1995-1 C.B. 20; T.D. 8584;
*1995 IRB LEXIS 1822, **

DEPARTMENT OF THE TREASURY

Treasury Decision 8584

Capitalization of Interest

1995-1 C.B. 20; **T.D. 8584;** 1995 IRB LEXIS 1822

January 1995

[*1]

SUBJECT MATTER: Section 263A.-Capitalization and Inclusion in Inventory Costs of Certain Expenses

APPLICABLE SECTIONS:

26 CFR 1.263A-0: Outline of regulations under section 263A. Internal Revenue Service 26 CFR Parts 1 and 602

TEXT:

AGENCY:

Internal Revenue Service (IRS), Treasury.

ACTION:

Final regulations.

SUMMARY:

This document contains final regulations relating to the requirement to capitalize interest with respect to the production of property. The regulations provide guidance necessary for taxpayers to comply with the requirement to capitalize interest with respect to certain produced property.

EFFECTIVE DATE:

January 1, 1995.

SUPPLEMENTAL INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3504 (h)) under control number 1545-1265. The estimated average annual burden per recordkeeper is 14 minutes. The estimated average annual reporting burden per respondent is 2 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service,** Attn: IRS Reports Clearance Officer PC:FP, **[*2]** Washington DC 20224, and to the **Office of Management and Budget,** Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington DC 20503.

Background

On Friday, August 16, 1991, the **Federal Register** published proposed amendments (56 FR 40815 [IA-120-86, 1991-2 C.B. 999]) to the Income Tax Regulations (26 CFR part 1) under section 263A (f) of the Internal Revenue Code (Code). Written comments responding to the notice were received and a public hearing was held on November 20, 1991. After careful consideration of all the comments, the proposed amendments are adopted, except as revised and renumbered by this document.

IN GENERAL

The uniform capitalization rules of section 263A generally require the capitalization of certain costs relating to the acquisition of property for resale or the production of property. Interest is a cost subject to section 263A. Section 263A (f) provides special rules for capitalizing interest.

In general, section 263A (f) limits the capitalization of interest to interest that is paid or incurred during the production period of certain property (referred to as designated property). Designated property includes all real **[*3]** property and certain tangible personal property.

The amount of interest required to be capitalized is determined using the avoided cost method. Under the avoided cost method, interest on any indebtedness directly attributable to production expenditures for designated property (traced debt) is capitalized first. If production expenditures for designated property exceed the amount of traced debt, interest on any other debt is capitalized to the extent such interest could have been reduced if production expenditures had not been incurred. The application of the avoided cost method does not depend on whether the taxpayer actually would have used amounts expended for production to repay or reduce debt. Instead, the avoided cost method is based on the assumption that if production expenditures had not been incurred, debt of the taxpayer would have been repaid or reduced without regard to the taxpayer's subjective intentions or to restrictions against repayment or use of the debt proceeds.

For example, if Corporation X has incurred $1.5 million of production expenditures for a unit of real property it is constructing, and has an outstanding $1 million loan (from an unrelated party) for the **[*4]** construction of the real property, Corporation X must capitalize interest on the loan as provided in section 263A (f). In addition, because Corporation X has production expenditures ($1.5 million) that exceed traced debt ($1 million), Corporation X must capitalize interest on any other debt (subject to certain limitations) as provided in section 263A (f). In general, to determine the amount of interest it must capitalize on its other debt, Corporation X multiplies its excess production expenditures ($.5 million) by a weighted average interest rate for its other debt.

Public Comments

SIMPLIFICATION

The proposed regulations include several provisions designed to reduce administrative complexity without undermining the principles of section 263A (f). These provisions include (1) a de minimis rule exempting certain insignificant production activities from the requirement to capitalize interest; (2) an exception from the requirement to capitalize interest for inventory property that has a class life of 20 years or more but does not satisfy the other classification thresholds for tangible personal property; (3) an election not to trace debt to designated property; (4) an election to calculate **[*5]** interest under the avoided cost method on a taxable year basis in lieu of a monthly or more frequent basis; and (5) a simplified method to calculate the amount of interest required to be capitalized with respect to certain inventory property.

Commentators made several suggestions for further simplifying the proposed rules. As discussed in more detail below, the final regulations add a number of these simplifying suggestions. For example, the final regulations permit certain small taxpayers to use a specified external rate as a substitute for the weighted average interest rate. In addition, the final rules make the 3-month, $10,000 de minimis rule of the proposed regulations more flexible by increasing the dollar threshold for production expenditures to $1 million divided by the number of days in the production period. Further, the final regulations shorten the time required to qualify for the suspension rule from 12 months to 120 consecutive days and apply the suspension rule retroactively.

DESIGNATED PROPERTY

In general

Designated property includes all real property produced by the taxpayer. Tangible personal property produced by the taxpayer is also designated property, but only if it **[*6]** has a class life of 20 years or more, an estimated production period of more than 1 year and total production costs of more than $1 million, or an estimated production period of more than 2 years.

De minimis exception

The proposed regulations provide a de minimis exception from interest capitalization for property that would otherwise be designated property. This exception applies if the property has a production period that does not exceed 3 months and a total cost of production that does not exceed $10,000.

Commentators recommended a number of changes to this de minimis rule. Several commentators argued that the proposed de minimis rule should be liberalized by either applying the production period and cost thresholds in the disjunctive or increasing the thresholds. One commentator recommended that, in addition to a de minimis rule for property, the final regulations should provide a "small taxpayer" exception.

The final regulations revise the 3 month, $10,000 de minimis rule. The revised rule liberalizes the de minimis rule and provides more flexibility in its application by adopting a dollarday rule. As revised the de minimis rule excepts from interest capitalization property with **[*7]** a production period of not more than 90 days and a total cost of production that does not exceed $1,000,000 divided by the number of days in the production period. The final regulations, however, do not adopt a small taxpayer exception.

Commentators also recommended that interest that would be capitalized if property were designated property be excluded from production costs in determining whether the $10,000 threshold of the proposed de minimis rule is met. The final regulations adopt this recommendation for purposes of determining production expenditures under the revised de minimis rule.

Definition of real property

The proposed regulations provide that real property includes land, unsevered natural products of land, buildings, and inherently permanent structures. An inherently permanent structure is property that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time.

Certain commentators believed that the proposed definition of real property is too broad. They argued that the section 263A (f) regulations should define real property to exclude property classified as section 1245 property, as well as property classified or treated as personal **[*8]** property for investment tax credit purposes (former section 48).

Neither section 263A (f) nor its legislative history expressly defines "real property." Nevertheless, the IRS and Treasury do not believe it is necessary or appropriate to define "real property" as narrowly as some commentators have suggested.

Section 1245 provides for the recapture of the benefit of accelerated depreciation on, or amortization with respect to, certain property. Congress clearly intended to classify certain real property as property subject to the section 1245 rules. See section 1245 (a) (3) (B) and (C). Nothing in either section 263A (f) or its legislative history (or in section 189, the predecessor of section 263A (f), and its legislative history) suggests Congress intended to exclude real property subject to section 1245 from the definition of real property for purposes of interest capitalization. See S. Rep. No. 169, 98th Cong., 2d Sess. 1-280 n. 19 (1984).

Congress intended that the benefit of the investment tax credit apply expansively under former section 48. See H. Rep. No. 1447, 87th Cong., 2d Sess. (1962) 1962-3 C.B. 405, 415. Consistent with this intent, tangible personal property was not to be **[*9]** defined narrowly and was not to follow state law. Id. Nothing in the legislative history of section 263A (f) suggests, however, that Congress intended that such a broad definition of personal property be adopted for interest capitalization purposes.

Some commentators interpreted certain language in proposed § 1.263A (f)-1 (relating to the classification of property for purposes of former section 48 and § 1.48-1 (c) and § 1.48-1 (d)) to provide that property that would otherwise be an inherently permanent structure under section 263A (f) (i.e., because it is affixed to real property and will ordinarily remain affixed for an indefinite period of time) is not an inherently permanent structure under section 263A (f) if such property would constitute property in the nature of machinery under the principles of former section 48 and § 1.48-1 (c).

As indicated above, however, the IRS and Treasury do not believe that the classification or treatment of property as personal property for purposes of former section 48 should be determinative of the classification of property as personal property for purposes of section 263A (f). Accordingly, the final regulations provide that a structure may be an **[*10]** inherently permanent structure, and not property in the nature of machinery or essentially an item of machinery, even if the structure is necessary to operate or use, supports, or is otherwise associated with machinery.

Classification thresholds for personal property

Under the proposed regulations, designated property includes tangible personal property that is (i) property with a class life of 20 years or more, but only if produced for self-use, (ii) property with an estimated production period exceeding 2 years (2-year property), or (iii) property with an estimated production period exceeding 1 year and a cost exceeding $1 million (1-year property). Commentators made recommendations regarding the $1 million cost threshold for 1-year property and the production period thresholds for 1-year and 2-year property produced under a contract.

One commentator recommended the final regulations clarify whether interest that would be required to be capitalized if property were designated property is taken into account in determining whether the production costs for property exceed the $1 million production costs threshold. The final regulations clarify that such interest is not taken into account **[*11]** in determining whether property is designated property.

Classification thresholds for personal property produced under a contract

In the case of tangible personal property produced under a contract, the proposed regulations require the contractor and the customer each to determine whether the 1-year and 2-year production period thresholds are satisfied. For this purpose, the proposed regulations require the customer to treat the production period as beginning on the earlier of the date the contract is executed or the date the customer's accumulated production expenditures are at least 5 percent of the customer's total estimated production expenditures (contract date rule). One commentator recommended that a customer be allowed to elect to use the contract date rule, and in the absence of an election, treat the production period as beginning when the customer's accumulated production expenditures are at least 5 percent of the total estimated production expenditures.

The final regulations retain the contract date rule. However, to address commentators' concerns, the final regulations provide that a customer may elect to determine the 1-and 2-year production period thresholds by treating **[*12]** the customer's production period as beginning on the date that aggregate accumulated production expenditures for both the contractor and the customer are at least 5 percent of the customer's estimated production expenditures for the property. The IRS and Treasury believe that a 5-percent rule based only on production expenditures incurred by a customer could be abused (e.g. a customer could avoid designated property classification and, thus, interest capitalization by simply withholding payments to the contractor).

Definition of a contract

Section 263A (g) (2) provides that the taxpayer shall be treated as producing any property produced for the taxpayer under a contract with the taxpayer. The final regulations under section 263A (relating to the capitalization of costs other than interest) published in the Federal Register on August 9, 1993, reserved the definition of a contract for this purpose.

The preamble to those regulations stated that the definition of a contract was being studied under the section 263A (f) regulations. Commentators believed that the definition of a contract provided in the proposed regulations under section 263A (f) should be modified, for example, to exclude **[*13]** routine purchase orders.

For purposes of determining whether property is produced under a contract, the final regulations define a contract as any agreement providing for the production of property if the agreement is entered into before the production of the property to be delivered under the contract is completed. Whether an agreement exists depends on all the facts and circumstances. Facts and circumstances to be taken into account include making a prepayment, or entering into an arrangement to make a prepayment, for property prior to the date of completion of the production of property or incurring significant expenditures for property of specialized design or specialized application.

In response to commentators' concerns, the amendments to the final regulations provide that a routine purchase order for the production of fungible property is not a contract for purposes of section 263A (g) (2). Under this rule, an agreement will not be treated as a routine purchase order for the production of fungible property if the seller is required to make more than de minimis modifications to the property to tailor it to the customer's specific needs, or if at the time the agreement is entered **[*14]** into, the customer knows or has reason to know that the seller cannot satisfy the agreement within 30 days out of existing stocks and normal production of finished goods.

THE AVOIDED COST METHOD

In general

The proposed regulations require taxpayers to use the avoided cost method described in proposed § 1.263A (f)-2 to calculate the amount of interest required to be capitalized under section 263A (f). A number of commentators argued that, for purposes of capitalizing interest under section 263A (f), taxpayers should be permitted to elect to use Statement of Financial Accounting Standards No. 34 (SFAS 34), which establishes standards for capitalizing interest for financial statement purposes.

Congress indicated that it intended interest to be capitalized under the avoided cost method, using rules similar to those applicable under former section 189. See S. Rep. No. 313, 99th Cong., 2d

Sess. 144 (1986). Former section 189 applied rules similar to those contained in Financial Accounting Standards Board (FASB) Statement No. 34. H. R. Conf. Rep. No. 760, 97th Cong., 2d Sess. 484-85 (1982). The proposed section 263A (f) regulations adopt an approach similar to the rules in SFAS 34 in that they **[*15]** treat interest that would have been avoided if production expenditures had been used to repay indebtedness of the taxpayer as interest subject to capitalization.

Although the proposed regulations use an approach similar to SFAS 34, the IRS and Treasury are not persuaded that the regulations should be changed to permit the use of the financial accounting rules of SFAS 34 instead of the avoided cost method in the proposed regulations. The IRS and Treasury believe that the results obtained by applying SFAS 34 could diverge significantly from the results obtained by applying tax principles. For example, differences in the amount of interest capitalized could result because: the bases of assets for book and tax purposes differ; SFAS 34 allows more discretion and subjectivity (e.g., in identifying borrowings used to determine interest capitalization) than does the statute; and materiality standards used under financial accounting rules may not be acceptable for tax purposes. Accordingly, the final regulations do not permit the use of SFAS 34 as an alternative to the avoided cost method set forth in the regulations.

Accounts payable and simplification rule for tracing

Under the proposed regulations, **[*16]** the calculation of the amount of interest required to be capitalized is made by reference to eligible debt. Eligible debt generally includes all debt of the taxpayer on which interest is deductible in computing taxable income. However, noninterest bearing debt is excluded from the definition of eligible debt unless the debt is traced debt (or, if the taxpayer makes an election not to trace debt, is debt that would have been treated as traced debt in the absence of such an election).

Commentators indicated that noninterest bearing debt such as accounts payable should be treated as eligible debt whether or not the debt is traced to the accumulated production expenditures of designated property.

The IRS and Treasury continue to believe that treating all noninterest bearing debt as eligible debt is inconsistent with Congressional intent. Such treatment is not similar to the FASB 34 rule and would distort the interest capitalization rate. The final regulations, therefore, maintain the treatment prescribed in the proposed regulations.

Some commentators believed that it is administratively impracticable or virtually impossible for certain taxpayers to determine the noninterest bearing debt traced **[*17]** to the accumulated production expenditures of designated property. These commentators recommended that, if the regulations do not treat all accounts payable as eligible debt, the regulations should provide a simplification measure under which a taxpayer may "deem" a certain portion of noninterest bearing debt as constituting traced debt.

One commentator suggested a safe harbor under which the amount of noninterest bearing debt deemed to be traced debt would be that portion of accounts payable equal to the ratio of the production expenditures for designated property over the production expenditures for all property. The IRS and Treasury believe that this recommendation would not sufficiently approximate the portion of noninterest bearing debt that is traced debt for all or certain segments of taxpayers. Moreover, the IRS and Treasury were unable to establish a workable safe harbor. Finally, except for immaterial amounts, taxpayers must perform the same sort of tracing to adjust production expenditures for noninterest bearing accounts payable when they prepare financial statements. Under SFAS 34, the expenditures that attract interest capitalization include only expenditures requiring **[*18]** the payment of cash, the transfer of other assets, or the incurring of a liability on which interest is charged. Accordingly, the final regulations do not adopt a safe harbor under which a certain portion of noninterest bearing debt would be deemed traced debt.

Interest capitalized on traced debt

Under the avoided cost method in the proposed regulations, the interest capitalized on debt traced to the accumulated production expenditures for a unit of designated property includes the interest on the traced debt for the entire measurement period for any measurement period in which production occurs (traced debt amount).

Commentators objected to this rule because the production period of a unit may not begin on the first day of the first measurement period of the production period and may not end on the last day of the last measurement period of the production period. In these situations, the commentators argued that only interest incurred on traced debt for the actual number of days encompassing the production period of a unit should constitute the traced debt amount.

The IRS and Treasury believe that the proposed traced debt amount rule is an appropriate simplification measure. Moreover, **[*19]** a taxpayer desiring a more precise traced debt amount can effect greater precision by choosing more frequent measurement dates. Under the proposed rule, taxpayers can choose their measurement periods, the choice is not a method of accounting, and taxpayers may change measurement periods each taxable year. Accordingly, the final regulations adopt the proposed traced debt amount rule without change.

External rate-substitute for weighted average interest rate

The avoided cost method involves the capitalization of two amounts of interest with respect to a unit of property: (1) an amount of interest with respect to traced debt, and (2) an amount of interest with respect to nontraced debt. The amount of interest required to be capitalized with respect to nontraced debt is determined by multiplying the accumulated production expenditures that exceed traced debt for a unit (excess expenditures) by the weighted average interest rate determined on all eligible debt of a taxpayer other than traced debt (nontraced debt).

To simplify the interest capitalization computation with respect to nontraced debt, commentators suggested that the final regulations permit taxpayers to elect to use an external **[*20]** rate as a substitute for the weighted average interest rate. Most commentators suggested the election of a rate based on the applicable federal rate (AFR). Certain commentators believed that small taxpayers, at a minimum, should be allowed this simplifying election.

The IRS and Treasury believe that an election to use an external rate as a substitute for the weighted average interest rate on nontraced debt would generally be inappropriate because of the difficulty in establishing a suitable external rate for all taxpayers. Accordingly, the final regulations do not adopt the recommendation to permit all taxpayers to elect to use an external rate as a substitute for the weighted average interest rate.

The final regulations do, however, permit certain small taxpayers to elect to use the highest AFR under section 1274 (d) in effect during the computation period plus 3 percentage points (AFR plus 3) as a substitute for the weighted average interest rate. A taxpayer may elect to use the AFR plus 3 for a taxable year if the average annual gross receipts of the taxpayer (or any predecessor) for the preceding 3 taxable years do not exceed $10,000,0000 (the $10,000,000 gross receipts test), and **[*21]** the taxpayer has met the $10,000,000 gross receipts test for all prior taxable years beginning after December 31, 1994. The rules of § 1.263A-3 (b) apply in determining whether a taxpayer satisfies the $10,000,000 gross receipts test. A taxpayer making the AFR plus 3 election may not trace debt.

NOTIONAL PRINCIPAL CONTRACTS

The treatment of notional principal contracts and other derivatives under section 263A (f) is reserved in the final regulations.

DEFINITION OF UNIT OF PROPERTY

The proposed regulations provide that a unit includes any components owned by the taxpayer or a related party that are functionally interdependent. Components of property are functionally interdependent when the placing in service of one component is dependent on the placing in service of one or more other components.

Certain commentators recommended that the final regulations adopt the definition of a unit provided under § 1.167 (a)-11 (d) (2) (vi), which defines a unit of property for purposes of applying the elective alternative depreciation (ADR) repair allowance provisions. Section 1.167 (a)-11 (d) (2) (vi) defines a unit to include each operating unit that performs a discrete function and that a taxpayer **[*22]** customarily acquires for original installation and retires as a unit. Commentators argued that taxpayers are already familiar with this definition of a unit.

