\$700) equals the unadjusted basis of the account (\$700). The depreciation allowable in the eighth year for the special basis vintage account is \$15, that is, unadjusted basis of \$300, multiplied by $\frac{1}{10}$, the asset depreciation period selected for the special basis vintage account, but limited to \$15 under the modified half-year convention. (See paragraph (e)(1)(iv) of this section for treatment of \$150 of the property improvement as first placed in service in the first half of the taxable year and \$150 of the property improvement as first placed in service in the last half of the taxable year.)

Example (2). Taxpayer B has a 1971 multiple asset vintage account for section 1245 property with an unadjusted basis of \$100,000. B selects from the asset depreciation range an asset depreciation period of 10 years and adopts the straight line method of depreciation and the modified half-year convention. B establishes a salvage value for the account of \$10,000. All the assets in the account are first placed in service on January 15, 1971. B follows the practice of reducing salvage value for the account as ordinary retirements occur in accordance with subparagraph (3)(vii) of this paragraph, but does not follow the optional practice of determining the basis of assets transferred to supplies or

scrap in accordance with subparagraph (3)(vii) of this paragraph. No retirements occur during the first five years. The depreciation reserve at the beginning of the sixth year is \$50,000. In the sixth year an asset with an unadjusted basis of \$20,000 is transferred to supplies in an ordinary retirement. By application of subparagraph (3)(vii) (c) and (d)(2) of this paragraph B determines the reduction in salvage value for the account attributable to such asset to be

$$\begin{aligned} & \$2,000 \text{ (that is, } \$20,000 \div \$100,000 \times \$10,000 = \\ & \quad \$2,000). \end{aligned}$$

B reduces the salvage value for the account by \$2,000 and adds 2,000 to the depreciation reserve for the account. The basis of the retired asset in the supplies account is \$2,000. The depreciation allowable for the account for the sixth year is \$10,000. The depreciation reserve for the account at the beginning of the seventh year is \$62,000. At the mid-point of the seventh year all the remaining assets in the account are sold in an ordinary retirement for \$20,000, which is added to the depreciation reserve as of the beginning of the seventh year, thus increasing the reserve to \$82,000. The \$5,000 depreciation allowable for the account for the seventh year (one-half of a full-year's depreciation of \$10,000) increases the depreciation reserve to \$87,000. Under subparagraph (3)(ix)(b) of this paragraph, a loss of \$13,000 subject to section 1231 is realized in the seventh year (that is, the excess of the unadjusted basis of \$100,000 over the depreciation reserve of \$87,000). No depreciation is allowable for the account after the mid-point of the seventh year since all the assets are retired and the account has terminated.

(e) *Accounting for eligible property—* (1) *Definition of first placed in service—*(i) *In general.* The term “first placed in service” refers to the time the property is first placed in service by the taxpayer, not to the first time the property is placed in service. Property is first placed in service when first placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity, or in a personal activity. In general, the provisions of paragraph (d)(1)(ii) and (d)(2) of § 1.46-3 shall apply for the purpose of determining the date on which property is placed in service, but see subdivision (ii) of this subparagraph for special rule for certain replacement parts. In the case of a building which is intended to house machinery and equipment and which is constructed, reconstructed, or

erected by or for the taxpayer and for the taxpayer's use, the building will ordinarily be placed in service on the date such construction, reconstruction, or erection is substantially complete and the building is in a condition or state of readiness and availability. Thus, for example, in the case of a factory building, such readiness and availability shall be determined without regard to whether the machinery or equipment which the building houses, or is intended to house, has been placed in service. However, in an appropriate case, as for example where the building is essentially an item of machinery or equipment, or the use of the building is so closely related to the use of the machinery or equipment that it clearly can be expected to be replaced or retired when the property it initially houses is replaced or retired, the determination of readiness or availability of the building shall be made by taking into account the readiness and availability of such machinery or equipment. The date on which depreciation begins under a convention used by the taxpayer or under a particular method of depreciation, such as the unit of production method or the retirement method, shall not determine the date on which the property is first placed in service. See paragraph (c)(2) of this section for application of a first-year convention to determine the allowance for depreciation of property in a vintage account.

(ii) *Certain replacement parts.* Property (such as replacement parts) the cost or other basis of which is deducted as a repair expense in accordance with the asset guideline repair allowance described in paragraph (d)(2)(iii) of this section shall not be treated as placed in service.

(iii) *Property improvements and excluded additions.* (a) Except as provided in (b) of this subdivision, a property improvement determined under paragraph (d)(2)(vii)(b) of this section, and an excluded addition (other than an excluded addition referred to in the succeeding sentence) is first placed in service when its cost is paid or incurred. The general rule in subdivision (i) of this subparagraph applies to an

excluded addition described in paragraph (d) (2)(vi) (d), (e), (f), or (g) of this section.

(b) If a property improvement or an excluded addition to which the first sentence of (a) of this subdivision applies is paid or incurred in part in one taxable year and in part in the succeeding taxable year (or in part in the first half of a taxable year and in part in the last half of the taxable year) the taxpayer may at his option consistently treat such property improvements and excluded additions under the general rule in subdivision (i) of this subparagraph.

(iv) *Certain property improvements.* In the case of an amount of property improvement determined under paragraph (d)(2)(vii)(a) of this section, one-half of such amount is first placed in service in the first half of the taxable year in which the cost is paid or incurred and one-half is first placed in service in the last half of such taxable year.

(v) *Special rules for clearing accounts.* In the case of public utilities which consistently account for certain property through "clearing accounts," the date on which such property is first placed in service shall be determined in accordance with rules to be prescribed by the Commissioner.

(2) *Special rules for transferred property.* If eligible property is first placed in service by the taxpayer during a taxable year of election, and the property is disposed of before the end of the taxable year, the election for such taxable year shall include such property unless such property is excluded in accordance with paragraph (b)(5) (iii), (iv), (v), (vi), or (vii) of this section.

(3) *Special rules in the case of certain transfers—(i) Transaction to which section 381(a) applies.* (a) In general the acquiring corporation in a transaction to which section 381(a) applies is for the purposes of this section treated as if it were the distributor or transferor corporation.

(b) If the distributor or transferor corporation (including any distributor or transferor corporation of any distributor or transferor corporation) has made an election to apply this section to eligible property transferred in a transaction to which section 381(a) applies, the acquiring corporation must

segregate such eligible property (to which the distributor or transferor corporation elected to apply this section) into vintage accounts as nearly coextensive as possible with the vintage accounts created by the distributor or transferor corporation identified by reference to the year the property was first placed in service by the distributor or transferor corporation. The asset depreciation period for the vintage account in the hands of the distributor or transferor corporation must be used by the acquiring corporation. The method of depreciation adopted by the distributor or transferor corporation, shall be used by the acquiring corporation unless such corporation obtains the consent of the Commissioner to use another method of depreciation in accordance with paragraph (e) of §1.446-1 or changes the method of depreciation under paragraph (c)(1)(iii) of this section.

(c) The acquiring corporation may apply this section to the property so acquired only if the distributor or transferor corporation elected to apply this section to such property.

(d) See paragraph (b)(7) of this section for special rule for certain property where there is a mere change in the form of conducting a trade or business.

(ii) *Partnerships, trusts, estates, donees, and corporations.* Except as provided in subdivision (i) of this subparagraph with respect to transactions to which section 381(a) applies and subdivision (iv) of this subparagraph with respect to certain transfers between members of an affiliated group of corporations or other related parties, if eligible property is placed in service by an individual, trust, estate, partnership or corporation, the election to apply this section shall be made by the individual, trust, estate, partnership or corporation placing such property in service. For example, if a partnership places in service property contributed to the partnership by a partner, the partnership may elect to apply this section to such property. If the partnership does not make the election, this section will not apply to such property. See paragraph (b)(7) of this section for special rule for certain property where there is mere change in

the form of conducting a trade or business.