The IRS and Treasury believe that section 263A (f) and its legislative history indicate that property includes the functionally interdependent components of property. Congress repealed former section 189 (relating to the capitalization of interest and taxes during the construction period of real property) and enacted the more expansive, uniform capitalization rules under section 263A (f). Under former section 189, an entire building (including the land component) was property to which interest was capitalized. See H.R. Conf. Rep. No. 760, 97th Cong., 2d Sess. 48 (1982). The IRS and Treasury believe that Congress did not intend that property be defined more narrowly under section 263A (f) than under former section 189. Accordingly, under section 263A (f), property also includes an entire building (including the land component), as the aggregation of functionally interdependent components of property. Section 263A (f) defines property uniformly, and therefore, property in all circumstances includes the functionally interdependent **[*23]** components of property.

Treating the functionally interdependent components of property as a single property for interest capitalization is consistent with the concept of a single property that applies under section 167 in determining the date on which components of a single property are placed in service. As the commentators recognized, this concept of a single property may differ from the concept of a single or separate property that taxpayers use for other purposes (e.g., for computing amounts of depreciation deductions or separately tracking the bases of assets).

The § 1.167 (a)-11 (d) (2) (vi) definition of a unit may not encompass the functionally interdependent components of property. This definition of a unit applied for purposes of applying the alternative depreciation (ADR) repair allowance provisions, which were elective. The provisions provided a simplification procedure for treating a taxpayer's expenditures as either capitalized expenditures or deductible expenses. Taxpayers that elected the provisions, and used this § 1.167 (a)-11 (d) (2) (vi) definition of a unit, were required to use the same standard that other taxpayers used in determining the date on which property **[*24]** was placed in service (i.e., the standard consistent with the concept of a single property as an aggregation of functionally interdependent components). Accordingly, the final regulations do not adopt commentators' recommendation to modify the definition of a unit of property.

COMMON FEATURE RULES

Land attributable to benefitted property

Under the proposed regulations, an allocable share of a common feature that benefits real property and the real property being benefitted are a single unit of real property (common feature rule). The production period for the entire unit begins when production begins on either the benefitted real property or a common feature allocable to the unit. Thus, commencing production on only a common feature results in interest being capitalized not only on the costs of the common feature but also on the costs of land underlying the benefitted property.

Commentators argued that the proposed common feature rule produces harsh consequences. For example, when construction commences on a single common feature that benefits each house in a housing development, interest capitalization commences on all land in the housing development even if no direct production activity **[*25]** has been undertaken on any house. Commentators also indicated that the proposed interest suspension rule provides insufficient relief in these circumstances. Under the proposed regulations, interest capitalization may be suspended prospectively for a unit only when production activities have ceased for the unit for at least a 12-month period. Thus, in the case of the housing development described above, the proposed regulations would require interest on land costs attributable to the houses to be capitalized from the commencement of construction of the common feature until the 13th month after its completion. Interest capitalization would be required with respect to those costs for that period even if no direct production activity will be undertaken on the houses for several years.

The final regulations continue to provide that the allocable share of a common feature and the benefitted property are a single unit of real property, but provide two new rules in response to the commentators' concerns. Under the first new rule, the land costs of the benefitted property are not treated as included in the accumulated production expenditures for the unit (i.e., are not treated as included in **[*26]** the costs that attract interest capitalization) until a direct production activity commences on the benefitted property. Thus, for example, if no direct production activities have been undertaken on planned houses, such as clearing and grading activities on the land underlying the houses, the cost of the land underlying the houses is not treated as included in the accumulated production expenditures for the unit. This treatment is permitted until direct production activities begin on the houses, even though the production periods for the house units have begun because production has begun on common features benefitting the houses. The second new rule provides that if after clearing and grading has been undertaken with respect to the land attributable to the benefitted property (the land underlying the houses in the above example), there is no direct production activity taken with respect to the benefitted property for a period of at least 120 consecutive days, the accumulated production expenditures attributable to the benefitted property are treated as not included in the accumulated production expenditures of the unit from the first measurement period after the beginning of the 120-day **[*27]** period until the measurement period in which direct production activity resumes with respect to the benefitted property.

Benefitted property completed

The proposed regulations indicate that, when benefitted property is sold or placed in service prior to the completion of a common feature allocable to a unit, the costs of the benefitted property and allocable common features no longer attract interest capitalization. See § 1.263A-10 (b) (6), Example 5.

Commentators suggested that the final regulations provide a rule under which the costs of a benefitted property would not be included in accumulated production expenditures when the benefitted property is completed prior to the completion of a common feature included in the unit, irrespective of whether such benefitted property is sold or placed in service.

The IRS and Treasury believe the exception provided in the proposed regulations should not be extended to cases where a benefitted property is not sold or placed in service prior to the completion of the common feature. Accordingly, the final regulations do not adopt the commentators' recommendation.

Rev. Proc. 92-29, 1992-1 C.B. 748, permits a developer to include in the basis of properties **[*28]** sold their allocable share of the estimated cost of common improvements without regard to whether the costs are incurred under section 461 (h) of the Code, relating to economic performance. As of the end of any taxable year, however, the total amount of common improvement costs included in the basis of the properties sold may not exceed the amount of common improvement costs that have been incurred under section 461 (h) ("the alternative cost limitation"). The final regulations clarify that Rev. Proc. 92-29 does not affect the determination of accumulated production expenditures of unsold units even if the costs of common improvements for those unsold units have been used to determine the alternative cost limitation for purposes of including common improvement costs in the basis of sold units.

UTILITIES-CONSTRUCTION WORK IN PROCESS

Under the proposed regulations, the accumulated production expenditures for a unit of property (i.e, the costs that attract interest capitalization) generally include the amount of the direct and indirect costs that are required to be capitalized with respect to the unit.

Certain commentators indicated that if construction work in process (CWIP) is included **[*29]** in rate base for ratemaking purposes (of utilities, for example), the CWIP should be excluded from the accumulated production expenditures. These commentators pointed out that in enacting section 263A (f), Congress intended to match the interest incurred in producing property with the related income from property. These commentators argued that by including CWIP in rate base for ratemaking purposes, income is currently taken into account, and that to match interest with its related income, the interest attributable to CWIP should be currently deductible. They believed that to achieve this match, CWIP should be excluded from accumulated production expenditures.

Under the avoided cost method of section 263A (f), CWIP expenditures are incurred with respect to property produced, and no statutory exception excludes them from the production expenditures for property. The legislative history of section 263A (f) indicates that the avoided cost method is intended to apply to a taxpayer, such as a regulated utility company, irrespective of whether the method is required, authorized, or considered appropriate under financial or regulatory accounting principles. See H.R. Conf. Rep. No. 841, 99th **[*30]** Cong., 2d Sess. 11-309 (1986). CWIP is therefore intended to be included in the production expenditures for property produced, and interest capitalized with respect to CWIP is intended to become a cost of the property produced, which is recovered as the property is used in the taxpayer's trade or business. Moreover, the suggestion that the commentators urge the IRS and Treasury to adopt in the final regulations is inconsistent with the rules that apply to determine the date on which CWIP is placed in service for depreciation purposes and is inconsistent with the rules that apply under broader section 263A provisions to capitalize other direct and indirect costs to CWIP during periods for which the commentators argue the CWIP is generating income.

Further, the commentators' suggestion would not present a consistent resolution to the matching concerns that the commentators argue exist with respect to the treatment of CWIP within regulated utilities industries. Interest incurred prior to the beginning of the production period on CWIP that is not included in rate base, for example, presents matching concerns that would not be resolved by the commentators' suggestion. For this and the other **[*31]** reasons summarized above, the commentators' suggestion has not been adopted in the final regulations.

As an alternative suggestion, commentators urged the IRS and Treasury to adopt a book conformity rule for the treatment of interest on CWIP. This suggestion was not adopted, however, for principally the same reasons that the use of the SFAS 34 computation as a substitute for section 263A (f) avoided cost computations was not adopted. Additionally, the difference between the regulatory accounting for CWIP and the required statutory treatment of CWIP under section 263A (f) is but one example of the many inconsistencies between regulatory and tax accounting (some of which were illustrated above). Therefore, the IRS and Treasury believe it would be inappropriate to adopt a book conformity rule for interest capitalization alone given the existence of these other inconsistencies.

IMPROVEMENTS TO REAL PROPERTY

Property taken out of service

The proposed regulations provide special rules for determining the accumulated production expenditures for an improvement to existing real property. The accumulated production expenditures for an improvement include all direct and indirect costs required to **[*32]** be capitalized with respect to the improvement, plus an allocable portion of the cost of associated land. Additionally, the adjusted bases of any existing structure or common features that directly benefit or are incurred by reason of the improvement are included in the accumulated production expenditures if they either are not already placed in service or must be taken out of service in order to complete the improvement.

Commentators indicated that sometimes property must be temporarily disconnected or otherwise taken out of service for health, safety, or regulatory reasons in order to make certain improvements (e.g., a power generating facility must be taken out of service in order to make capital improvements). Commentators suggested that the regulations provide that property is taken out of service only if the property is taken out of service for depreciation purposes.

The final regulations do not adopt the suggestion concerning when property should be considered taken out of service. However, the final regulations provide a de minimis rule for property taken out of service. Under the de minimis rule, the aggregate costs of all property or common features taken out of service to **[*33]** complete an improvement (associated property costs) are excluded from the accumulated production expenditures for the improvement unit during its production period if, on the date the production period of the unit begins, the taxpayer reasonably expects that on no date during the production period of the unit will the accumulated production expenditures for the unit, determined without regard to associated property costs, exceed 5 percent of associated property costs.

Inclusion of land

The proposed regulations provide that an improvement to existing real property includes the allocable portion of land associated with the improvement. As such, the basis of land may be included in the accumulated production expenditures for more than one unit of designated property. For example, a portion of the basis of land included in the accumulated production expenditures for a building unit must also be included in the accumulated production expenditures for a separate tenant improvement unit.

Commentators objected to this rule. They suggested that, once land was included in the accumulated production expenditures for a unit of property, it should not be included in the accumulated production expenditures **[*34]** for any other unit of property.

Section 263A (f) (4) (C) provides that the production expenditures for property include all capitalized costs of property, whether or not those costs are incurred during the production period of property. Land expenditures are part of the capitalized costs of property, and land costs should be included in the accumulated production expenditures for property during its production period, even if they are incurred before the production period. Accordingly, the final regulations do not adopt the commentators' recommendation.

END OF THE PRODUCTION PERIOD-CUSTOMIZING ACTIVITIES

The proposed regulations provide that the production period generally ends for a unit of property that will be held for sale on the date the unit is ready to be held for sale and all production activities reasonably expected to be undertaken with respect to the unit are completed. The proposed regulations provide that the production period generally ends for a unit of property produced for selfuse on the date the unit is ready to be placed in service and all production activities reasonably expected to be undertaken with respect to the unit are completed.

Commentators believe it is unfair **[*35]** for the production period to continue for a residential or commercial unit that is complete except for activities relating to "de minimis" production expenditures for customized features chosen by a buyer or lessee. These features, which include carpeting, cabinets, appliances, wall coverings, and flooring, are often not added to a unit until an identified buyer or lessee selects the features, or the unit is sold. These commentators recommended that the production period should end for a unit when only "de minimis" customizing activities remain to be performed.

The final regulations do not adopt this recommendation, however, because the IRS and Treasury continue to believe that customizing activities are production activities and that the production period does not end until these activities are completed. Nevertheless, a shortened, retroactive suspension period rule adopted in the final regulations (and explained below) will provide relief in situations that involve long periods of delay in the performance of customizing activities.

SUSPENSION PERIOD

The proposed regulations provide that, when production activities related to the production of a unit of designated property cease for **[*36]** a period of 12 consecutive months, the capitalization of interest is not required (i.e., is suspended) for the period beginning with the 13th month of cessation. The suspension period ends when production activities resume. For administrative convenience, the proposed regulations use an objective time test, and therefore, the reasons for suspending production are not considered.

Commentators believed that the rule in the proposed regulations unduly delays the suspension of interest capitalization. They argued that a taxpayer should not have to wait 12 months before suspending interest capitalization if production activities cease for reasons such as strikes, fires, or natural disasters. Some commentators believed that the determination of whether activities have ceased should be a facts and circumstances test and that interest capitalization should be suspended in the month following the cessation of production activities. Others argued that the cessation period should be only 3 or 4 months. Still others argued that, if the 12-month cessation period is retained, the suspension of interest capitalization should apply retroactively as of the first month of cessation.

In response to these **[*37]** comments, the final regulations shorten the cessation period from 12 consecutive months to 120 consecutive days and, once the cessation period is satisfied, permit taxpayers to retroactively suspend interest capitalization as of the first measurement period following the measurement period in which production activities ceased. Alternatively, if the cessation period spans more than one taxable year, and a taxpayer does not want to file an amended return for the prior year, the taxpayer may suspend the capitalization of interest with respect to its units of designated property beginning with the first measurement period of the taxable year in which the 120-day period is satisfied.

In connection with the shorter 120-day cessation period, however, the final regulations introduce several new criteria for determining whether production activities are considered to have ceased. Production activities are not considered to have ceased under the final regulations if they cease because of any delays inherent in the asset production process.

OIL AND GAS PROVISIONS

Section 614 costs in accumulated production expenditures

Under the proposed regulations, the costs with respect to a section 614 property **[*38]** (section 614 costs) are included in the accumulated production expenditures for the first well in a multi-phase development. Each subsequent well includes a pro rata share of these undepleted costs based on total wells that the taxpayer could feasibly drill on the section 614 property. However, the taxpayer may partition the section 614 costs among the number of wells to be drilled on the section 614 property if the taxpayer can devise a "definite plan" upfront that identifies the number and location of wells to be drilled.

Commentators indicated that the "definite plan" requirement is impracticable. According to them, the number and location of wells to be drilled on a property may not be known on the date that a first drilling activity is undertaken on the section 614 property. Commentators, therefore, suggested that the final regulations allow taxpayers to partition the section 614 costs among the number of wells "feasibly expected" to be drilled on the section 614 property. Alternatively, commentators suggested that the final regulations require taxpayers to include the section 614 costs only in the accumulated production expenditures for a first well drilled on the section 614 **[*39]** property.

The final regulations retain the definite plan rule. In light of the unique nature of a mineral interest and the circumstances surrounding the development of such an interest, however, the final regulations revise the rule for taxpayers unable to establish a definite plan. Under the revised rule, the section 614 costs are generally only included once in the accumulated production expenditures for a first productive well unit on the section 614 property. (However, the final regulations provide that the undepleted portion of section 614 costs allocated to the first productive well unit must be included in the accumulated production expenditures for an improvement to the unit.) The final regulations provide that a first productive well unit generally includes all wells that are drilled on a section 614 property prior to the date the first productive well on the property is placed in service and all production activities reasonably expected to be undertaken are completed. Accordingly, the section 614 costs are included in a unit (to attract interest capitalization) from the date the first physical site activity is undertaken with respect to the section 614 property until the date **[*40]** the first productive well on the section 614 property is placed in service and all production activities reasonably expected to be undertaken are completed. Generally, each well on a section 614 property that is drilled subsequent to such date comprises a separate unit of property. The IRS and Treasury believe this rule is more objective and practical than a rule that would require the section 614 costs to be partitioned among the number of wells "feasibly expected" to be drilled on a section 614 property.

The final regulations provide a rule for common feature costs similar to the rule provided for section 614 property costs. Under the final regulations, the costs of the common features are generally included only in the accumulated production expenditures for the first productive well unit.

Beginning of production period

The proposed regulations provide that the production period begins for an oil or gas well on the first date physical site preparation activities are undertaken with respect to the property.

Certain commentators believed that the production period should begin for an onshore oil or gas well unit on the "spud date," rather than on the first date of physical site preparation **[*41]** activity. Commentators indicated that taxpayers often do not separately track the first date of physical site activity on a property, but do maintain records with respect to the spud date for purposes of applying other provisions of the Code, such as section 291 (b).

The IRS and Treasury do not believe that the spud date is an appropriate date to adopt as the beginning of the production period for an onshore oil or gas well unit. The spud date may occur long after the first date that a physical site preparation activity is undertaken on a section 614 property. Using the spud date could, therefore, be too great a deviation from the general rule that treats site preparation as the beginning of the production period of other real property. Accordingly, the final regulations do not adopt the commentators' recommendation regarding the spud date.

Surface equipment and end of production period

The proposed regulations provide that the production period generally ends for an oil or gas well on the date that surface production equipment is installed and the well is placed in service.

Commentators argued that the production period for a well unit should not continue beyond the date a "christmas **[*42]** tree" is installed on the well and that the accumulated production expenditures for the well should not include the costs of surface production equipment.

The final regulations provide that the production period generally ends for a productive well unit on the date that the productive well included in the unit is placed in service and all production activities reasonably expected to be undertaken are completed. These rules are consistent with the general rules that apply in the case of other types of produced property.

Casing point

The proposed regulations provide that the production period generally ends for a nonproductive well on the date that the nonproductive well is plugged and abandoned.

Commentators believed that the production period for a nonproductive well unit should end at the casing point, which they indicate is the date that a decision is made not to complete the well for production.

The final regulations do not address the date on which the production period ends for a nonproductive well. The IRS and Treasury believe, however, that the general standards that apply in the case of other types of abandoned property should be used to determine the date on which the production **[*43]** period ends for a nonproductive well.

Allocation of capitalized interest to depreciable or depletable unit components

The proposed regulations provide that the interest required to be capitalized with respect to a unit is added to the basis of designated property, rather than to the bases of any assets used to produce the designated property. Additionally, interest required to be capitalized with respect to the production of land is added to the basis of any related depreciable improvement.

Commentators believed that the final regulations should provide that interest required to be capitalized with respect to an oil or gas well unit is first capitalized into the basis of the unit's depreciable property components, if any, prior to the bases of the unit's depletable property components. The commentators believed that this rule is substantially similar to the rule in the proposed regulations with respect to the allocation of capitalized interest to components of a land improvement unit.

The IRS and Treasury believe that interest capitalized with respect to components of a unit of property that are not subject to an allowance for depreciation or depletion is appropriately added to the basis **[*44]** of the components of a unit of property that are subject to an allowance for depreciation or depletion. Thus, the proposed regulations provided that interest capitalized with respect to land, the cost of which is not depreciable or depletable, is added to the basis of related depreciable improvements, if any. However, interest capitalized with respect to the depletable property components of a well unit is subject to an allowance for depletion. Accordingly, the final regulations do not adopt commentators' suggestions.

Independent producer onshore well exemption

Certain commentators suggested that independent producer onshore wells should be exempted from interest capitalization based on their belief that the compliance costs for these wells outweigh the tax revenues to be gained.

Under section 263A (c) (3), Congress exempted from the uniform capitalization rules certain costs incurred with respect to oil and gas activities, but did not exempt oil and gas activities themselves. Thus, the IRS and Treasury do not believe that a specific exemption for all independent onshore wells is appropriate. Accordingly, the final regulations do not provide a specific exemption for independent onshore **[*45]** wells.

EXAMPLES

The final regulations provide examples, but delete the comprehensive real estate example. The IRS anticipates providing illustrations of interest capitalization in other guidance.

RELATED PERSON RULES

In general

Section 263A (i) provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of the uniform capitalization rules, including regulations to prevent the use of related persons, pass-through entities, or intermediaries to avoid these rules.