(iii) *Leased property.* The asset depreciation range and the asset depreciation period for eligible property subject to a lease shall be determined without regard to the period for which such property is leased, including any extensions or renewals of such period. See paragraph (b)(5)(v) of this section for exclusion of property amortized under paragraph (b) of § 1.162-11 from an election to apply this section. In the case of a lessor of property, unless there is an asset guideline class in effect for lessors of such property, the asset guideline class for such property shall be determined as if the property were owned by the lessee. However, in the case of an asset guideline class based upon the type of property (such as trucks or railroad cars) as distinguished from the activity in which used, the property shall be classified without regard to the activity of the lessee. Notwithstanding the preceding sentence, if a lease with respect to property, which would be includible in an asset guideline class based upon the type of property under the preceding sentence (such as trucks or railroad cars), is entered into after March 12, 1971, and before April 23, 1973, or a written contract to execute such a lease is entered into during such period and such contract is binding on April 23, 1973, and at all times thereafter, and if the rent or rate of return is based on a classification of such property as if it were owned by the lessee, then such property shall be classified as if it were owned by the lessee. However, the preceding sentence shall not apply if pursuant to the terms or conditions of the lease or binding contract the rent or rate of return may be adjusted to take account of a change in the period for depreciation with respect to the property resulting from inclusion of the property in an asset guideline class based upon the type of property rather than in an asset guideline class based upon the activity of the lessee. Similarly, where the terms of such a lease or contract provide that the obligation of the taxpayer to enter into the lease is subject to a condition that the property be included in an asset guideline class based upon the activity of the les-

see, the contract or lease will not be considered as binding upon the taxpayer, for purposes of this subdivision. See paragraph (b)(4)(iii)(b) of this section for general rule for classification of property according to primary use.

(iv) *Treatment of certain transfers between members of affiliated groups or other related persons.* If section 38 property in an asset guideline class (determined without regard to whether the taxpayer elects to apply this section) is transferred by the taxpayer to a person who bears a relationship described in section 179(d)(2) (A) or (B), such property is in the same asset guideline class in the hands of transferee, and the transfer is neither described in section 381(a) nor treated as a disposition or cessation within the meaning of section 47, then the asset guideline period for such property selected by the taxpayer under this section shall not be shorter than the period used for computing the qualified investment with respect to the property under section 46(c). In a case in which the asset depreciation range for the asset guideline class which includes such property does not include the period for depreciation used by the transferor in computing the qualified investment with respect to such property, the transferee will not be permitted to include such property in an election under this section. However, in such a case, the transferor of the property may recompute the qualified investment for the year the property was placed in service using a period for depreciation which falls within the asset depreciation range.

(f) *Election with respect to eligible property—(1) Time and manner of election—(i) In general.* An election to apply this section to eligible property shall be made with the income tax return filed for the taxable year in which the property is first placed in service (see paragraph (e)(1) of this section) by the taxpayer. In the case of an affiliated group of corporations (as defined in section 1504(a)) which makes a consolidated return with respect to income tax in accordance with section 1502 and the regulations thereunder, each corporation which joins in the making of such return may elect to apply this section for a taxable year. An election to compute the allowance for depreciation under

this section is a method of accounting but the consent of the Commissioner will be deemed granted to make an annual election. For election by a partnership see section 703 (b) and paragraph (e)(3)(ii) of this section. If the taxpayer does not file a timely return (taking into account extensions of the time for filing) for the taxable year in which the property is first placed in service, the election shall be filed at the time the taxpayer files his first return for that year. The election may be made with an amended return filed within the time prescribed by law (including extensions) for filing the original return for the taxable year of election. If an election is not made within the time and in the manner prescribed in this paragraph, no election may be made for such taxable year (by the filing of an amended return or in any other manner) with respect to any eligible property placed in service in the taxable year.

(ii) *Other elections under this section.* All other elections under this section may be made only within the time and in the manner prescribed by subdivision (i) of this subparagraph with respect to an election to apply this section.

(iii) *Effective date.* See paragraph (f)(6) of this section for the effective date of this paragraph.

(2) *Information required.* A taxpayer who elects to apply this section must specify in the election:

(i) That the taxpayer makes such election and consents to and agrees to apply, all the provisions of this section;

(ii) The asset guideline class for each vintage account of the taxable year;

(iii) The first-year convention adopted by the taxpayer for the taxable year of election;

(iv) Whether the special 10 percent used property rule described in paragraph (b)(5)(iii) of this section has been applied to exclude used property from the election;

(v) Whether the taxpayer elects to apply the asset guideline class repair allowance described in paragraph (d)(2)(iii) of this section;

(vi) Whether the taxpayer elects for the taxable year to allocate the adjusted basis of a special basis vintage

account in accordance with paragraph (d)(3)(vi) of this section;

(vii) Whether any eligible property for which the taxpayer was not required or permitted to make an election was excluded because of the special rules of paragraph (b)(5)(v) or (6), or paragraph (e)(3)(i) or (iv) of this section;

(viii) Whether any "section 38 property" was excluded under paragraph (b)(5)(iv) of this section from the election to apply this section;

(ix) If the taxpayer is an electric or gas utility, whether the taxpayer elects to apply this section on the basis of a composite asset guideline class in accordance with paragraph (b)(4)(iii)(a) of this section; and

(x) Such other information as may reasonably be required.

The information required under this subparagraph may be provided in accordance with rules prescribed by the Commissioner for reasonable grouping of assets or accounts. Form 4832 is provided for making an election and for submission of the information required. An election may be made and the information submitted only in accordance with Form 4832. An election to apply this section will not be rendered invalid under this subparagraph so long as there is substantial compliance, in good faith, with the requirements of this subparagraph.

(3) *Irrevocable election.* An election to apply this section to eligible property for any taxable year may not be revoked or changed after the time for filing the election prescribed under subparagraph (1) of this paragraph has expired. No other election under this section may be revoked or changed after such time unless expressly provided for under this section. (See paragraph (b)(5)(v)(b) of this section for special rule.)

(4) *Special conditions to election to apply this section—*(1) *Maintenance of books and records.* The taxpayer may not elect to apply this section for a taxable year unless the taxpayer maintains the books and records required under this section. In addition to any other information required under this section, the taxpayer's books and records must specify—

(a) The asset depreciation period selected by the taxpayer for each vintage account;

(b) If the taxpayer applies the modified half-year convention, the total cost or other basis of all eligible property first placed in service in the first half of the taxable year and the total cost or other basis of all eligible property first placed in service in the last half of the taxable year;

(c) The unadjusted basis and salvage value for each vintage account, and the amount, if any, by which gross salvage value was decreased under section 167(f);

(d) Each asset guideline class for which the taxpayer elects to apply the asset guideline class repair allowance described in paragraph (d)(2)(iii) of this section;

(e) The amount of property improvement, determined under paragraph (d)(2)(vii)(a) of this section, for each asset guideline class for which the taxpayer elects to apply the asset guideline class repair allowance;

(f) A reasonable description of property excluded from an election to apply this section and the basis for the exclusion;

(g) The total unadjusted basis of all assets retired during the taxable year from each asset guideline class, and the proceeds realized during the taxable year from such retirements; and

(h) The vintage (that is, the taxable year in which established) of the assets retired during the year from each asset guideline class.

For purposes of paragraph (f)(4)(i) (g) and (h) of this section, all accounts of the same vintage and asset guideline class may be treated as a single account. The taxpayer must specify the information required under paragraph (f)(4)(i) (g) and (h) without regard to the retirement of an asset by transfer to a supplies account for reuse.

(ii) *Response to survey.* Taxpayers who elect to apply this section must respond to infrequent data surveys conducted by the Treasury Department. These periodic surveys, which will be conducted on the basis of scientifically sound sampling methods, are designed to obtain data (including industry asset acquisitions and retirements)

used to keep the asset guideline classes and periods up to date.

(iii) *Effect of noncompliance.* An election to apply this section will not be rendered invalid under this subparagraph so long as there is substantial compliance, in good faith, with the requirements of this subparagraph.

(5) *Mass assets.* In the case of mass assets, if the taxpayer assigns retirements to vintage accounts in the manner provided in paragraph (d)(3)(v)(c) of this section, the following information must be supplied with form 4832:

(i) Whether the taxpayer used the standard mortality dispersion curve or a curve based upon his own experience, and

(ii) Such other reasonable information as may be required by the Commissioner.

(6) *Effective date.* The rules in this paragraph apply to elections for taxable years ending on or after December 31, 1978. In the case of an election for a taxable year ending before December 31, 1978, the rules in paragraph (f) of this section, in effect before the amendments made by T.D. 7593 approved January 11, 1979, shall apply. See 26 CFR § 1.167(a)-11(f) (1977) for paragraph (f) of this section as it appeared before the amendments made by T.D. 7593.