Notice 88-99, issued August 17, 1988, provides the principal source of guidance concerning the application of related person rules under section 263A (f). Notice 88-99 generally provides that if a taxpayer is producing designated property and has accumulated production expenditures that exceed the total amount of its eligible debt, one or more related persons (generally members of the same parent-subsidiary controlled group as defined in section 1563 (a) (1), whether or not filing consolidated returns) must capitalize interest with respect to the excess expenditures. Under Notice 88-99, the related persons, in effect, capitalize interest with respect to the excess expenditures **[*46]** as if the related persons had incurred those expenditures directly. The notice provides similar rules in the case of flow through entities (i.e., partnerships or S corporations).

The proposed regulations also provide certain related person rules and direct taxpayers to follow applicable administrative pronouncements in applying the rules. More comprehensive related person rules will be proposed at a future date under a separate regulations project. Until more specific rules are provided under related person regulations, however, Notice 88-99 generally indicates the position of the IRS with respect to the application of related person rules under section 263A (f). To the extent that Notice 88-99 rules are modified by specific provisions in, or principles of, these final regulations, the rules and principles of the final regulations are controlling.

Consolidated return interest rule

Consistent with the purposes of section 263A (f), the proposed regulations provide that to the extent of a consolidated group's outside interest deduction, the consolidated group must currently report, rather than defer, the interest income on intragroup debt on which it capitalizes interest (consolidated section 263A (f) **[*47]** interest rule). Without this rule, a consolidated group could effectively avoid capitalizing interest under section 263A (f) if the group were to capitalize interest on intragroup debt, but at the same time defer reporting the associated interest income and deduct outside interest equal to or less than the interest capitalized.

Certain taxpayers believed that the consolidated section 263A (f) interest rule does not apply unless and until final regulations are issued under section 263A or section 1502. The IRS and Treasury believe, however, that a consolidated group that effectively deducts interest by capitalizing interest on intragroup debt under section 263A (f) and deferring the associated interest income on the debt adopts an unreasonable interpretation of the statute and legislative history of section 263A (f) to the extent the associated interest income on the intragroup debt is less than or equal to the group's outside interest expense deductions.

Comments on related person rules

Commentators submitted comments on certain related persons issues. In particular, commentators believed that, under Notice 88-99 and the proposed rules, capitalizing interest on the intragroup debt of **[*48]** an affiliated group that is not a consolidated group may create an overcapitalization of interest. According to the commentators, overcapitalization may occur, for example, if two or more members capitalize interest with respect to the same debt (e.g., back-to-back loans). Additionally, one commentator believed that interest on debt owed to a producing member by a nonproducing member should not be subject to capitalization.

In response to commentator concerns, the IRS and Treasury are studying whether the amount of interest capitalized by the related person members of an affiliated group should be limited to the interest incurred by all affiliated group members on outside debt, less any interest capitalized by the producing member on outside and intragroup debt. It is generally the intent of Notice 88-99 and the final regulations to prevent taxpayers from avoiding the purposes of interest capitalization through the use of related persons. The IRS and Treasury welcome additional comments on this and other related person issues that should be addressed in future related person regulations.

ACCOUNTING METHOD CHANGES

The final section 263A (f) regulations are generally effective for taxable **[*49]** years beginning on or after January 1, 1995. Taxpayers that have previously adopted methods of accounting under section 263A (f) may be required to change their methods of accounting under section 263A (f) to comply with the final regulations. Within 30 days, the IRS will issue a revenue procedure prescribing the procedures, terms, and conditions for effecting method changes necessary due to the promulgation of these regulations.

The revenue procedure will facilitate election of early application of the regulations to the first taxable year beginning on or after January 1, 1994 so that taxpayers may combine, within the same taxable year, changes under the final section 263A (f) regulations and changes under the final general section 263A regulations.

CLARIFICATION OF MIXED SERVICE COSTS DE MINIMIS RULES

The final regulations clarify the application of the 90 percent de minimis rule for mixed service department costs contained in the final main section 263A regulations. Under that rule, an electing taxpayer is not required to allocate any portion of a mixed service department's costs to property produced or acquired for resale if 90 percent or more of the department's costs are deductible **[*50]** service costs. The final regulations clarify that if this election is made, the taxpayer must also allocate all of a mixed service department's costs to property produced or acquired for resale if 90 percent or more of the department's costs are capitalizable service costs.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553 (b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805 (f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

Paragraph 1. The authority citation for part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805☐ ☐ ☐ Sections 1.263A-8 through 1.263 A-15 **[*51]** also issued under 26 U.S.C. 263A (i).

Par. 2. Section 1.263A-0 is amended by revising the introductory text, removing the word "Reserved" after § 1.263A-2 (a) (1) (ii) (B) (2), removing the word "Reserved" after §§ 1.263A-3 (c) (4) (vi) (A) through (C) to reflect issuance of T.D. 8559 on August 5, 1994, and adding the following headings for §§ 1.263A-8 through 1.263A-15 to read as follows:

§ 1.263A-0 Outline of regulations under section 263A.

This section lists the paragraphs and §§ 1.263A-1 through 1.263A-3 and §§ 1.263A-8 through 1.263A-15.

□□□

§ 1.263A-8 Requirement to capitalize interest.

(a) In general.

(1) General rule.

(2) Treatment of interest required to be capitalized.

(3) Methods of accounting under section 263A (f).

(4) Special definitions.

(i) Related person.

(ii) Placed in service.

(b) Designated property.

(1) In general.

(2) Special rules.

(i) Application of thresholds.

(ii) Relevant activities and costs.

(iii) Production period and cost of production.

(3) Excluded property.

(4) *De minimis* rule.

(i) In general.

(ii) Determination of total production expenditures.

(c) Definition of real property.

(1) In general.

(2) Unsevered natural products of land.

(3) Inherently permanent structures.

(4) **[*52]** Machinery.

(i) Treatment.

(ii) Certain factors not determinative.

(d) Production.

(1) Definition of produce.

(2) Property produced under a contract.

(i) Customer.

(ii) Contractor.

(iii) Definition of a contract.

(iv)Determination of whether thresholds are satisfied.

(A) Customer.

(B) Contractor.

(v) Exclusion for property subject to long-term contract rules.

(3) Improvements to existing property.

(i) In general.

(ii) Real property.

(iii) Tangible personal property.

§ 1.263A-9 The avoided cost method.

(a) In general.

(1) Description.

(2) Overview.

(i) In general.

(ii) Rules that apply in determining amounts.

(3) Definitions of interest and incurred.

(4) Definition of eligible debt.

(b) Traced debt amount.

(1) General rule.

(2) Identification and definition of traced debt.

(3) Example.

(c) Excess expenditure amount.

(1) General rule.

(2) Interest required to be capitalized.

(3) Example.

(4) Treatment of interest subject to a deferral provision.

(5) Definitions.

(i) Nontraced debt.

(A) Defined.

(B) Example.

(ii) Average excess expenditures.

(A) General rule.

(B) Example.

(iii) Weighted average interest rate.

(A) Determination of rate.

(B) Interest incurred on nontraced debt.

(C) Average nontraced debt.

(D)Special rules if taxpayer **[*53]** has no nontraced debt or rate is contingent.

(6) Examples.

(7) Special rules where the excess expenditure amount exceeds incurred interest.

(i) Allocation of total incurred interest to units.

(ii) Application of related person rules to average excess expenditures.

(iii) Special rule for corporations.

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(d) Election not to trace debt.

(1) General rule.

(2) Example.

(e) Election to use external rate.

(1) In general.

(2) Eligible taxpayer.

(f) Selection of computation period and measurement dates and application of averaging conventions.

(1) Computation period.

(i) In general.

(ii) Method of accounting.

(iii) Production period beginning or ending during the computation period.

(2) Measurement dates.

(i) In general.

(ii) Measurement period.

(iii) Measurement dates on which accumulated production expenditures must be taken into account.

(iv) More frequent measurement dates.

(3) Examples.

(g) Special rules.

(1) Ordering rules.

(i) Provisions preempted by section 263A (f).

(ii) Deferral provisions applied before this section.

(2) Application of section 263A (f) to deferred interest.

(i) In general.

(ii) Capitalization of deferral amount.

(iii) Deferred capitalization. (iv) Substitute capitalization.

(A) General **[*54]** rule.

(B) Capitalization of amount carried forward.

(C) Method of accounting. (v) Examples.

(3) Simplified inventory method.

(i) In general.

(ii) Segmentation of inventory.

(A) General rule.

(B) Example.

(iii) Aggregate interest capitalization amount.

(A) Computation period and weighted average interest rate.

(B) Computation of the tentative aggregate interest capitalization amount.

(C) Coordination with other interest capitalization computations.

(1) In general.

(2) Deferred interest.

(3) Other coordinating provisions.

(D) Treatment of increases or decreases in the aggregate interest capitalization amount.

(E) Example.

(iv) Method of accounting.

(4) Financial accounting method disregarded.

(5) Treatment of intercompany transactions.

(i) General rule.

(ii) Special rule for consolidated group with limited outside borrowing.

(iii) Example.

(6) Notional principal contracts and other derivatives. [Reserved]

(7) 15-day repayment rule.

§ 1.263A-10 Unit of property.

(a) In general.

(b) Units of real property.

(1) In general.

(2) Functional interdependence.

(3) Common features.

(4) Allocation of costs to unit.

(5) Treatment of costs when a common feature is included in a unit of real property.

(i) General rule.

(ii) Production **[*55]** activity not undertaken on benefitted property.

(A) Direct production activity not undertaken.

(1) In general.

(2) Land attributable to a benefitted property.

(B) Suspension of direct production activity after clearing and grading undertaken.

(1) General rule.

(2) Accumulated production expenditures.

(iii) Common feature placed in service before the end of production of a benefitted property.

(iv) Benefitted property sold before production completed on common feature.

(v) Benefitted property placed in service before production completed on common feature.

(6) Examples.

(c) Units of tangible personal property.

(d) Treatment of installations.

§ 1.263A-11 Accumulated production expenditures.

(a) General rule.

(b) When costs are first taken into account.

(1) In general.

(2) Dedication rule for materials and supplies.

(c) Property produced under a contract.

(1) Customer.

(2) Contractor.

(d) Property used to produce designated property.

(1) In general.

(2) Example.

(3) Excluded equipment and facilities.

(e) Improvements.

(1) General rule.

(2) *De minimis* rule.

(f) Mid-production purchases.

(g) Related person costs.

(h) Installation.

§ 1.263A-12 Production period.

(a) In general.

(b) Related person activities.

(c) Beginning **[*56]** of production period.

(1) In general.

(2) Real property.

(3) Tangible personal property.

(d) End of production period.

(1) In general.

(2) Special rules.

(3) Sequential production or delivery.

(4) Examples.

(e) Physical production activities.

(1) In general.

(2) Illustrations.

(f) Activities not considered physical production.

(1) Planning and design.

(2) Incidental repairs.

(g) Suspension of production period.

(1) In general.

(2) Special rule.

(3) Method of accounting.

(4) Example.

§ 1.263A-13 Oil and gas activities.

(a) In general.

(b) Generally applicable rules.

(1) Beginning of production period.

(i) Onshore activities.

(ii) Offshore activities.

(2) End of production period.

(3) Accumulated production expenditures.

(i) Costs included.

(ii) Improvement unit.

(c) Special rules when definite plan not established.

(1) In general.

(2) Oil and gas units.

(i) First productive well unit.

(ii) Subsequent units.

(3) Beginning of production period.

(i) First productive well unit.

(ii) Subsequent wells.

(4) End of production period.

(5) Accumulated production expenditures.

(i) First productive well unit,

(ii) Subsequent well unit.

(6) Allocation of interest capitalized with respect to first productive well unit.

(7) Examples.

§ 1.263A-14 Rules for related persons.

§ 1.263A-15 Effective dates, transitional rules, and anti-abuse rule.

(a) **[*57]** Effective dates.

(b) Transitional rule for accumulated production expenditures.

(1) In general.

(2) Property used to produce designated property.

(c) Anti-abuse rule.

Par. 3. Section 1.263A-1 is amended by revising the third sentence of paragraph (g) (4) (ii) to read as follows:

§ 1.263A-1 Uniform capitalization of costs.

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(g) ☐ ☐ ☐

(4) ☐ ☐ ☐

(ii) ☐ ☐ ☐ Under this election, however, if 90 percent or more of a mixed service department's costs are capitalizable service costs, a taxpayer must allocate 100 percent of the department's costs to the production or resale activity benefitted.☐ ☐ ☐

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Par. 4. Section 1.263A-2 is amended by revising paragraph (a) (1) (ii) (B) (2) to read as follows:

§ 1.263A-2 Rules relating to property produced by the taxpayer.

(a) ☐ ☐ ☐

(2) *Definition of a contract* -(0 *General rule.* Except as provided under paragraph (a) (1) (ii) (B) (2) (ii) of this section, a contract is any agreement providing for the production of property if the agreement is entered into before the production of the property to be delivered under the contract is completed. Whether an agreement exists depends on all the facts and circumstances. Facts and circumstances indicating an agreement include, **[*58]** for example, the making of a prepayment, or an arrangement to make a prepayment, for property prior to the date of the completion of production of the property, or the incurring of significant expenditures for property of specialized design or specialized application that is not intended for self-use.

(ii) Routine purchase order exception. A routine purchase order for fungible property is not treated as a contract for purposes of this section. An agreement will not be treated as a routine purchase order for fungible property, however, if the contractor is required to make more than *de minimis* modifications to the property to tailor it to the customer's specific needs, or if at the time the agreement is entered into, the customer knows or has reason to know that the contractor cannot satisfy the agreement within 30 days out of existing stocks and normal production of finished goods.

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Par. 5. Section 1.263A-7 is added and reserved and §§ 1.263A-8 through 1.263A-15 are added to read as follows:

§ 1.263A-8 Requirement to capitalize interest.

(a) *In general* -(1) *General rule.* Capitalization of interest under the avoided cost method described in § 1.263A-9 is required with respect to the **[*59]** production of designated property described in paragraph (b) of this section.

(2) *Treatment of interest required to be capitalized.* In general, interest that is capitalized under this section is treated as a cost of the designated property and is recovered in accordance with § 1.263A-1 (c) (4). Interest capitalized by reason of assets used to produce designated property (within the meaning of § 1.263A-11 (d)) is added to the basis of the designated property rather than the bases of the assets used to produce the designated property. Interest capitalized with respect to designated property that includes both components subject to an allowance for depreciation or depletion and components not subject to an allowance for depreciation or depletion is ratably allocated among, and is treated as a cost of, components that are subject to an allowance for depreciation or depletion.

(3) *Methods of accounting under section 263A (f).* Except as otherwise provided, methods of accounting and other computations under §§ 1.263A-8 through 1.263A-15 are applied on a taxpayer, as opposed to a separate and distinct trade or business, basis.

(4) *Special definitions* - (i) *Related person.* Except as otherwise **[*60]** provided, for purposes of §§ 1.263A-8 through 1.263A-15, a person is related to a taxpayer if their relationship is described in section 267*(b)* or 707 (b).

(ii) *Placed in service.* For purposes of §§ 1.263A-8 through 1.263A-15, *placed in service* has the same meaning as set forth in § 1.46-3 (d).

(b) *Designated property-(1) In general.* Except as provided in paragraphs (b) (3) and (b) (4) of this section, *designated property* means any property that is produced and that is either:

(i) Real property; or

(ii) Tangible personal property (as defined in § 1.263A-2 (a) (2)) which meets any of the following criteria:

(A) Property with a class life of 20 years or more under section 168 (long-lived property), but only if the property is not property described in section 1221 (1) in the hands of the taxpayer or a related person,

(B) Property with an estimated production period (as defined in § 1.263A-12) exceeding 2 years (2-year property), or

(C) Property with an estimated production period exceeding 1 year and an estimated cost of production exceeding $1,000,000 (1-year property).

(2) *Special rules* -(i) *Application of thresholds.* The thresholds described in paragraphs (b) (1) (ii) (A), (B), and (C) of this **[*61]** section are applied separately for each unit of property (as defined in § 1.263A-10).

(ii) *Relevant activities and costs.* For purposes of determining whether property is designated property, all activities and costs are taken into account if they are performed or incurred by, or for, the taxpayer or any related person and they directly benefit or are incurred by reason of the production of the property.

(iii) *Production period and cost of production.* For purposes of applying the classification thresholds under paragraphs (b) (1) (ii) (B) and (C) of this section to a unit of property, the taxpayer is required, at the beginning of the production period, to reasonably estimate the production period and the total cost of production for the unit of property. The taxpayer must maintain contemporaneous written records supporting the estimates and classification. If the estimates are reasonable based on the facts in existence at the beginning of the production period, the taxpayer's classification of the property is not modified in subsequent periods, even if the actual length of the production period or the actual cost of production differs from the estimates. To be considered reasonable, estimates **[*62]** of the production period and the total cost of production must include anticipated expense and time for delay, rework, change orders, and technological, design or other problems. To the extent that several distinct activities related to the production of the property are expected to occur simultaneously, the period during which these distinct activities occur is not counted more than once. The bases of assets used to produce a unit of property (within the meaning of § 1.263A-11 (d)) and any interest that would be required to be capitalized if a unit of property were designated property are disregarded in making estimates of the total cost of production for purposes of this paragraph (b) (2) (iii).

(3) *Excluded property.* Designated property does not include:

(i) Timber and evergreen trees that are more than 6 years old when severed from the roots, or

(ii) *Property produced by the taxpayer for use by the taxpayer other than in a trade or business or an activity conducted for profit.*

(4) *De minimis rule* -(i) *Ingeneral.* Designated property does not include property for which-

(A)The production period does not exceed 90 days; and

(B)The total production expenditures do not exceed $1,000,000 divided **[*63]** by the number of days in the production period.

(ii) *Determination of total production expenditures.* For purposes of determining whether the condition of paragraph (b) (4) (i) (B) of this section is met with respect to property, the cost of land, the adjusted basis of property used to produce property, and interest that would be capitalized with respect to property if it were designated property are excluded from total production expenditures.

(c) *Definition of real property*- (1) *Ingeneral.* Real property includes land, unsevered natural products of land, buildings, and inherently permanent structures. Any interest in real property of a type described in this paragraph (c), including fee ownership, co-ownership, a leasehold, an option, or a similar interest is real property under this section. Real property includes the structural components of both buildings and inherently permanent structures, such as walls, partitions, doors, wiring, plumbing, central air conditioning and heating systems, pipes and ducts, elevators and escalators, and other similar property. Tenant improvements to a building that are inherently permanent or otherwise classified as real property within the meaning of **[*64]** this paragraph (c) (1) are real property under this section. However, property produced for sale that is not real property in the hands of the taxpayer or a related person, but that may be incorporated into real property by an unrelated buyer, is not treated as real property by the producing taxpayer (*e.g.,* bricks, nails, paint, and windowpanes).

(2) *Unsevered natural products of land.* Unsevered natural products of land include growing crops and plants, mines, wells, and other natural deposits. Growing crops and plants, however, are real property only if the preproductive period of the crop or plant exceeds 2 years.

(3) *Inherently permanent structures.* Inherently permanent structures include property that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time, such as swimming pools, roads, bridges, tunnels, paved parking areas and other pavements, special foundations, wharves and docks, fences, inherently permanent advertising displays, inherently permanent outdoor lighting facilities, railroad tracks and signals, telephone poles, power generation and transmission facilities, permanently installed telecommunications cables, broadcasting **[*65]** towers, oil and gas pipelines, derricks and storage equipment, grain storage bins and silos. For purposes of this section, affixation to real property may be accomplished by weight alone. Property may constitute an inherently permanent structure even though it is not classified as a building for purposes of former section 48 (a) (1) (B) and § 1.48-1. Any property not otherwise described in this paragraph (c) (3) that constitutes other tangible property under the principles of former section 48 (a) (1) (B) and § 1.48-1 (d) is treated for the purposes of this section as an inherently permanent structure.

(4) *Machinery* -(i) *Treatment.* A structure that is property in the nature of machinery or is essentially an item of machinery or equipment is not an

inherently permanent structure and is not real property. In the case, however, of a building or inherently permanent structure that includes property in the nature of machinery as a structural component, the property in the nature of machinery is real property.

(ii) *Certain factors not determinative.* A structure may be an inherently permanent structure, and not property in the nature of machinery or essentially an item of machinery, even if **[*66]** the structure is necessary to operate or use, supports, or is otherwise associated with, machinery.

(d) *Production-* (1) *Definition of produce. Produce* is defined as provided in section 263A (g) and § 1.263A-2 (a) (1) (i).

(2) *Property produced under a contract-(i) Customer.* A taxpayer is treated as producing any property that is produced for the taxpayer (the customer) by another party (the contractor) under a contract with the taxpayer or an intermediary. Property produced under a contract is designated property to the customer if it is real property or tangible personal property that satisfies the classification thresholds described in paragraph (b) (1) (ii) of this section. If property produced under a contract will become part of a unit of designated property produced by the customer in the customer's hands, the property produced under the contract is designated property to the customer.

(ii) *Contractor.* Property produced under a contract is designated property to the contractor if it is real property, 2-year property, or 1-year property and the property produced under the contract is not excluded by reason of paragraph (d) (2) (v) of this section.

(iii) Definition of a contract. For **[*67]** purposes of this paragraph (d) (2), contract has the same meaning as under § 1.263A-2 (a) (1) (ii) (B) (2).

(iv) *Determination of whether thresholds are satisfied.* In the case of tangible personal property produced under a contract, the customer and the contractor each determine under this paragraph (d) (2), whether the property satisfies the classification thresholds described in paragraph (b) (1) (ii) of this section. Thus, tangible personal property may be designated property with respect to either, or both, the customer and the contractor. The provisions of paragraph (b) (2) (iii) of this section are modified as set forth in this paragraph (d) (2) (iv) for purposes of determining whether tangible personal property produced under a contract is 2-year property or 1-year property.

(A) *Customer.* In determining a customer's estimated cost of production, the customer takes into account costs and payments that are reasonably expected to be incurred by the customer, but does not take into account costs incurred (or to be incurred) by an unrelated contractor. In determining the customer's estimated length of the production period, the production period is treated as beginning on the earlier **[*68]** of the date the contract is executed or the date that the customer's accumulated production expenditures for the unit are at least 5 percent of the customer's total estimated production expenditures for the unit. The customer, however, may elect to treat the production period as beginning on the date the sum of the accumulated production expenditures of the contractor (or contractors if more than one contractor is producing components for the unit of property) and of the customer are at least 5 percent of the customer's estimated production expenditures for the unit.

(B) *Contractor.* In determining a contractor's estimated cost of production, the contractor takes into account only the costs that are reasonably expected to be incurred by the contractor, without any reduction for payments from the customer. In determining the contractor's estimated length of the production period, the production period is treated as beginning on the date the contractor's accumulated production expenditures (without any reduction for payments from the customer) are at least 5 percent of the contractor's total estimated accumulated production expenditures.

(v) *Exclusion for property subject to long-term contract* **[*69]** *rules.* Property described in paragraph (b) of this section is designated property with respect to a contractor only if-

(A) The contract is not a long-term contract (within the meaning of section 460 (f)); or

(B) The contract is a home construction contract (within the meaning of section 460 (e) (6) (A)) with respect to which the requirements of section 460 (e) (1) (B) (i) and (ii) are not met.

(3) *Improvements to existing property* -(i) *Ingeneral.* Any improvement to property described in § 1.263 (a)-1 (b) constitutes the production of property. Generally, any improvement to designated property constitutes the production of designated property. An improvement is not treated as the production of designated property, however, if the *de minimis* exception described in paragraph (b) (4) of this section applies to the improvement. In addition, paragraph (d) (3) (iii) of this section provides an exception for certain improvements to tangible personal property. Incidental maintenance and repairs are not treated as improvements under this paragraph (d) (3). See § 1.162-4.

(ii) *Real property.* The rehabilitation or preservation of a standing building, the clearing of raw land prior to sale, and the **[*70]** drilling of an oil well are activities constituting improvements to real property and, therefore, the production of designated property. Similarly, the demolition of a standing building generally constitutes an activity that is an improvement to real property and, therefore, the production of designated property. See the exceptions, however, in paragraphs (b) (3) and (b) (4) of this section.

(iii) *Tangible personal property.* If the taxpayer has treated a unit of tangible personal property as designated property under this section, an improvement to such property constitutes the production of designated property regardless of the remaining useful life of the improved property (or the improvement) and, except as provided in paragraph (b) (4) of this section, regardless of the estimated length of the production period or the estimated cost of the improvement. If the taxpayer has not treated a unit of tangible personal property as designated property under this section, an improvement to such property constitutes the production of designated property only if the improvement independently meets the classification thresholds described in paragraph (b) (1) (ii) of this section.

§ 1.263A-9 The avoided cost method.

(a) **[*71]** *In general* -(1) *Description.* The avoided cost method described in this section must be used to calculate the amount of interest required to be capitalized under section 263A (f). Generally, any interest that the taxpayer theoretically would have avoided if accumulated production expenditures (as defined in § 1.263A-11) had been used to repay or reduce the taxpayer's outstanding debt must be capitalized under the avoided cost method. The application of the avoided cost method does not depend on whether the taxpayer actually would have used the amounts expended for production to repay or reduce debt. Instead, the avoided cost method is based on the assumption that debt of the taxpayer would have been repaid or reduced without regard to the taxpayer's subjective intentions or to restrictions (including legal, regulatory, contractual, or other restrictions) against repayment or use of the debt proceeds.

(2) *Overview* -(i) *Ingeneral.* For each unit of designated property (within the meaning of § 1.263A-8 (b)), the avoided cost method requires the capitalization of-

(A)The traced debt amount under paragraph (b) of this section, and

(B)The excess expenditure amount under paragraph (c) of this **[*72]** section.

(ii) *Rules that apply in determining amounts.* The traced debt and excess expenditure amounts are determined for each taxable year or shorter computation period that includes the production period (as defined in § 1.263A-12) of a unit of designated property. Paragraph (d) of this section provides an election not to trace debt to specific units of designated property. Paragraph (f) of this section provides rules for selecting the computation period, for calculating averages, and for determining measurement dates within the computation period. Special rules are in paragraph (g) of this section.

(3) *Definitions of interest and incurred.* Except as provided in the case of certain expenses that are treated as a substitute for interest under paragraphs (c) (2) (iii) and (g) (2) (iv) of this section, interest refers to all amounts that are characterized as interest expense under any provision of the Code, including, for example, sections 482, 483, 1272, 1274, and 7872. Incurred refers to the amount of interest that is properly accruable during the period of time in question determined by taking into account the loan agreement and any applicable provisions of the Internal Revenue laws **[*73]** and regulations such as section 163, § 1.446-2, and sections 1271 through 1275.

(4) *Definition of eligible debt.* Except as provided in this paragraph (a) (4), eligible debt includes all outstanding debt (as evidenced by a contract, bond, debenture, note, certificate, or other evidence of indebtedness). Eligible debt does not include-

(i) Debt (or the portion thereof) bearing interest that is disallowed under a provision described in § 1.163-8T (m) (7) (ii);

(ii) Debt, such as accounts payable and other accrued items, that bears no interest, except to the extent that such debt is traced debt (as defined in paragraph (b) (2) of this section);

(iii) Debt that is borrowed directly or indirectly from a person related to the taxpayer and that bears a rate of interest that is less than the applicable Federal rate in effect under section 1274 (d) on the date of issuance;

(iv) Debt (or the portion thereof) bearing personal interest within the meaning of section 163 (h) (2);

(v) Debt (or the portion thereof) bearing qualified residence interest within the meaning of section 163 (h) (3);

(vi) Debt incurred by an organization that is exempt from Federal income tax under section 501 (a), except to the extent **[*74]** interest on such debt is directly attributable to an unrelated trade or business of the organization within the meaning of section 512;

(vii) Reserves, deferred tax liabilities, and similar items that are not treated as debt for Federal income tax purposes, regardless of the extent to which the taxpayer's applicable financial accounting or other regulatory reporting principles require or support treating these items as debt; and

(viii) Federal, State, and local income tax liabilities, deferred tax liabilities under section 453A, and hypothetical tax liabilities under the look-back method of section 460 (b) or similar provisions.

(b) *Traced debt amount* -(1) *General rule.* Interest must be capitalized with respect to a unit of designated property in an amount (the traced debt amount) equal to the total interest incurred on the traced debt during each measurement period (as defined in paragraph (f) (2) (ii) of this section) that ends on a measurement date described in paragraph (f) (2) (iii) of this section. See the example in paragraph (b) (3) of this section. If any interest incurred on the traced debt is not taken into account for the taxable year that includes the measurement period because **[*75]** of a deferral provision, see paragraph (g) (2) of this section for the time and manner for capitalizing and recovering that amount. This paragraph (b) (1) does not apply if the taxpayer elects under paragraph (d) of this section not to trace debt.

(2) *Identification and definition of traced debt.* On each measurement date described in paragraph (f) (2) (iii) of this section, the taxpayer must identify debt that is traced debt with respect to a unit of designated property. On

each such date, traced debt with respect to a unit of designated property is the outstanding eligible debt (as defined in paragraph (a) (4) of this section) that is allocated, on that date, to accumulated production expenditures with respect to the unit of designated property under the rules of § 1.163-8T. Traced debt also includes unpaid interest that has been capitalized with respect to such unit under paragraph (b) (1) of this section and that is included in accumulated production expenditures on the measurement date.

(3) **Example.** The provisions of paragraphs (b) (1) and (b) (2) of this section are illustrated by the following example.

Example. Corporation X, a calendar year taxpayer, is engaged in the production **[*76]** of a single unit of designated property during 1995 (unit A). Corporation X adopts a taxable year computation period and quarterly measurement dates. Production of unit A starts on January 14, 1995, and ends on June 16, 1995. On March 31, 1995 and on June 30, 1995, Corporation X has outstanding a $1,000,000 loan that is allocated under the rules of § 1.163-8T to production expenditures with respect to unit A. During the period January 1, 1995, through June 30, 1995, Corporation X incurs $50,000 of interest related to the loan. Under paragraph (b) (1) of this section, the $50,000 of interest Corporation X incurs on the loan during the period January 1, 1995, through June 30, 1995, must be capitalized with respect to unit A.

(c) *Excess expenditure amount* -(1) General rule. If there are accumulated production expenditures in excess of traced debt with respect to a unit of designated property on any measurement date described in paragraph (f) (2) (iii) of this section, the taxpayer must, for the computation period that includes the measurement date, capitalize with respect to the unit the excess expenditure amount calculated under this paragraph (c) (1). However, if the sum of the excess **[*77]** expenditure amounts for all units of designated property of a taxpayer exceeds the total interest described in paragraph (c) (2) of this section, only a prorata amount (as determined under paragraph (c) (7) of this section) of such interest must be capitalized with respect to each unit. For each unit of designated property, the excess expenditure amount for a computation period equals the product of-

(i) The average excess expenditures (as determined under paragraph (c) (5) (ii) of this section) for the unit of designated property for that period, and

(ii) The weighted average interest rate (as determined under paragraph (c) (5) (iii) of this section) for that period.

(2) *Interest required to be capitalized.* With respect to an excess expenditure amount, interest incurred during the computation period is capitalized from the following sources and in the following sequence but not in excess of the excess expenditure amount for all units of designated property:

(i) Interest incurred on nontraced debt (as defined in paragraph (c)

(5) (i) of this section);

(ii) Interest incurred on borrowings described in paragraph (a) (4) (iii) of this section (relating to certain borrowings from related persons); **[*78]** and

(iii) In the case of a partnership, guaranteed payments for the use of capital (within the meaning of section 707 (c)) that would be deductible by the partnership if section 263A (f) did not apply.

(3) *Example.* The provisions of paragraph (c) (1) and (2) of this section are illustrated by the following example.

Example. (i) P, a partnership owned equally by Corporation A and Individual B, is engaged in the construction of an office building during 1995. Average excess expenditures for the office building for 1995 are $2,000,000. When P was formed, A and B agreed that A would be entitled to an annual guaranteed payment of $70,000 in exchange for A's capital contribution. The only borrowing of P, A, and B for 1995 is a loan to P from an unrelated lender of $1,000,000 (loan #1). The loan is nontraced debt and bears interest at an annual rate of 10 percent. Thus, P's weighted average interest rate (determined under paragraph (c) (5) (iii) of this section) is 10 percent and interest incurred during 1995 is $100,000.

(ii) In accordance with paragraph (c) (1) of this section, the excess expenditure amount is $200,000 ($2,000,000 × 10%). The interest capitalized under paragraph (c) (2) of this **[*79]** section is $170,000 ($100,000 of interest plus $70,000 of guaranteed payments).

(4) *Treatment of interest subject to a deferral provision.* If any interest described in paragraph (c) (2) of this section is not taken into account for the taxable year that includes the computation period because of a deferral provision described in paragraph (g) (1) (ii) of this section, paragraph (c) (2) of this section is first applied without regard to the amount of the deferred interest. After applying paragraph (c) (2) without regard to the deferred interest, if the amount of interest capitalized with respect to all units of designated property for the computation period is less than the amount that would have been capitalized if a deferral provision did not apply, see paragraph (g) (2) of this section for the time and manner for capitalizing and recovering the difference (the shortfall amount).

(5) *Definitions* -(i) *Nontraced debt-(A) Defined. Nontraced debt* means all eligible debt on a measurement date other than any debt that is treated as traced debt with respect to any unit of designated property on that measurement date. For example, nontraced debt includes eligible debt that is allocated to expenditures **[*80]** that are not capitalized under section 263A (a) (*e.g.,* expenditures deductible under section 174 (a) or 263 (c)). Similarly, even if eligible debt is allocated to a production expenditure for a unit of designated property, the debt is included in nontraced debt on measurement dates before the first or after the last measurement date for that unit of designated property.

Thus, nontraced debt may include debt that was previously treated as traced debt or that will be treated as; traced debt on a future measurement date.

(B) *Example.* The provisions of paragraph (c) (5) (i) (A) of this section are illustrated by the following example.

Example. In 1995, Corporation X begins, but does not complete, the construction of two office buildings that are separate units of designated property as defined in § 1.263A-10 (Property D and Property E). At the beginning of 1995, X borrows $2,500,000 (the $2,500,000 loan), which will be used exclusively to finance production expenditures for Property D. Although interest is paid currently, the entire principal amount of the loan remains outstanding at the end of 1995. Corporation X also has outstanding during all of 1995 a long-term loan with a principal amount **[*81]** of $2,000,000 (the $2,000,000 loan). The proceeds of the $2,000,000 loan were used exclusively to finance the production of Property C, a unit of designated property that was completed in 1994. Under the rules of paragraph (b) (2) of this section, the portion of the $2,500,000 loan allocated to accumulated production expenditures for property D at each measurement date during 1995 is treated as traced debt for that measurement date. The excess, if any, of $2,500,000 over the amount treated as traced debt at each measurement date during 1995 is treated as nontraced debt for that measurement date, even though it is expected that the entire $2,500,000 will be treated as traced debt with respect to Property D on subsequent measurement dates as more of the proceeds of the loan are used to finance additional production expenditures. In addition, the entire principal amount of the $2,000,000 loan is treated as nontraced debt for 1995, even though it was treated as traced debt with respect to Property C in a previous period.

(ii) *Average excess expenditures* -(A) *General rule.* The average excess expenditures for a unit of designated property for a computation period are computed by-

(1) Determining **[*82]** the amount (if any) by which accumulated production expenditures exceed traced debt at each measurement date during the computation period; and

(2) Dividing the sum of these amounts by the number of measurement dates during the computation period.

(B) *Example.* The provisions of paragraph (c) (5) (ii) (A) of this section are illustrated by the following example.

Example. Corporation X, a calendar year taxpayer, is engaged in the production of a single unit of designated property during 1995 (unit A). Corporation X adopts the taxable year as the computation period and quarterly measurement dates. The production period for unit A begins on January 14, 1995, and ends on June 16, 1995. On March 31, 1995, and on June 30, 1995, Corporation X has outstanding $1,000,000 of traced debt with respect to unit A. Accumulated production expenditures for unit A on March 31, 1995, are $1,400,000 and on June 30, 1995, are $1,600,000. Accumulated production expenditures in excess of traced debt for unit A on March 31, 1995, are $400,000 and on June 30, 1995, are $600,000. Average excess expenditures for unit A during 1995 are therefore $250,000

([$400,000 $plus; $600,000 + $0 + $0] 4).

(iii) *Weighted* **[*83]** *average interest rate* -(A) *Determination of rate.* The weighted average interest rate for a computation period is determined by dividing interest incurred on non-traced debt during the period by average nontraced debt for the period.

(B) *Interest incurred on nontraced debt.* Interest incurred on nontraced debt during the computation period is equal to the total amount of interest incurred during the computation period on all eligible debt minus the amount of interest incurred during the computation period on traced debt. Thus, all interest incurred on nontraced debt during the computation period is included in the numerator of the weighted average interest rate, even if the underlying nontraced debt is repaid before the end of a measurement period and excluded from nontraced debt outstanding for measurement dates after repayment, in determining the denominator of the weighted average interest rate. However, see paragraph (g) (7) of this section for an election to treat eligible debt that is repaid within the 15-day period immediately preceding a quarterly measurement date as outstanding on that measurement date. See paragraph (a) (3) of this section for the definitions of interest and **[*84]** incurred.

(C) *Average nontraced debt.* The average nontraced debt for a computation period is computed by-

(1) Determining the amount of nontraced debt outstanding on each measurement date during the computation period; and

(2) Dividing the sum of these amounts by the number of measurement dates during the computation period.

(D) *Special rules if taxpayer has no nontraced debt or rate is contingent.* If the taxpayer does not have non-traced debt outstanding during the computation period, the weighted average interest rate for purposes of applying paragraphs (c) (1) and (c) (2) of this section is the highest applicable Federal rate in effect under section 1274 (d) during the computation period. If interest is incurred at a rate that is contingent at the time the return for the year that includes the computation period is filed, the amount of interest is determined using the higher of the fixed rate of interest (if any) on the underlying debt or the applicable Federal rate in effect under section 1274 (d) on the date of issuance.