(g) *Relationship to other provisions—(1) Useful life—(i) In general.* Except as provided in subdivision (ii) of this subparagraph, an election to apply this section to eligible property constitutes an agreement under section 167(d) and this section to treat the asset depreciation period for each vintage account as the useful life of the property in such account for all purposes of the Code, including sections 46, 47, 48, 57, 163(d), 167(c), 167(f)(2), 179, 312(m), 514(a), and 4940(c). For example, since section 167(c) requires a useful life of at least 3 years and the asset depreciation period selected is treated as the useful life for purposes of section 167(c), the taxpayer may adopt a method of depreciation described in section 167(b) (2) or (3) for an account only if the asset depreciation period selected for the account is at least 3 years.

(ii) *Special rules.* (a) For the purposes of paragraph (d) of this section, the anticipated period of use (estimated at

the close of the taxable year in which the asset is first placed in service) on the basis of which salvage value is estimated, shall be determined without regard to the asset depreciation period for the property.

(b) For the purposes of sections 162 and 263 and the regulations thereunder, whether an expenditure prolongs the life of an asset shall be determined on the basis of the anticipated period of use of the asset (estimated at the close of the taxable year in which the asset is first placed in service) without regard to the asset depreciation period for such asset.

(c) The determination whether a transaction with respect to qualified property constitutes a sale or a lease of such property shall be made without regard to the asset depreciation period for the property.

(d) The principles of this subdivision may be illustrated by the following example:

Example. Corporation X has assets in asset guideline class 32.3 which are used in the manufacture of stone and clay products. The asset depreciation range for assets in asset guideline class 32.3 is from 12 to 18 years. Assume that corporation X selects 14 years as the asset depreciation period for all assets in asset guideline class 32.3. Under paragraph (d)(1)(i) of this section, corporation X must estimate salvage value on the basis of the anticipated period of use of the property (determined as of the close of the taxable year in which the property is first placed in service). The anticipated period of use must also be used for purposes of sections 162 and 263 in determining whether an expenditure materially prolongs the useful life of an asset. The anticipated period of use of an asset is determined without regard to the asset depreciation period of 14 years. Corporation X has, among other assets in the asset guideline class, machines A, B, and C. Corporation X estimates the anticipated period of use of machines A, B, and C as 8 years, 14 years, and 22 years, respectively. These estimates are reasonable and will be used for estimating salvage value and for purposes of sections 162 and 263.

(2) *Section 167(d) agreements.* If the taxpayer has, prior to January 1, 1971, entered into a section 167(d) agreement which applies to any eligible property, the taxpayer will be permitted to withdraw the eligible property from the agreement provided that an election is made to apply this section to such

property. The statement of intent to withdraw eligible property from such an agreement must be made in an election filed for the taxable year in which the property is first placed in service. The withdrawal, in accordance with this subparagraph, of any eligible property from a section 167(d) agreement shall not affect any other property covered by such an agreement.

(3) *Relationship to the straight line method—(i) In general.* For purposes of determining the amount of depreciation which would be allowable under the straight line method of depreciation, such amount shall be computed with respect to any property in a vintage account using the straight line method in the manner described in paragraph (c)(1)(i) of this section and a rate based upon the period for the vintage account selected from the asset depreciation range. Thus, for example, section 57(a)(3) requires a taxpayer to compute an amount using the straight line method of depreciation if the taxpayer uses an accelerated method of depreciation. For purposes of section 57(a)(3), the amount for property in a vintage account shall be computed using the asset depreciation period for the vintage account selected from the asset depreciation range. In the case of property to which the taxpayer does not elect to apply this section, such amount computed by using the straight line method shall be determined under § 1.167(b)-1 without regard to this section.

(ii) *Examples.* The principles of this subparagraph may be illustrated by the following example:

Example. (a) Corporation X places a new asset in service to which it elects to apply this section. The cost of the asset is \$200,000 and the estimated salvage value is zero. The taxpayer selects 9 years from the applicable asset depreciation range of 8 to 12 years. Corporation X adopts the double declining balance method of depreciation and thus the rate of depreciation is 22.2 percent (twice the applicable straight line rate). The depreciation allowance in the first year would be \$44,400, that is, 22.2 percent of \$200,000.