(6) *Examples.* The following examples illustrate the principles of this paragraph (c):

Example 1. (i) W, a calendar year taxpayer, is engaged in the production of a unit **[*85]** of designated property during 1995. For purposes of applying the avoided cost method of this section, W uses the taxable year as the computation period. During 1995, W's only debt is a $1,000,000 loan bearing interest at a rate of 7 percent from Y, a person that is related to W. Assuming the applicable Federal rate in effect under section 1274 (d) on the date of issuance of the loan is 10 percent, the loan is not eligible debt under paragraph (a) (4) of this section. However, even though W has no eligible debt, W incurs $70,000 ($1,000,000 x 7%) of interest during the computation period. This interest is described in paragraph (c) (2) of this section and must be capitalized under paragraph (c) (1) of this section to the extent it does not exceed W's excess expenditure amount for the unit of property.

(ii) W determines, under paragraph (c) (5) (ii) of this section, that average excess expenditures for the unit of property are $600,000. Assuming the highest applicable Federal rate in effect under section 1274 (d) during the computation period is 10 percent, W uses 10 percent as the weighted average interest rate for purposes of determining the excess expenditure amount. See paragraph **[*86]** (c) (5) (iii) (D) of this section. In accordance with paragraph (c) (1) of this section, the excess expenditure amount is therefore $60,000. Because this amount does not exceed the total amount of interest described in paragraph (c) (2) of this section ($70,000), W is required to capitalize $60,000 of interest with respect to the unit of designated property for the 1995 computation period.

Example 2.(i) Corporation X, a calendar year taxpayer, is engaged in the production of a single unit of designated property during 1995 (unit A). Corporation X adopts the taxable year as the computation period and quarterly measurement dates. Production of unit A begins in 1994 and ends on June 30, 1995. On March 31, 1995, and on June 30, 1995, Corporation X has outstanding $1,000,000 of eligible debt (loan #1) that is allocated under the rules of § 1.163-8T to production expenditures for unit A. During each of the first two quarters of 1995, $30,000 of interest is incurred on loan #1. The loan is repaid on July 1, 1995. Throughout 1995, Corporation X also has outstanding $2,000,000 of eligible debt (loan #2) which is not allocated under the rules of § 1.163-8T to the production of unit A. During **[*87]** 1995, $200,000 of interest is incurred on this nontraced debt. Accumulated production expenditures on March 31, 1995, are $1,400,000 and on June 30, 1995, are $1,600,000. Accumulated production expenditures in excess of traced debt on March 31, 1995, are $400,000 and on June 30, 1995, are $600,000.

(ii) Under paragraph (b) (1) of this section, the amount of interest capitalized with respect to traced debt is $60,000 ($30,000 for the measurement period ending March 31, 1995, and $30,000 for the measurement period ending June 30, 1995). Under paragraph (c) (5) (ii) of this section, average excess expenditures for unit A are $250,000 ([($1,400,000 ? $1,000,000) + ($1,600,000 − $1,000,000) + $0 + $0] 4). Under paragraph (c) (5) (iii) (C) of this section, average nontraced debt is $2,000,000 ([$2,000,000 + $2,000,000 + $2,000,000 + $2,000,000] 4). Under paragraph (c) (5) (iii) (B) of this section, interest incurred on nontraced debt is $200,000 ($260,000 of interest incurred on all eligible debt less $60,000 of interest incurred on traced debt). Under paragraph (c) (5) (iii) (A) of this section, the weighted average interest rate is 10 percent ($200,000 $2,000,000).

[*88] Under paragraph (c) (1) of this section, Corporation X capitalizes the excess expenditure amount of $25,000 ($250,000 × 10%), because it does not exceed the total amount of interest subject to capitalization under paragraph (c) (2) of this section ($200,000). Thus, the total interest capitalized with respect to unit A during 1995 is $85,000 ($60,000 + $25,000).

(7) *Special rules where the excess expenditure amount exceeds incurred interest-(i) Allocation of total incurred interest to units.* For a computation period in which the sum of the excess expenditure amounts under paragraph (c) (1) of this section for all units of designated property exceeds the total amount of interest (including deferred interest) available for capitalization, as determined under paragraph (c) (2) of this section, the amount of interest that is allocated to a unit of designated property is equal to the product of-

(A) The total amount of interest (including deferred interest) available for capitalization, as determined under paragraph (c) (2) of this section; and

(B) A fraction, the numerator of which is the average excess expenditures for the unit of designated property and the denominator of which is the **[*89]** sum of the average excess expenditures for all units of designated property.

(ii) *Application of related person rules to average excess expenditures.* Certain excess expenditures must be taken into account by the persons (if any) required to capitalize interest with respect to production expenditures of the taxpayer under applicable related person rules. For each computation period, the amount of average excess expenditures that must be taken into account by such persons for each unit of the taxpayer's property is computed by-

(A) Determining, for the computation period, the amount (if any) by which the excess expenditure amount for the unit exceeds the amount of interest allocated to the unit under paragraph (c) (7) (i) of this section; and

(B) Dividing the excess by the weighted average interest rate for the period.

(iii) *Special rule for corporations.* If a corporation is related to another person for the purposes of the applicable related party rules, the District Director upon examination may require that the corporation apply this paragraph (c) (7) and other provisions of the regulations by excluding deferred interest from the total interest available for capitalization.

(d) *Election* **[*90]** *not to trace debt-(1) General rule.* Taxpayers may elect not to trace debt. If the election is made, the average excess expenditures and weighted average interest rate under paragraph (c) (5) of this section are determined by treating all eligible debt as nontraced debt. For this purpose, debt specified in paragraph (a) (4) (ii) of this section *(e.g.*, accounts payable) may be included in eligible debt, provided it would be treated as traced debt but for an election under this paragraph (d). The election not to trace debt is a method of accounting that applies to the determination of capitalized interest for all designated property of the taxpayer. The making or revocation of the election is a change in method of accounting requiring the consent of the Commissioner under section 446 (e) and § 1.446-1 (e).

(2) *Example.* The provisions of paragraph (d) (1) of this section are illustrated by the following example.

Example. (i) Corporation X, a calendar year taxpayer, is engaged in the production of a single unit of designated property during 1995 (unit A). Corporation X adopts the taxable year as the computation period and quarterly measurement dates. At each measurement date (March 31, June **[*91]** 30, September 30, and December 31) Corporation X has the following outstanding indebtedness:

Noninterest-bearing accounts payable traced to unit A	$
Noninterest-bearing accounts payable that are not traced to unit A	$
Interest-bearing loans that are eligible debt within the meaning of paragraph (a) (4) of this section	$

(ii) Corporation X elects under this paragraph (d) not to trace debt. Eligible debt at each measurement date for purposes of calculating the weighted average interest rate under paragraph (c) (5) (iii) of this section is $1,000,000 ($100,000 + $900,000).

(e) *Election to use external rate* -(1) *In general.* An eligible taxpayer may elect to use the highest applicable Federal rate (AFR) under section 1274 (d) in effect during the computation period plus 3 percentage points (AFR plus 3) as a substitute for the weighted average interest rate determined under paragraph (c) (5) (iii) of this section. A taxpayer that makes this election may not trace debt. The use of the AFR plus 3 as provided under this paragraph (e) (1) constitutes a method of accounting. A taxpayer makes the election to use the AFR plus 3 method by using the AFR plus 3 as the taxpayer's **[*92]** weighted average interest rate, and any change to the AFR plus 3 method by a taxpayer that has never previously used the method does not require the consent of the Commissioner. Any other change to or from the use of the AFR plus 3 method under this paragraph (e) (1) (other than by reason of a taxpayer ceasing to be an eligible taxpayer) is a change in method of accounting requiring the consent of the Commissioner under section 446 (e) and § 1.446-1 (e). All changes to or from the AFR plus 3 method are effected on a cut-off basis.

(2) *Eligible taxpayer.* A taxpayer is an eligible taxpayer for a taxable year for

purposes of this paragraph (e) if the average annual gross receipts of the taxpayer for the three previous taxable years do not exceed $10,000,000 (the $10,000,000 gross receipts test) and the taxpayer has met the $10,000,000 gross receipts test for all prior taxable years beginning after December 31, 1994. For purposes of this paragraph (e) (2), the principles of section 263A (b) (2) (B) and (C) and § 1.263A-3 (b) apply in determining whether a taxpayer is an eligible taxpayer for a taxable year.

(f) *Selection of computation period and measurement dates and application of averaging* **[*93]** *conventions* -(1) *Computation period* -(i) *In general.* A taxpayer may (but is not required to) make the avoided cost calculation on the basis of a full taxable year. If the taxpayer uses the taxable year as the computation period, a single avoided cost calculation is made for each unit of designated property for the entire taxable year. If the taxpayer uses a computation period that is shorter than the full taxable year, an avoided cost calculation is made for each unit of designated property for each shorter computation period within the taxable year. If the taxpayer uses a shorter computation period, the computation period may not include portions of more than one taxable year and, except as provided in the case of short taxable years, each computation period within a taxable year must be the same length. In the case of a short taxable year, a taxpayer may treat a period shorter than the taxpayer's regular computation period as the first or last computation period, or as the only computation period for the year if the year is shorter than the taxpayer's regular computation period. A taxpayer must use the same computation periods for all designated property produced during a single **[*94]** taxable year.

(ii) *Method of accounting.* The choice of a computation period is a method of accounting. Any change in the computation period is a change in method of accounting requiring the consent of the Commissioner under section 446 (e) and § 1.446-1 (e).

(iii) *Production period beginning or ending during the computation period.* The avoided cost method applies to the production of a unit of designated property on the basis of a full computation period, regardless of whether the production period for the unit of designated property begins or ends during the computation period.

(2) *Measurement dates* -(i) *In general.* If a taxpayer uses the taxable year as the computation period, measurement dates must occur at quarterly or more frequent regular intervals. If the taxpayer uses computation periods that are shorter than the taxable year, measurement dates must occur at least twice during each computation period and at least four times during the taxable year (or consecutive 12-month period in the case of a short taxable year). The taxpayer must use the same measurement dates for all designated property produced during a computation period. Except in the case of a computation period that **[*95]** differs from the taxpayer's regular computation period by reason of a short taxable year (see paragraph (f) (1) (i) of this section), measurement dates must occur at equal intervals during each computation period that falls within a single taxable year. For any computation period that differs from the taxpayer's regular computation period by reason of a short taxable year, the measurement dates used by the taxpayer during that period must be consistent with the principles and purposes of section 263A (f). A taxpayer is permitted to modify the frequency of measurement dates from year to year.

(ii) *Measurement period.* For purposes of this section, *measurement period* means the period that begins on the first day following the preceding measurement date and that ends on the measurement date.

(iii) *Measurement dates on which accumulated production expenditures must be taken into account.* The first measurement date on which accumulated production expenditures must be taken into account with respect to a unit of designated property is the first measurement date following the beginning of the production period for the unit of designated property. The final measurement date on which accumulated **[*96]** production expenditures with respect to a unit of designated property must be taken into account is the first measurement date following the end of the production period for the unit of designated property. Accumulated production expenditures with respect to a unit of designated property must also be taken into account on all intervening measurement dates. See § 1.263A-12 to determine when the production period begins and ends.

(iv) More frequent measurement dates. When in the opinion of the District Director more frequent measurement dates are necessary to determine capitalized interest consistent with the principles and purposes of section 263A (f) for a particular computation period, the District Director may require the use of more frequent measurement dates. If a significant segment of the taxpayer's production activities (the first segment) requires more frequent measurement dates than another significant segment of the taxpayer's production activities, the taxpayer may request a ruling from the Internal Revenue Service permitting, for a taxable year and all subsequent taxable years, a segregation of the two segments and, notwithstanding paragraph (f) (2) (i) of this section, **[*97]** the use of the more frequent measurement dates for only the first segment. The request for a ruling must be made in accordance with any applicable rules relating to submissions of ruling requests. The request must be filed on or before the due date (including extensions) of the original Federal income tax return for the first taxable year to which it will apply.

(3) *Examples.* The following examples illustrate the principles of this paragraph (f):

> *Example 1.* Corporation X, a calendar year taxpayer, is engaged in the production of designated property during 1995. Corporation X adopts the taxable year as the computation period and quarterly measurement dates. Corporation X must identify traced debt, accumulated production expenditures, and nontraced debt at each quarterly measurement date (March 31, June 30, September 30, and December 31). Under paragraph (c) (5) (ii) of this section, Corporation X must calculate average excess expenditures for each unit of designated property by determining the amount by which accumulated production expenditures exceed traced debt for each unit at the end of each quarter and dividing the sum of these amounts by four. Under paragraph (c) (5) (iii) (C) of **[*98]** this section, Corporation X must calculate average nontraced debt by determining the amount of nontraced debt outstanding at the end of each quarter and dividing the sum of these amounts by four.
>
> *Example 2.* Corporation X, a calendar year taxpayer, is engaged in the production of designated property during 1995. Corporation X adopts a 6-month computation period with two measurement dates within each computation period. Corporation X must identify traced debt, accumulated production expenditures, and nontraced debt at each measurement date

(March 31 and June 30 for the first computation period and September 30 and December 31 for the second computation period). Under paragraph (c) (5) (ii) of this section, Corporation X must, for each computation period, calculate average excess expenditures for each unit of designated property by determining the amount by which accumulated production expenditures exceed traced debt for each unit at each measurement date during the period and dividing the sum of these amounts by two. Under paragraph (c) (5) (iii) (C) of this section, Corporation X must calculate average nontraced debt for each computation period by determining the amount of nontraced **[*99]** debt outstanding at each measurement date during the period and dividing the sum of these amounts by two.

Example 3. (i) Corporation X, a calendar year taxpayer, is engaged in the production of two units of designated property during 1995. Production of Unit A starts in 1994 and ends on June 20, 1995. Production of Unit B starts on April 15, 1995, but does not end until 1996. Corporation X adopts the taxable year as its computation period and does not elect under paragraph (d) of this section not to trace debt. Corporation X uses quarterly measurement dates and pays all interest on eligible debt in the quarter in which the interest is incurred. During 1995, Corporation X has two items of eligible debt. The debt and the manner in which it is used are as follows:

#	Principal	Annual rate	Period outstanding	Use
1	$1,000,000	9%	1/01-9/01	
2	2,000,000	11%	6/01-12/31	

(ii) Based on the annual 9 percent rate of interest, Corporation X incurs $7,500 of interest during each month that Loan #1 is outstanding.

(iii) Accumulated production expenditures at the end of each quarter during 1995 are as follows:

Measurement Date	Unit A	Unit
March 31	$1,200,000	$-(
June 30	$1,800,000	$ 500
Sept. 30	-0-	$1,00(
Dec. 31	-0-	$1,60(

(iv) **[*100]** Corporation X must first determine the amount of interest incurred on traced debt and capitalize the interest incurred on this debt (the traced debt amount). Loan #1 is allocated to Unit A on the March 31 and June 30 measurement dates. Accordingly, Loan #1 is treated as traced debt with respect to unit A for the measurement periods beginning January

1 and ending June 30. The interest incurred on Loan #1 during the period that Loan #1is treated as traced debt must be capitalized with respect to Unit A. Thus, $45,000 ($7,500 per month for 6 months) is capitalized with respect to Unit A.

(v) Second, Corporation X must determine average excess expenditures for Unit A and Unit B. For Unit A, this amount is $250,000 ([$200,000 + $800,000 + $0 + $0] 4). For Unit B, this amount is $775,000 ([$0 + $500,000 + $1,000,000 + $1,600,000] ÷ 4).

(vi) Third, Corporation X must determine the weighted average interest rate and apply that rate to the average excess expenditures for Units A and B. The rate is equal to the total amount of interest incurred on nontraced debt (i.e., interest incurred on all eligible debt reduced by interest incurred on traced debt) divided by the **[*101]** average nontraced debt. The interest incurred on nontraced debt equals $143,333 ([$1,000,000 × 9% × 8/12] + [$2,000,000 × 11% × 7/12] − $45,000). The average nontraced debt equals $1,500,000 ([$0 + $2,000,000 + $2,000,000 + $2,000,000] 4). The weighted average interest rate of 9.56 percent ($143,333 $1,500,000), is then applied to average excess expenditures for Units A and

B. Accordingly, Corporation X capitalizes an additional $23,900 ($250,000 × 9.56%) with respect to Unit A and $74,090 ($775,000 × 9.56%) with respect to Unit B (the excess expenditure amounts).

(g) *Special rules* -(1) *Ordering rules* -(i) *Provisions preempted by section 263A (f).* Interest must be capitalized under section 263A (f) before the application of section 163 (d) (regarding the investment interest limitation), section 163 (j) (regarding the limitation on interest paid to a taxexempt related person), section 266 (regarding the election to capitalize carrying charges), section 469 (regarding the limitation on passive losses), and section 861 (regarding the allocation of interest to United States sources). Any interest that is capitalized under section 263A (f) is not taken into account as interest **[*102]** under those sections. However, in applying section 263A (f) with respect to the excess expenditure amount, the taxpayer must capitalize all interest that is neither investment interest under section 163 (d), exempt related person interest under section 163 (j), nor passive interest under section 469 before capitalizing any interest that is either investment interest, exempt related person interest, or passive interest. Any interest that is not required to be capitalized after the application of section 263A (f) is then taken into account as interest subject to sections 163 (d), 163 (j), 266, 469, and 861. If, after the application of section 263A (f), interest is deferred under sections 163 (d), 163 (j), 266, or 469, that interest is not subject to capitalization under section 263A (f) in any subsequent taxable year.

(ii) *Deferral provisions applied before this section.* Interest (including contingent interest) that is subject to a deferral provision described in this paragraph (g) (1) (ii) is subject to capitalization under section 263A (f) only in the taxable year in which it would be deducted if section 263A (f) did not apply. Deferral provisions include sections 163 (e) (3), 267, **[*103]** 446, and 461, and all other deferral or limitation provisions that are not described in paragraph (g) (1) (i) of this section. In contrast to the provisions of paragraph (g) (1) (i) of this section, deferral provisions are applied before the application of section 263A (f).

(2) *Application of section 263A (f) to deferred interest* -(i) *In general.* This paragraph (g) (2) describes the time and manner of capitalizing and recovering the deferral amount. The deferral amount for any computation period equals the sum of-

(A)The amount of interest that is incurred on traced debt that is deferred during the computation period and is not deductible for the taxable year that includes the computation period because of a deferral provision described in paragraph (g) (1) (ii) of this section, and

(B)The shortfall amount described in paragraph (c) (40 of this section.

(ii) *Capitalization of deferral amount.* The rules described in paragraph (g) (2) (iii) of this section apply to the deferral amount unless the taxpayer elects under paragraph (g) (2) (iv) of this section to capitalize substitute costs.

(iii) *Deferred capitalization.* If the taxpayer does not elect under paragraph (g) (2) (iv) of this section **[*104]** to capitalize substitute costs, deferred interest to which the deferral amount is attributable (determined under any reasonable method) is capitalized in the year or years in which the deferred interest would have been deductible but for the application of section 263A (f) (the capitalization year). For this purpose, any interest that is deferred from a prior computation period is taken into account in subsequent capitalization years in the same order in which the interest was deferred. If a unit of designated property to which previously deferred interest relates is sold before the capitalization year, the deferred interest applicable to that unit of property is taken into account in the capitalization year and treated as if recovered from the sale of the property. If the taxpayer continues to hold, throughout the capitalization year, a unit of depreciable property to which previously deferred interest relates, the adjusted basis and applicable recovery percentages for the unit of property are redetermined for the capitalization year and subsequent years so that the increase in basis is accounted for over the remaining recovery periods beginning with the capitalization year. See Example **[*105]** 2 of paragraph (g) (2) (v) of this section.

(iv) *Substitute capitalization* -(A) *General rule.* In lieu of deferred capitalization under paragraph (g) (2) (iii) of this section, the taxpayer may elect the substitute capitalization method described in this paragraph (g) (2) (iv). Under this method, the taxpayer capitalizes for the computation period in which interest is incurred and deferred (the deferral period) costs that would be deducted but for this paragraph (g) (2) (iv) (substitute costs). The taxpayer must capitalize an amount of substitute costs equal to the deferral amount for each unit of designated property, or if less, a prorata amount (determined in accordance with the principles of paragraph (c) (7) (i) of this section) of the total substitute costs that would be deducted but for this paragraph (g) (2) (iv) during the deferral period. If the entire deferral amount is capitalized pursuant to this paragraph (g) (2) (iv) in the deferral period, any interest incurred and deferred in the deferral period is neither capitalized nor deducted during the deferral period and, unless subsequently capitalized as a substitute cost under this paragraph (g) (2) (iv), is deductible in the **[*106]** appropriate subsequent period without regard to section 263A (f).

(B) *Capitalization of amount carried forward.* If the taxpayer has an insufficient amount of substitute costs in the deferral period, the amount by which substitute costs are insufficient with respect to each unit of designated property is a deferral amount carryforward to succeeding computation periods beginning with the next computation period. In any carryforward year, the taxpayer must capitalize an amount of substitute costs equal to the deferral amount carryforward or, if less, a prorata amount (determined in accordance with the principles of paragraph (c) (7) (i) of this section) of the total substitute costs that would be deducted during the carryforward year or years (the carryforward capitalization year) but for this paragraph (g) (2) (iv) (after applying the substitute cost method of this paragraph (g) (2) (iv) to the production of designated property in the carryforward period). If a unit of designated property to which the deferral amount carryforward relates is sold prior to the carryforward capitalization year, substitute costs applicable to that unit of property are taken into account in the carryforward **[*107]** capitalization year and treated as if recovered from the sale of the property. If the taxpayer continues to hold, throughout the capitalization year, a unit of depreciable property to which a deferral amount carryforward relates, the adjusted basis and applicable recovery percentages for the unit of property are redetermined for the carryforward capitalization year and subsequent years so that the increase in basis is accounted for over the remaining recovery periods beginning with the carryforward capitalization year. See Example 2 of paragraph (g) (2) (v) of this section.

(C) *Method of accounting.* The substitute capitalization method under this paragraph (g) (2) (iv) is a method of accounting that applies to all designated property of the taxpayer. A change to or from the substitute capitalization method is a change in method of accounting requiring the consent of the Commissioner under section 446 (e) and § 1.446-1 (e).

(v) *Examples.* The following examples illustrate the application of the avoided cost method when interest is subject to a deferral provision:

Example 1. (i) Corporation X is a calendar year taxpayer and uses the taxable year as its computation period. During 1995, X **[*108]** is engaged in the construction of a warehouse which X will use in its storage business. The warehouse is completed and placed in service in December 1995. X's average excess expenditures for 1995 equal $1,000,000. Throughout 1995, X's only outstanding debt is nontraced debt of $900,000 and $1,200,000, bearing interest at 15 percent and 9 percent, respectively, per year. Of the $243,000 interest incurred during the year ([$900,000 × 15%] + [$1,200,000 × 9%] = [$135,000 + $108,000]), $75,000 is deferred under section 267 (a) (2).

(ii) X must first determine the amount of interest required to be capitalized under paragraph (c) (1) of this section for 1995 (the deferral period) without applying section 267 (a) (2). The weighted average interest rate is 11.6 percent ([$135,000 + $108,000] $2,100,000), and the excess expenditure amount under paragraph (c) (1) of this section is $116,000 ($1,000,000 × 11.6%). Under paragraph (c) (4) of this section, X must then determine the amount of interest that would be capitalized by applying paragraph (c) (2) of this section without regard to the amount of deferred interest. Disregarding deferred interest, the amount of interest **[*109]** available for capitalization is $168,000 ([$900,000 × 15%] + [$1,200,000 × 9%] + $75,000). Thus, the full excess expenditure amount ($116,000) is capitalized from interest that is not deferred under section 267 (a) (2) and there is no shortfall amount.

Example 2. (i) The facts are the same as in Example 1, except that $140,000 of interest is deferred under section 267 (a) (2) in 1995. The taxpayer does not elect to use the substitute capitalization method. This interest is also deferred in 1996 but would be deducted in 1997 if section 263A (f) did not apply. As in Example 1, the excess expenditure amount is $116,000. However, the amount of interest available for capitalization after excluding the amount of deferred interest is $103,000 ([$900,000 × 15%] + [$1,200,000 times; 9%] + $140,000). Thus, only $103,000 of interest is capitalized with respect to the warehouse in 1995. Since $116,000 of interest would be capitalized if section 267 (a) (2) did not apply, the deferral amount determined under paragraphs (c) (2) and (g) (2) (i) of this section is $13,000 ($116,000 plus; $103,000), and $13,000 of deferred interest must be capitalized in the year in which it would **[*110]** be deducted if section 263A (f) did not apply.

(ii) The $140,000 of interest deferred under section 267 (a) (2) in 1995 would be deducted in 1997 if section 263A (f) did not apply. X is therefore required to capitalize an additional $13,000 of interest with respect to the warehouse in 1997 and must redetermine its basis and recovery percentage.

(3) *Simplified inventory method* -(i) *In general.* This paragraph (g) (3) provides a simplified method of capitalizing interest expense with respect to designated property that is inventory. Under this method, the taxpayer determines beginning and ending inventory and cost of goods sold applying all other capitalization provisions, including, for example, the simplified production method of § 1.263A-2 (b), but without regard to the capitalization of interest with respect to inventory. The taxpayer must establish a separate capital asset, however, in an amount equal to the aggregate interest capitalization amount (as defined in paragraph (g) (3) (iii) (C) of this section). Under the simplified inventory method, increases in the aggregate interest capitalization amount from one year to the next generally are treated as reductions in interest expense, **[*111]** and decreases in the aggregate interest capitalization amount from one year to the next are treated as increases to cost of goods sold.

(ii) *Segmentation of inventory* -(A) *General rule.* Under the simplified inventory method, the taxpayer first separates its total ending inventory value into segments that are equal to the total ending inventory value divided by the inverse inventory turnover rate. Each inventory segment is then assigned an age starting with one year and increasing by one year for each additional segment. The inverse inventory turnover rate is determined by finding the average of beginning and ending inventory, dividing the average by the cost of goods sold for the year, and rounding the result to the nearest whole number. Beginning and ending inventory amounts are determined using total current cost of inventory for the year (rather than carrying value). Cost of goods sold, however, may be determined using either total current cost or the taxpayer's inventory method. In addition, for purposes of this paragraph (g) (3) (ii), current costs for a year (and, if applicable, the cost of goods sold for the year under the taxpayer's inventory method) are determined without regard **[*112]** to the capitalization of interest with respect to inventory.

(B) *Example.* The provisions of paragraph (g) (3) (ii) (A) of this section are illustrated by the following example.

Example. X, a taxpayer using the FIFO inventory method, determines that total cost of goods sold for 1995 equals $900, and the cost of both beginning and ending inventory equals $3,000. Thus, X's inverse inventory turnover rate equals 3 (3.33 rounded to the nearest whole number). Total ending inventory of $3,000 is divided into three segments of $1,000 each. One segment is treated as 3-year-old inventory, one segment is treated as 2-year-old inventory, and one segment is treated as 1-year-old inventory.

(iii) *Aggregate interest capitalization amount* -(A) *Computation period and weighed average interest rate.* If a taxpayer elects the simplified inventory method, the taxpayer must use the taxable year as its computation period and use the weighted average interest rate determined under this paragraph (g) (3) (iii) (A) in determining the aggregate interest capitalization amount defined in paragraph (g) (3) (iii) (C) of this section and in determining the amount of interest capitalized with respect to any designated **[*113]** property that is not inventory. Under the simplified inventory method, the taxpayer determines the weighted average interest rate in accordance with paragraph (c) (5) (iii) of this section, treating all eligible debt (other than debt traced to noninventory property in the case of a taxpayer tracing debt) as nontraced debt (i.e., without tracing debt to inventory). A taxpayer that has elected under paragraph (e) of this section to use an external rate as a substitute for the weighted average interest rate determined under paragraph (c) (5) (iii) of this section uses the rate described in paragraph (e) (1) as the weighted average interest rate.

(B) *Computation of the tentative aggregate interest capitalization amount.* The weighted average interest rate is compounded annually by the number of years assigned to a particular inventory segment to produce an interest factor (applicable interest factor) for that segment. The amounts determined by multiplying the value of each inventory segment by its applicable interest factor are then combined to produce a tentative aggregate interest capitalization amount.

(C) *Coordination with other interest capitalization computations* -(1) *In general.* If **[*114]** the tentative aggregate interest capitalization amount for a year exceeds the aggregate interest capitalization amount (defined in paragraph (g) (3) (iii) (D) of this section) as of the close of the preceding year, then, for purposes of applying the rules of paragraph (c) (7) of this section, the excess is treated as an excess expenditure amount and the inventory to which the simplified inventory method of this paragraph (g) (3) applies is treated as a single unit of designated property. If, after these modifications, no paragraph (c) (7) interest allocation is necessary (i.e., the excess expenditure amounts for all units of designated property do not exceed the total amount of interest (including deferred interest) available for capitalization), the aggregate interest capitalization amount generally equals the tentative aggregate interest capitalization amount. If, on the other hand, a paragraph (c) (7) allocation is necessary, the tentative aggregate interest capitalization amount is generally adjusted to reflect the results of that allocation (*i.e.*, the increase in the aggregate interest capitalization amount is limited to the amount of interest allocated to inventory, reduced, **[*115]** however, by any substitute costs that are capitalized with respect to inventory under applicable related party rules).

(2) *Deferred interest.* In determining the aggregate interest capitalization amount, the tentative aggregate interest capitalization amount is adjusted (after the application of paragraph (c) (7) of this section) as appropriate to reflect the deferred interest rules of paragraph (g) (2) of this section. The tentative aggregate interest capitalization amount would be reduced, for example, by the amount of a taxpayer's deferred interest for a taxable year unless the taxpayer has elected the substitute capitalization method under paragraph (g) (2) (iv).

(3) *Other coordinating provisions.* The Commissioner may prescribe, by revenue ruling or revenue procedure, additional provisions to coordinate the election and use of the simplified inventory method with other interest capitalization requirements and methods. See § 601.601 (d) (2) (ii) (b) of this chapter.

(D) *Treatment of increases or decreases in the aggregate interest capitalization amount.* Except as otherwise provided in this paragraph (g) (3) (iii) (D), increases in the aggregate interest capitalization amount from one **[*116]** year to the next are treated as reductions in interest expense, and decreases in the aggregate interest capitalization amount from one year to the next are treated as increases to cost of goods sold. To the extent a taxpayer capitalizes substitute costs under either applicable related party rules or the deferred interest rules in paragraph (g) (2) of this section, increases in the aggregate interest capitalization amount are treated as reductions in applicable substitute costs, rather than interest expense.

(E) *Example.* The provisions of this paragraph (g) (3) (iii) are illustrated by the following example.

Example. The facts are the same as in the example in paragraph (g) (3) (ii) (B) of this section, and, in addition X determines that its weighted average interest rate for 1995 is 10 percent. Additionally, assume that X has no deferred interest in 1995 or 1996 and no deferral amount carryforward to either 1995 or 1996 (See paragraph (g) (2) of this section.) Also assume that no allocation is necessary under paragraph (c) (7) of this section in either 1995 or 1996. Under the rules of paragraph (g) (3) (ii) of this section, S divides ending inventory into segments of $1,000 each. One **[*117]** segment is 1-year old inventory, one segment is 2-year old inventory, and one segment is 3-year old inventory. Under paragraph (g) (3) (iii) (B) of this section, X must compute the applicable interest factor for each segment. The applicable interest factor for the 1-year old inventory is not compounded. The applicable interest factor for the 2-year old inventory is compounded for 1 year. The applicable interest factor for the 3-year old inventory is compounded for 2 years. The interest factor applied to the 1-year old inventory segment is 1. The interest factor applied to the 2-year old inventory segment is .21 [(1.1 × 1.1) − 1]. The interest factor applied to the 3-year old inventory is .331 [(1.1 × 1.1 × 1.1) − 1]. Thus, the tentative aggregate interest capitalization amount for 1995 is $641 (1,000 × [.1 + .21 + .331]). Because X has no deferred interest in 1995, no deferral amount carryforward to 1995, and no required allocation under paragraph (c) (7) of this section in 1995, X's aggregate interest capitalization amount equals its $641 tentative aggregate interest capitalization amount. If, in 1996, X computes an aggregate interest capitalization amount of $750, the $109 **[*118]** increase in the amount from 1995 to 1996 would be treated as a reduction in interest expense for 1996.

(iv) *Method of accounting.* The simplified inventory method is a method of accounting that must be elected for and applied to all inventory within a single trade or business of the taxpayer (within the meaning of section 446 (d) and § 1.446-1 (d)). This method may be elected only if the inventory in that trade or business consists only of designated property and only if the taxpayer's inverse inventory turnover rate for that trade or business (as defined in paragraph (g) (3) (ii) (A) of this section) is greater than or equal to one. A change from or to the simplified inventory method is a change in method of accounting requiring the consent of the Commissioner under section 446 (e) and § 1.446-(1) (e).

(4) *Financial accounting method disregarded.* The avoided cost method is applied under this section without regard to any financial or regulatory accounting principles for the capitalization of interest. For example, this section determines the amount of interest that must be capitalized without regard to Financial Accounting Standards Board (FASB) Statement Nos. 34, 71, and 90, issued **[*119]** by the Financial Accounting Standards Board, Norwalk, CT 06856-5116. Similarly, taxpayers are not permitted to net interest income and interest expense in determining the amount of interest that must be capitalized under this section with respect to certain restricted tax-exempt borrowings even though netting is permitted under FASB Statement No. 62.

(5) *Treatment of intercompany transactions* -(i) *General rule.* If interest capitalized under section 263A (f) by a member of a consolidated group (within the meaning of § 1.1502-1 (h)) with respect to a unit of designated property is attributable to a loan from another member of the group (the lending member), the intercompany transaction provisions of the consolidated return regulations do not apply to the lending member's interest income with respect to that loan, except as provided in paragraph (g) (5) (ii) of this section. For this purpose, the capitalized interest expense that is attributable to a loan from another member is determined under any method that reasonably reflects the principles of the avoided cost method, including the traced and nontraced concepts. For purposes of this paragraph (g) (5) (i) and paragraph (g) (5) (ii) **[*120]** of this section, in order for a method to be considered reasonable it must be consistently applied.

(ii) *Special rule for consolidated group with limited outside borrowing.* If, for any year, the aggregate amount of interest income described in paragraph (g) (5) (i) of this section for all members of the group with respect to all units of designated property exceeds the total amount of interest that is deductible for that year by all members of the group with respect to debt of a member owed to nonmembers (group deductible interest) after applying section 263 A (f), the intercompany transaction provisions of the consolidated return regulations are applied to the excess, and the amount of interest income that must be taken into account by the group under paragraph (g) (5) (i) of this section is limited to the amount of the group deductible interest. The amount to which the intercompany transaction provisions of the consolidated return regulations apply by reason of this paragraph (g) (5) (ii) is allocated among the lending members under any method that reasonably reflects each member's share of interest income described in paragraph (g) (5) (i) of this section. If a lending member has **[*121]** interest income that is attributable to more than one unit of designated property, the amount to which the intercompany transaction provisions of the consolidated return regulations apply by reason of this paragraph (g) (5) (ii) with respect to the member is allocated among the units in accordance with the principles of paragraph (c) (7) (i) of this section.

(iii) *Example.* The provisions of paragraph (g) (5) (ii) of this section are illustrated by the following example.

Example, (i) P and S1 are the members of a consolidated group. In 1995, S1 begins and completes the construction of a shopping center and is required to capitalize interest with respect to the construction. S1's average excess expenditures for 1995 are $5,000,000. Throughout 1995, S1's only borrowings include a $6,000,000 loan from P bearing interest at an annual rate of 10 percent ($600,000 per year). Under the avoided cost method, S1 is required to capitalize interest in the amount of $500,000 ([$600,000 $6,000,000] × $5,000,000).

(ii) P's only borrowing from unrelated lenders is a $2,000,000 loan bearing interest at an annual rate of 10 percent ($200,000 per year). Under the principles of paragraph (g) (5) (ii) of this **[*122]** section, because the aggregate amount of interest described in paragraph (g) (5) (i) of this section ($500,000) exceeds the aggregate amount of currently deductible interest of the group ($200,000), the intercompany transaction provisions of the consolidated return regulations apply to the excess of $300,000 and the amount of P's interest income that is subject to current inclusion by reason of paragraph (g) (5) (i) of this section is limited to $200,000.

(6) *Notional principal contracts and other derivatives.* [Reserved]

(7) *15-day repayment rule.* A taxpayer may elect to treat any eligible debt that is repaid within the 15-day period immediately preceding a quarterly measurement date as outstanding as of that measurement date for purposes of determining traced debt, average nontraced debt, and the weighted average interest rate. This election may be made or discontinued for any computation period and is not a method of accounting.

§ 1.263A-10 Unit of property.

(a) *In general.* The unit of property as defined in this section is used as the basis to determine accumulated production expenditures under § 1.263A-11 and the beginning and end of the production period under § 1.263A-12. Whether **[*123]** property is 1-year or 2-year property under § 1.263A-8 (b) (1) (ii) is also determined separately with respect to each unit of property as defined in this section.

(b) *Units of real property* -(1) *In general.* A unit of real property includes any components of real property owned by the taxpayer or a related person that are functionally interdependent and an allocable share of any common feature owned by the taxpayer or a related person that is real property even though the common feature does not meet the functional interdependence test. When the production period begins with respect to any functionally interdependent component or any common feature of the unit of real property, the production period has begun for the entire unit of real property. See, however, paragraph (b) (5) of this section for rules under which the costs of a common feature or benefitted property are excluded from accumulated production expenditures for one or more measurement dates. The portion of land included in a unit of real property includes land on which real property (including a common feature) included in the unit is situated, land subject to setback restrictions with respect to such property, and any **[*124]** other contiguous portion of the tract of land other than land that the taxpayer holds for a purpose unrelated to the unit being produced (e.g., investment purposes, personal use purposes, or specified future development as a separate unit of real property).