(b) Assume that the provisions of section 57(a)(3) apply to the property. The amount of the tax preference would be \$22,200, that is, the excess of the depreciation allowed under this section (\$44,400) over the depreciation which would have been allowable if the taxpayer had used the period selected from the

Internal Revenue Service, Treasury

§ 1.167(a)-12

asset depreciation range and the straight line rate (\$22,200).

(Secs. 167(m), 85 Stat. 508 (26 U.S.C. 167(m)) and 7805, 68A Stat. 917, (26 U.S.C. 7805))

[T.D. 7272, 38 FR 9967, Apr. 23, 1973]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.167(a)-11, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and on GPO Access.

§ 1.167(a)-12 Depreciation based on class lives for property first placed in service before January 1, 1971.

(a) *In general*—(1) *Summary*. This section provides an elective class life system for determining the reasonable allowance for depreciation of certain classes of assets for taxable years ending after December 31, 1970. The system applies only to assets placed in service before January 1, 1971. Depreciation for such assets during periods prior to January 1, 1971, may have been determined in accordance with Revenue Procedure 62-21. Accordingly, rules are provided which permit taxpayers to apply the system in taxable years ending after December 31, 1970, to such assets without the necessity of changing or regrouping their depreciation accounts other than as previously required by Revenue Procedure 62-21. The system is designed to minimize disputes between taxpayers and the Internal Revenue Service as to the useful life of assets, salvage value, and repairs. See § 1.167(a)-11 for a similar system for property placed in service after December 31, 1970. See paragraph (d)(2) of § 1.167(a)-11 for treatment of expenditures for the repair, maintenance, rehabilitation or improvement of certain property. The system provided by this section is optional with the taxpayer. An election under this section applies only to qualified property in an asset guideline class for which an election is made and only for the taxable year of election. The taxpayer's election is made with the income tax return for the taxable year. This section also revokes the reserve ratio test for taxable years ending after December 31, 1970, and provides transitional rules for taxpayers who after January 11, 1971, adopt Revenue Procedure 62-21 for a taxable year ending prior to January 1, 1971.

(2) *Revocation of reserve ratio test and other matters*. Except as otherwise expressly provided in this section and in paragraph (b)(5)(vi) of § 1.167(a)-11, the provisions of Revenue Procedure 62-21 shall not apply to any property for any taxable year ending after December 31, 1970, whether or not the taxpayer elects to apply this section to any property. See paragraph (f) of this section for rules for the adoption of Revenue Procedure 62-21 for taxable years ending prior to January 1, 1971.

(3) *Definition of qualified property*. The term "qualified property" means tangible property which is subject to the allowance for depreciation provided by section 167(a), but only if—

(i) An asset guideline class and asset guideline period are in effect for such property for the taxable year, and

(ii) The property is first placed in service by the taxpayer before January 1, 1971.

(iii) The property is placed in service before January 1, 1971, but first placed in service by the taxpayer after December 31, 1970, and is not includible in an election under § 1.167(a)-11 by reason of § 1.167(a)-11(b)(7) (property acquired as a result of a mere change in form) or § 1.167(a)-11(e)(3)(i) (certain property acquired in a transaction to which section 381(a) applies), or

(iv) The property is acquired and first placed in service by the taxpayer after December 31, 1970, pursuant to a binding written contract entered into prior to January 1, 1971, and is excluded in accordance with paragraph (b)(5)(iv) of § 1.167(a)-11 from an election to apply § 1.167(a)-11.

The provisions of paragraph (e)(1) of § 1.167(a)-11 apply in determining whether property is first placed in service before January 1, 1971. See subparagraph (4)(ii) of this paragraph for special rules for the exclusion of property from the definition of qualified property.

(4) *Requirements of election*—(i) *In general*. An election to apply this section to qualified property must be made within the time and in the manner specified in paragraph (e) of this section. The election must specify that the taxpayer consents to and agrees to apply all the provisions of this section. The election may be made separately