(2) *Functional interdependence.* Components of real property produced by, or for, the taxpayer, for use by the taxpayer or a related person are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component by the taxpayer or a related person. In the case of property produced for sale, components of real property are functionally interdependent if they are customarily sold as a single unit. For example, the real property components of a single-family house (*e.g.,* the land, foundation, and walls) are functionally interdependent. In contrast, components of real property that are expected to be separately placed in service or held for resale are not functionally interdependent. Thus, dwelling units within a multiunit building that are separately placed in service or sold (within the meaning of § 1.263A-12 (d) (1)) are treated as functionally independent of any other **[*125]** units, even though the units are located in the same building.

(3) *Common features.* For purposes of this section, a common feature generally includes any real property (as defined in § 1.263A-8 (c)) that benefits real property produced by, or for, the taxpayer or a related person, and that is not separately held for the production of income. A common feature need not be physically contiguous to the real property that it benefits. Examples of common features include streets, sidewalks, playgrounds, clubhouses, tennis courts, sewer lines, and cables that are not held for the production of income separately from the units of real property that they benefit.

(4) *Allocation of costs to unit.* Except as provided in paragraph (b) (5) of this section, the accumulated production expenditures for a unit of real property include, in all cases, the costs that directly benefit, or are incurred by reason of the production of, the unit of real property. Accumulated production expenditures also include the adjusted basis of property used to produce the unit of real property. The accumulated costs of a common feature or land that benefits more than one unit of real property, or that benefits designated **[*126]** property and property other than designated property, is apportioned among the units of designated property, or among the designated property and property other than designated property, in determining accumulated production expenditures. The apportionment of the accumulated costs of the common feature (allocable share) or land (attributable land costs) generally may be made using any method that is applied on a consistent basis and that reasonably reflects the benefits provided. For example, an apportionment based on relative costs to be incurred, relative space to be occupied, or relative fair market values may be reasonable.

(5) *Treatment of costs when a common feature is included in a unit of real property* -(i) *General rule.* Except as provided in this paragraph (b) (5), the accumulated production expenditures of a unit of real property include the costs of functionally interdependent components (benefitted property) and an allocable share of the cost of common features throughout the entire production period of the unit. See § 1.263A-12, relating to the production period of a unit of property.

(ii) *Production activity not undertaken on benefitted property* -(A) *Direct* *production activity* **[*127]** *not undertaken* -(1) *In general.* The costs of land attributable to a benefitted property may be treated as not included in accumulated production expenditures for a unit of real property for measurement dates prior to the first date a production activity (direct production activity), including the clearing and grading of land, has been undertaken with respect to the land attributable to the benefitted property. Thus, the costs of land attributable to a benefitted property (as opposed to land attributable to the common features) with respect to which no direct production activities have been undertaken may be treated as not included in the accumulated production expenditures of a unit of real property even though a production activity has begun on a common feature allocable to the unit.

(2) *Land attributable to a benefitted property.* For purposes of this paragraph (b) (5) (ii), land attributable to a benefitted property includes all land in the unit of real property that includes the benefitted property other than land for a common feature. (Thus, land attributable to a benefitted property does not include land attributable to a common feature.)

(B) *Suspension of direct production activity* **[*128]** *after clearing and grading undertaken* -(1) *General rule.* This paragraph (b) (5) (ii) (B) may be used to determine the accumulated production expenditures for a unit of real property, if the only production activity with respect to a benefitted property has been clearing and grading and no further direct production activity is undertaken with respect to the benefitted property for at least 120 consecutive days (i.e., direct production activity has ceased). Under this paragraph (b) (5) (ii) (B), the accumulated production expenditures attributable to a benefitted property qualifying under this paragraph (b) (5) (ii) (B) may be excluded from the accumulated production expenditures of the unit of real property even though production continues on a common feature allocable to the unit. For purposes of this paragraph (b) (5) (ii) (B), production activity is considered to occur during any time which would not qualify as a cessation of production activities under the suspension period rules of § 1.263A-12 (g).

(2) *Accumulated production expenditures.* If this paragraph (b) (5) (ii) (B) applies, accumulated production expenditures attributable to the benefitted property of the unit of real property **[*129]** may be treated as not included in the accumulated production expenditures for the unit starting with the first measurement period beginning after the first day of the 120 consecutive day period, but must be included in the accumulated production expenditures for the unit beginning in the measurement period in which direct production activity has resumed on the benefitted property. Accumulated production expenditures with respect to common features allocable to the unit of real property may not be excluded under this paragraph (b) (5) (ii) (B).

(iii) *Common feature placed in service before the end of production of a benefitted property.* To the extent that a common feature with respect to which all production activities to be undertaken by, or for, a taxpayer or a related person are completed is placed in service before the end of the production period of a unit that includes an allocable share of the costs of the common feature, the costs of the common feature are not treated as included in accumulated production expenditures of the unit for measurement periods beginning after the date the common feature is placed in service.

(iv) *Benefitted property sold before production completed on* **[*130]** *common feature.* If a unit of real property is sold before common features included in the unit are completed, the production period of the unit ends on the date of sale. Thus, common feature costs actually incurred and properly allocable to the unit as of the date of sale are excluded from accumulated production expenditures for measurement periods beginning after the date of sale. Common feature costs properly allocable to the unit and actually incurred after the sale are not taken into account in determining accumulated production expenditures.

(v) *Benefitted property placed in service before production completed on common feature.* Where production activities remain to be undertaken on a common feature allocable to a unit of real property that includes benefitted property, the costs of the benefitted property are not treated as included in the accumulated production expenditures for the unit for measurement periods beginning after the date the benefitted property is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person with respect to the benefitted property are completed.

(6) Examples. The principles of paragraph **[*131]** (b) of this section are illustrated by the following examples:

Example 1. B, an individual, is in the trade or business of constructing custom-built houses for sale. B owns a 10-acre tract upon which B intends to build four houses on 2-acre lots. In addition, on the remaining 2 acres B plans to construct a perimeter road that benefits the four houses and is not held for the production of income separately from the sale of the houses. In 1995, B begins constructing the perimeter road and clears the land for one house. Under the principles of paragraph (b) (1) of this section, each planned house (including attributable land) is part of a separate unit of real property (house unit). Under the principles of paragraph (b) (3) of this section, the perimeter road (including attributable land) constitutes a common feature with respect to each planned house (i.e., benefitted property). In accordance with paragraph (b) (1), the production period for all four house units begins when production commences on the perimeter road in 1995. In addition, under the principles of paragraph (b) (4) of this section, the accumulated production expenditures for the four house units include the allocable costs **[*132]** of the road. In addition, for the house with respect to which B has cleared the land, the accumulated production expenditures for the house unit include the land costs attributable to the house. See paragraph (b) (5) (i) of this section. However, the accumulated production expenditures for each of the three house units that include a house for which B has not yet undertaken a direct production activity do not include the land costs attributable to the house. See paragraph (b) (5) (ii) of this section.

Example 2. Assume the same facts as Example 1, except that B undertakes no further direct production activity with respect to the house for which the land was cleared for a period of at least 120 days but continues constructing the perimeter road during this period. In accordance with paragraph (b) (5) (ii) (B) of this section, B may exclude the accumulated production expenditures attributable to the benefitted property from the accumulated production expenditures of the house unit starting with the first measurement period that begins after the first day of the 120 consecutive day period. B must include the accumulated production expenditures attributable to the benefitted property in **[*133]** the accumulated production expenditures for the house unit beginning with the measurement period in which direct production resumes on the benefitted property. The house unit will continue to include the accumulated production expenditures attributable to the perimeter road during the period in which direct production activity was suspended on the benefitted property.

Example 3. (i) D, a corporation, is in the trade or business of developing commercial real property. D owns a 20-acre tract upon which D intends to build a shopping center with 150 stores. D intends to lease the stores. D will also provide on the 20 acres a 1500-car parking lot, which is not held by D for the production of income separately from the stores in the shopping center. Additionally, D will not produce any other common features as part of the project. D intends to complete the shopping center in phases and expects that each store will be placed in service independently of any other store.

(ii) Under paragraphs (b) (1) and (b) (2) of this section, each store (including attributable land) is part of a separate unit of real property (store unit). The 1500-car parking lot is a common feature benefitting each store, **[*134]** and D must include an allocable share of the parking lot in each store unit. See paragraphs (b) (1) and (b) (3). In accordance with paragraph (b) (5) (i), D includes in the accumulated production expenditures for each store unit during each store unit's production period: the costs capitalized with respect to the store (including attributable land costs in accordance with paragraph (b) (5) of this section) and an allocable share of the parking lot costs (including attributable land costs in accordance with paragraph (b) (5) of this section). Under paragraph (b) (4), the portion of the parking lot costs that is included in the accumulated production expenditures of a store unit is determined using a reasonable method of allocation.

Example 4. X, a real estate developer, begins a project to construct a condominium building and a convenience store for the benefit of the condominium. X intends to separately lease the convenience store. Because the convenience store is held for the production of income separately from the condominium units that it benefits, the convenience store is not a common feature with respect to the condominium building. Instead, the convenience store is a separate **[*135]** unit of property with a separate production period and for which a separate determination of accumulated production expenditures must be made.

Example 5. (i) In 1995, X, a real estate developer, begins a project consisting of a condominium building and a common swimming pool that is not held for the production of income separately from the condominium sales. The condominium building consists of 10 stories, and each story is occupied by a single condominium. Production of the swimming pool begins in January. No direct production activity is undertaken on any condominium until September, when direct production activity commences on each condominium. On December 31, 1995, 1 condominium that was completed in December has been sold, 3 condominiums that were completed in December have not been sold, and 6 condominiums are only partially complete; additionally, the swimming pool is completed. X is a calendar year taxpayer that uses a full taxable year as the computation period, and quarterly measurement dates.

(ii) Under paragraphs (b) (1) and (b) (2) of this section, each condominium (including attributable land) is part of a separate unit of real property. Under the principles of paragraph **[*136]** (b) (3) of this section, the swimming pool is a common feature with respect to each condominium and under paragraph (b) (4) of this section the cost of the swimming pool is allocated equally among the condominiums.

(iii) Under paragraph (b) (1) of this section, the production period of each of the 10 condominium units begins in January when production of the swimming pool begins. On X's March 31, 1995, and June 30, 1995, measurement dates, the accumulated production expenditures for each condominium unit include the allocable costs of the swimming pool, but not the land costs attributable to the condominium because no direct production activity has been undertaken on the condominium. See paragraph (b) (5) (ii) (A) of this section. On X's September 30, 1995, and December 31, 1995, measurement dates, the accumulated production expenditures for each unit include the allocable costs of the swimming pool, and the costs of the condominium (including attributable land costs) because a direct production activity has commenced on the condominium.

See paragraph (b) (5) (i) of this section.

(iv) The production period for the condominium unit that includes the condominium that is sold as of the end **[*137]** of 1995 ends on the date the condominium is sold. See paragraph (b) (5) (iv) of this section. The production period of each unit that is ready to be held for sale ends when all production activities have been completed on the unit, in this case on December 31, 1995, the date that the swimming pool included in the unit is completed. See § 1.263A-12 (d). Accordingly, interest capitalization ceases for each such unit that is sold or ready to be held for sale as of the end of 1995 (including each unit's allocable share of the completed swimming pool).

(v) The production periods for the condominium units that include the condominiums that are only partially complete at the end of 1995 continue after 1995. The accumulated production expenditures for each partially completed condominium unit continue to include the costs of the condominium (including attributable land costs) in addition to the costs of an allocable share of the completed swimming pool (including attributable land costs).

Example 6. Assume the same facts as in*Example 5,* except that the swimming pool is only partially complete as of the end of 1995. Under these facts, X capitalizes no interest during 1996 for the 1 unit that **[*138]** includes the condominium sold during 1995 (including the costs of the allocable share of the swimming pool). See paragraph (b) (5) (iv) of this section. However, with respect to the 6 condominiums that are partially complete and the 3 condominiums that are completed but unsold, interest capitalization continues after the end of 1995. The accumulated production expenditures for each of these 9 units include the costs of an allocable share of the swimming pool. See paragraph (b) (5) (i) of this section. In determining the costs of an allocable share of the swimming pool included in the accumulated production expenditures for each of the 9 units, X includes all costs of the swimming pool properly allocable to each unit, including those costs incurred as of the date of the sale of unit 1 that may have been used under applicable administrative procedures (e.g., Rev. Proc. 92-29, 1992-1 C.B. 748) in determining the basis of unit 1 solely for purposes of computing gain or loss on the sale of unit 1. See § 601.601 (d) (2) (ii) (b) of this chapter.

Example 7. (i) Assume the same facts as in*Example 5*, except that X intends to lease rather than sell the condominiums and the completed swimming **[*139]** pool is placed in service for depreciation purposes on December 31, 1995. Additionally, assume that all 10 condominiums are partially completed at the end of 1995.

(ii) Under these facts, because the swimming pool is a common feature that is placed in service separately from the condominiums that it benefits, under paragraph (b) (5) (iii) of this section, the accumulated production expenditures of each of the condominium units do not include the costs of the allocable share of the swimming pool after 1995.

(c) *Units of tangible personal property.* Components of tangible personal property are a single unit of property if the components are functionally interdependent. Components of tangible personal property that are produced by, or for, the taxpayer, for use by the taxpayer or a related person, are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component by the taxpayer or a related person. In the case of tangible personal property produced for sale, components of tangible personal property are functionally interdependent if they are customarily sold as a single unit. For example, if an aircraft manufacturer customarily **[*140]** sells completely assembled aircraft, the unit of property includes all components of a completely assembled aircraft. If the manufacturer also customarily sells aircraft engines separately, any engines that are reasonably expected to be sold separately are treated as single units of property.

(d) *Treatment of installations.* If the taxpayer produces or is treated as producing any property that is installed on or in other property, the production activity and installation activity relating to each unit of property generally are not aggregated for purposes of this section. However, if the taxpayer is treated as producing and installing any property for use by the taxpayer or a related person or if the taxpayer enters into a contract requiring the taxpayer to install property for use by a customer, the production activity and installation activity are aggregated for purposes of this section.

§ 1.263A-11 Accumulated production expenditures.

(a) *General rule. Accumulated production expenditures* generally means the cumulative amount of direct and indirect costs described in section 263A (a) that are required to be capitalized with respect to the unit of property (as defined in § 1.263A-10), **[*141]** including interest capitalized in prior computation periods, plus the adjusted bases of any assets described in paragraph (d) of this section that are used to produce the unit of property during the period of their use. Accumulated production expenditures may also include the basis of any property received by the taxpayer in a nontaxable transaction.

(b) When costs are first taken into account-(1) In general. Except as provided in paragraph (c) (1) of this section, costs are taken into account in the computation of accumulated production expenditures at the time and to the extent they would otherwise be taken into account under the taxpayer's method of accounting (*e.g.*, after applying the requirements of section 461, including the economic performance requirement of section 461 (h)). Costs that have been incurred and capitalized with respect to a unit of property prior to the beginning of the production period are taken into account as accumulated production expenditures beginning on the date on which the production period of the property begins (as defined in § 1.263A-12 (c)). Thus, for example, the cost of raw land acquired for development, the cost of a leasehold in mineral properties **[*142]** acquired for development, and the capitalized cost of planning and design activities are taken into account as accumulated production expenditures beginning on the first day of the production period. For purposes of determining accumulated production expenditures on any measurement date during a computation period, the interest required to be capitalized for the computation period is deemed to be capitalized on the day immediately following the end of the computation period. For any subsequent measurement dates and computation periods, that interest is included in accumulated production expenditures. If the cost of land or common features is allocated among planned units of property that are completed in phases, any portion of the cost properly allocated to completed units is not reallocated to any incomplete units of property.

(2) *Dedication rule for materials and supplies.* The costs of raw materials, supplies, or similar items are taken into account as accumulated production expenditures when they are incurred and dedicated to production of a unit of property. Dedicated means the first date on which the raw materials, supplies, or similar items are specifically associated with the **[*143]** production of any unit of property, including by record, assignment to the specific job site, or physical incorporation. In contrast, in the case of a component or subassembly that is reasonably expected to be become a part of (e.g., be incorporated into) any unit of property, costs incurred (including dedicated raw materials) for the component or subassembly are taken into account as accumulated production expenditures during the production of any portion of the component or subassembly and prior to its connection with (e.g., incorporation into) any specific unit of property. For purposes of the preceding sentence, components and subassemblies must be aggregated at each measurement date in a reasonable manner that is consistent with the purposes of section 263A (f).

(c) *Property produced under a contract* -(1) *Customer.* If a unit of property produced under a contract is designated property under § 1.263A-8 (d) (2) (i) with respect to the customer, the customer's accumulated production expenditures include any payments under the contract that represent part of the purchase price of the unit of designated property or, to the extent costs are incurred earlier than payments are made (determined **[*144]** on a cumulative basis for each unit of designated property), any part of such price for which the requirements of section 461 have been satisfied. The customer has made a payment under this section if the transaction would be considered a payment by a taxpayer using the cash receipts and disbursements method of accounting. The customer's accumulated production expenditures also include any other costs incurred by the customer, such as interest, or any other direct or indirect costs that are required to be capitalized under section 263A (a) and the regulations thereunder with respect to the production of the unit of designated property.

(2) *Contractor.* If a unit of property produced under a contract is designated property under § 1.263A-8 (d) (2) (ii) with respect to the contractor, the contractor must treat the cumulative amount of payments made by the customer under the contract attributable to the unit of property as a reduction in the contractor's accumulated production expenditures. The customer has made a payment under this section if the transaction would be considered a payment by a taxpayer using the cash receipts and disbursements method of accounting.

(d) *Property used to produce* **[*145]** *designated property* -(1) *In general.* Accumulated production expenditures include the adjusted bases (or portion thereof) of any equipment, facilities, or other similar assets, used in a reasonably proximate manner for the production of a unit of designated property during any measurement period in which the asset is so used. Examples of assets used in a reasonably proximate manner include machinery and equipment used directly or indirectly in the production process, such as assembly-line structures, cranes, bulldozers, and buildings. A taxpayer apportions the adjusted basis of an asset used in the production of more than one unit of designated property in a measurement period among such units of designated property using reasonable criteria corresponding to the use of the asset, such as machine hours, mileage, or units of production. If an asset used in a reasonably proximate manner for the production of a unit of designated property is temporarily idle (within the meaning of § 1.263A-1 (e) (3) (iii) (E)) for an entire measurement period, the adjusted basis of the asset is excluded from the accumulated production expenditures for the unit during that measurement period. Notwithstanding **[*146]** this paragraph (d) (1), the portion of the depreciation allowance for equipment, facilities, or any other asset that is capitalized with respect to a unit of designated property in accordance with § 1.263A-1 (e) (3) (ii) (I) is included in accumulated production expenditures without regard to the extent of use under this paragraph (d) (1) (i.e., without regard to whether the asset is used in a reasonably proximate manner for the production of the unit of designated property).

(2) *Example.* The following example illustrates how the basis of an asset is allocated on the basis of time:

> *Example.* In 1995, X uses a bulldozer exclusively to clear the land on several adjacent real estate development projects, A, B, and C. A, B, and C are treated as separate units of property under the principles of § 1.263A-10. X decides to allocate the basis of the bulldozer among the three projects on the basis of time. At the end of the first quarter of 1995, the production period has commenced for all three projects. The bulldozer was operated for 30 hours on project A, 80 hours on project B, and 10 hours on project C, for a total of 120 hours for the entire period. For purposes of determining accumulated **[*147]**

production expenditures as of the end of the first quarter, 1/4 of the adjusted basis of the bulldozer is allocated to project A, 2/3 to project B, and 1/12 to project C. Nonworking hours, regularly scheduled nonworking days, or other periods in which the bulldozer is temporarily idle (within the meaning of § 1.263A-1 (e) (3) (iii) (E)) during the measurement period are not taken into account in allocating the basis of the bulldozer.

(3) *Excluded equipment and facilities.* The adjusted bases of equipment, facilities, or other assets that are not used in a reasonably proximate manner to produce a unit of property are not included in the computation of accumulated production expenditures. For example, the adjusted bases of equipment and facilities, including buildings and other structures, used in service departments performing administrative, purchasing, personnel, legal, accounting, or similar functions, are excluded from the computation of accumulated production expenditures under this paragraph (d) (3).

(e) *Improvements* -(1) *General rule.* If an improvement constitutes the production of designated property under § 1.263A-8 (d) (3), accumulated production expenditures with respect to the **[*148]** improvement consist of-

(i) All direct and indirect costs required to be capitalized with respect to the improvement,

(ii) In the case of an improvement to a unit of real property-

(A) An allocable portion of the cost of land, and

(B) For any measurement period, the adjusted basis of any existing structure, common feature, or other property that is not placed in service or must be temporarily withdrawn from service to complete the improvement (associated property) during any part of the measurement period if the associated property directly benefits the property being improved, the associated property directly benefits from the improvement, or the improvement was incurred by reason of the associated property. See, however, the de minimis rule under paragraph (e) (2) of this section that applies in the case of associated property.

(iii) In the case of an improvement to a unit of tangible personal property, the adjusted basis of the asset being improved if that asset either is not placed in service or must be temporarily withdrawn from service to complete the improvement.

(2) *De minimis rule.* For purposes of paragraph (e) (1) (ii) of this section,

the total costs of all associated property for **[*149]** an improvement unit (associated property costs) are excluded from the accumulated production expenditures for the improvement unit during its production period if, on the date the production period of the unit begins, the taxpayer reasonably expects that at no time during the production period of the unit will the accumulated production expenditures for the unit, determined without regard to the associated property costs, exceed 5 percent of the associated property costs.

(f) *Mid-production purchases.* If a taxpayer purchases a unit of property for further production, the taxpayer's accumulated production expenditures include the full purchase price of the property plus, in accordance with the principles of paragraph (e) of this section, additional direct and indirect costs incurred by the taxpayer.

(g) *Related person costs.* The activities of a related person are taken into account in applying the classification thresholds under § 1.263A-8 (b) (1) (ii) (B) and (C), and in determining the production period of a unit of designated property under § 1.263A-12. However, only those costs incurred by the taxpayer are taken into account in the taxpayer's accumulated production expenditures under **[*150]** this section because the related person includes its own capitalized costs in the related person's accumulated production expenditures with respect to any unit of designated property upon which the parties engage in mutual production activities. For purposes of the preceding sentence, the accumulated production expenditures of any property transferred to a taxpayer in a nontaxable transaction are treated as accumulated production expenditures incurred by the taxpayer.

(h) *Installation.* If the taxpayer installs property that is purchased by the taxpayer, accumulated production expenditures include the cost of the property that is installed in addition to the direct and indirect costs of installation.

§ 1.263A-12 Production period.

(a) *In general.* Capitalization of interest is required under § 1.263A-9 for computation periods (within the meaning of § 1.263A-9 (f) (1)) that include the production period of a unit of designated property. In contrast, section 263A (a) requires the capitalization of all other direct or indirect costs, such as insurance, taxes, and storage, that directly benefit or are incurred by reason of the production of property without regard to whether they are incurred **[*151]** during a period in which production activity occurs.

(b) *Related person activities.* Activities performed and costs incurred by a person related to the taxpayer that directly benefit or are incurred by reason of the taxpayer's production of designated property are taken into account in determining the taxpayer's production period (regardless of whether the related person is performing only a service or is producing a subassembly or component that the related person is required to treat as an item of designated property). These activities and the related person's costs are also taken into account in determining whether tangible personal property produced by the taxpayer is 1-year or 2-year property under § 1.263A-8 (b) (1) (ii) (B) and (C).

(c) *Beginning of production period* -(1) *In general.* A separate production period is determined for each unit of property defined in § 1.263A-10. The production period begins on the date that production of the unit of property begins.

(2) *Real property.* The production period of a unit of real property begins on the first date that any physical production activity (as defined in paragraph (e) of this section) is performed with respect to a unit of real **[*152]** property. See § 1.263A-10 (b) (1). The production period of a unit of real property produced under a contract begins for the contractor on the date the contractor begins physical production activity on the property. The production period of a unit of real property produced under a contract begins for the customer on the date either the customer or the contractor begins physical production activity on the property.

(3) *Tangible personal property.* The production period of a unit of tangible personal property begins on the first date by which the taxpayer's accumulated production expenditures, including planning and design expenditures, are at least *5* percent of the taxpayer's total estimated accumulated production expenditures for the property unit. Thus, the beginning of the production period is determined without regard to whether physical production activity has commenced. The production period of a unit of tangible personal property produced under a contract begins for the contractor when the contractor's accumulated production expenditures, without any reduction for payments from the customer, are at least 5 percent of the contractor's total estimated accumulated production expenditures. **[*153]** The production period for a unit of tangible personal property produced under a contract begins for the customer when the customer's accumulated production expenditures are at least 5 percent of the customer's total estimated accumulated production expenditures.

(d) *End of production period-(1) In general.* The production period for a unit of property produced for self use ends on the date that the unit is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed. The production period for a unit of property produced for sale ends on the date that the unit is ready to be held for sale and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed. See, however, § 1.263A-10 (b) (5) (iv) providing an exception for common features in the case of a benefitted property that is sold. In the case of a unit of property produced under a contract, the production period for the customer ends when the property is placed in service by the customer and all production activities reasonably expected to be undertaken are complete (*i.e.*, generally, no earlier **[*154]** than when the customer takes delivery). In the case of property that is customarily aged (such as tobacco, wine, or whiskey) before it is sold, the production period includes the aging period.

(2) *Special rules.* The production period does not end for a unit of property prior to the completion of physical production activities by the taxpayer even though the property is held for sale or lease, since all production activities reasonably expected to be undertaken by the taxpayer with respect to such property have not in fact been completed. See, however, § 1.263A-10 (b) (5) regarding separation of certain common features.

(3) *Sequential production or delivery.* The production period ends with respect to each unit of property (as defined in § 1.263A-10) and its associated accumulated production expenditures as the unit of property is completed within the meaning of paragraph (d) (1) of this section, without regard to the production activities or costs of any other units of property. Thus, for example, in the case of separate apartments in a multi-unit building, each of which is a separate unit of property within the meaning of § 1.263A-10, the production period ends for each separate apartment **[*155]** when it is ready to be held for sale or placed in service within the

meaning of paragraph (d) (1) of this section. In the case of a single unit of property that merely undergoes separate and distinct stages of production, the production period ends at the same time (*i.e.,* when all separate stages of production are completed with respect to the entire amount of accumulated production expenditures for the property).

(4) *Examples.* The provisions of paragraph (d) of this section are illustrated by the following examples:

> *Example 1.* E is engaged in the original construction of a high-rise office building with two wings. At the end of 1995, Wing #1, but not Wing #2, is placed in service. Moreover, at the end of 1995, all production activities reasonably expected to be undertaken on Wing #1 are completed. In accordance with § 1.263A-10 (b) (1), Wing #1 and Wing #2 are separate units of designated property. E may stop capitalizing interest on Wing #1 but not on Wing *#2.*
>
> *Example 2.* F is in the business of constructing finished houses. F generally paints and finishes the interior of the house, although this does not occur until a potential buyer is located. Because F reasonably expects to undertake **[*156]** production activity (painting and finishing), the production period of each house does not end until these activities are completed.

(e) *Physical production activities* -(1) *In general.* The term *physical production activities* includes any physical activity that constitutes production within the meaning of § 1.263A-8 (d) (1). The production period begins and interest must be capitalized with respect to real property if any physical production activities are undertaken, whether alone or in preparation for the construction of buildings or other structures, or with respect to the improvement of existing structures. For example, the clearing of raw land constitutes the production of designated property, even if only cleared prior to resale.

(2) *Illustrations.* The following is a partial list of activities any one of which constitutes a physical production activity with respect to the production of real property:

> (i) Clearing, grading, or excavating of raw land;
>
> (ii) Demolishing a building or gutting a standing building;
>
> (iii) Engaging in the construction of infrastructure, such as roads, sewers, sidewalks, cables, and wiring;
>
> (iv) Undertaking structural, mechanical, or electrical activities with respect **[*157]** to a building or other structure; or

(v) Engaging in landscaping activities.

(f) *Activities not considered physical production.* The activities described in paragraphs (f) (1) and (f) (2) of this section are not considered physical production activities:

(1) *Planning and design.* Soil testing, preparing architectural blueprints or models, or obtaining building permits.

(2) Incidental repairs. Physical activities of an incidental nature that may be treated as repairs under § 1.162-4.

(g) *Suspension of production period* -(1) *In general.* If production activities related to the production of a unit of designated property cease for at least 120 consecutive days (cessation period), a taxpayer may suspend the capitalization of interest with respect to the unit of designated property starting with the first measurement period that begins after the first day in which production ceases. The taxpayer must resume the capitalization of interest with respect to a unit beginning with the measurement period during which production activities resume. In addition, production activities are not considered to have ceased if they cease because of circumstances inherent in the production process, such as normal adverse **[*158]** weather conditions, scheduled plant shut-downs, or delays due to design or construction flaws, the obtaining of a permit or license, or the settlement of groundfill to construct property. Interest incurred on debt that is traced debt with respect to a unit of designated property during the suspension period is subject to capitalization with respect to the production of other units of designated property as interest on nontraced debt. See § 1.263A-9 (c) (5) (i) of this section. For applications of the avoided cost method after the end of the suspension period, the accumulated production expenditures for the unit include the balance of accumulated production expenditures as of the beginning of the suspension period, plus any additional capitalized costs incurred during the suspension period. No further suspension of interest capitalization may occur unless the requirements for a new suspension period are satisfied.

(2) *Special rule.* If a cessation period spans more than one taxable year, the taxpayer may suspend the capitalization of interest with respect to a unit beginning with the first measurement period of the taxable year in which the 120-day period is satisfied.

(3) *Method* **[*159]** *of accounting.* An election to suspend interest capitalization under paragraph (g) (1) of this section is a method of accounting that must be consistently applied to all units that satisfy the requirements of paragraph (g) (1) of this section. However, the special rule in paragraph (g) (2) of this section is applied on an annual basis to all units of an electing taxpayer that satisfy the requirements of paragraph (g) (2) of this section.

(4) *Example.* The provisions of paragraph (g) (1) of this section are

illustrated by the following example.

Example. (i) D, a calendar-year taxpayer, began production of a residential housing development on January 1, 1995. D, in applying the avoided cost method, chose a taxable year computation period and quarterly measurement dates. On April 10, 1995, all production activities ceased with respect to the units in the development until December 1, 1996. The cessation, which occurred for a period of at least 120 consecutive days, was not attributable to circumstances inherent in the production process. With respect to the units in the development, D incurred production expenditures of $2,000,000 from January 1, 1995 through April 10, 1995. D incurred interest **[*160]** of $100,000 on traced debt with respect to the units for the period beginning January 1, 1995, and ending June 30, 1995. D did not incur any production expenditures for the more than 20-month cessation beginning April 10, 1995, and ending December 1, 1996, but incurred $200,000 of production expenditures from December 1, 1996, through December 31, 1996.

(ii) D is required to capitalize the $100,000 interest on traced debt incurred during the two measurement periods beginning January 1, 1995, and ending June 30, 1995. Because D satisfied the 120-day rule under this paragraph (g), D is not required to capitalize interest with respect to the accumulated production expenditures for the units for the measurement period beginning July 1, 1995, and ending September 30, 1995, which is the first measurement period that begins after the date production activities ceased. D is required to resume interest capitalization with respect to the $ 2,300,000 (2,000,000 + 100,000 + 200,000) of accumulated production expenditures for the units for the measurement period beginning October 1, 1996, and ending December 31, 1996 (the measurement period during which production activities resume). Accordingly, **[*161]** D may suspend the capitalization of interest with respect to the units from July 1, 1995, through September 30, 1996.

§ 1.263A-13 Oil and gas activities.

(a) *In general.* This section provides rules that are to be applied in tandem with §§ 1.263A-8 through 1.263A-12, 1.263A-14, and 1.263A-15 in capitalizing interest with respect to the development (within the meaning of section 263A (g)) of oil or gas property. For this purpose, oil or gas property consists of each separate operating mineral interest in oil or gas as defined in section 614 (a), or, if a taxpayer makes an election under section 614 (b), the aggregate of two or more separate operating mineral interests in oil or gas as described in section 614 (b) (section 614 property). Thus, an oil or gas property is designated property unless the de minimis rule applies. A taxpayer must apply the rules in paragraph (c) of this section if the taxpayer cannot establish, at the beginning of the production period of the first well drilled on the property, a definite plan that identifies the number and location of other wells planned with respect to the property. If a taxpayer can establish such a plan at the beginning of the production period **[*162]** of the first well drilled on the property, the taxpayer may either apply the rules of paragraph (c) of this section or treat each of the planned wells as a separate unit and partition the leasehold acquisition costs and costs of common features based on the number of planned well units.

(b) *Generally applicable rules* -(1) *Beginning of production period* -(i) *Onshore activities.* In the case of onshore oil or gas development activities, the production period for a unit begins on the first date physical site preparation activities (such as building an access road, leveling a site for a drilling rig, or excavating a mud pit) are undertaken with respect to the unit.

(ii) *Offshore activities.* In the case of offshore development activities, the production period for a unit begins on the first date physical site preparation activities, other than activities undertaken with respect to expendable wells, are undertaken with respect to the unit. For purposes of the preceding sentence, the first physical site preparation activity undertaken with respect to a section 614 property is generally the first activity undertaken with respect to the anchoring of a platform (e.g., drilling to drive the piles). **[*163]** For purposes of this section, an expendable well is a well drilled solely to determine the location and delineation of offshore hydrocarbon deposits.

(2) *End of production period.* The production period ends for a productive well unit on the date the well is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed. See § 1.263A-12 (d).

(3) *Accumulated production expenditures* -(i) *Costs included.* Accumulated production expenditures for a well unit include the following costs (to the extent they are not intangible drilling and development costs allowable as a deduction under section 263 (c), 263 (i), or 291 (b) (2)): the costs of acquiring the section 614 leasehold and the costs of taxes and similar items that are required to be capitalized under section 263A (a) with respect to the section 614 leasehold; the costs of real property associated with developing the section 614 property (e.g., casing); the basis of real property that constitutes a common feature within the meaning of § 1.263A-10 (b) (3); and the adjusted basis of property used to produce property (such as a mobile rig, drilling ship, or an **[*164]** offshore drilling platform).

(ii) *Improvement unit.* To the extent section 614 costs are allocated to a well unit, the undepleted portion of those section 614 costs must also be included in the accumulated production expenditures for any improvement unit (within the meaning of § 1.263A-8 (d) (3)) with respect to that well unit.

(c) *Special rules* when definite plan not established-(1) In general. The special rules of this paragraph (c) must be applied by a taxpayer that cannot establish, at the beginning of the production period of the first well drilled on the property, a definite plan that identifies the number and location of the wells planned with respect to the property. A taxpayer that can establish such a plan is permitted, but not required, to apply the rules of this paragraph (c), provided the rules of this paragraph (c) are consistently applied for all the taxpayer's oil or gas properties for which a definite plan can be established.

(2) *Oil and gas units* -(i) *First productive well unit.* Until the first productive well is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed, a first productive **[*165]** well unit includes the section 614 property and all real property associated with the development of the section 614 property. Thus, for example, a first productive well unit includes the section 614 property and real property associated with any nonproductive well drilled on the section 614 property on or before the date the first productive well is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed. For purposes of this section, a productive well is a well that produces in commercial quantities. See paragraph (c) (5) of this section, which provides a special rule whereby the costs of a section 614 property and common feature costs for a section 614 property generally are included only in the

accumulated production expenditures for the first productive well unit.

(ii) *Subsequent units.* Generally, real property associated with each productive or nonproductive well with respect to which production activities begin after the date the first productive well is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed, **[*166]** constitutes a unit of real property. Additionally, a productive or nonproductive well that is included in a first productive well unit and for which development continues after the date the first productive well is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed, generally is treated as a separate unit of property after that date. See, however, paragraph (c) (5) of this section, which provides rules for the treatment of costs included in the accumulated production expenditures of a first productive well unit.

(3) *Beginning of production period* -(i) *First productive well unit.* The beginning of the production period of the first productive well unit is determined as provided in paragraph (b) of this section.

(ii) *Subsequent wells.* In applying paragraph (b) of this section to subsequent well units (as described in paragraph (c) (2) (ii) of this section), any activities occurring prior to the date the production period ends for the first productive well unit are not taken into account in determining the beginning of the production period for the subsequent well units.

(4) *End of production period.* **[*167]** The end of the production period for both the first productive well unit and subsequent productive well units is determined as provided in paragraph (b) (2) of this section. See § 1.263A-12 (d). Nonproductive wells included in the first productive well unit need not be plugged and abandoned for the production period to end for a first productive well unit.

(5) *Accumulated production expenditures* -(i) *First productive well unit.* The accumulated production expenditures for a first productive well unit include all costs incurred with respect to the section 614 property and associated real property at any time through the end of the production period for the first productive well unit. Thus, the costs of acquiring the section 614 property, the costs of taxes and similar items that are required to be capitalized under section 263A (a) with respect to the section 614 property, and the costs of common features, that are incurred at any time through the end of the production period of the first productive well unit (section 614 costs) are included in the accumulated production expenditures for the first productive well unit.

(ii) *Subsequent well unit.* The accumulated production expenditures **[*168]** for a subsequent well do not include any costs included in the accumulated production expenditures for a first productive well unit. In the event that section 614 costs or common feature costs with respect to a section 614 property are incurred subsequent to the end of the production period of the first productive well unit, those common feature costs and undepleted section 614 costs are allocated among the accumulated production expenditures of wells being drilled as of the date such costs are incurred.

(6) Allocation of interest capitalized with respect to first productive well unit. Interest attributable to any productive or nonproductive well included in the first productive well unit (within the meaning of paragraph (c) (2) (ii) of this section) is allocated among and capitalized to the basis of the property

associated with the first productive well unit. See § 1.263A-8 (a) (2).

(7) *Example.* The provisions of this paragraph (c) are illustrated by the following example.

Example. (i) Corporation Z, an oil company, acquired a section 614 property in an onshore tract, Tract B, for development. In 1995, Corporation Z began site preparation activities on Tract B and also commenced drilling **[*169]** Well 1 on Tract B. Corporation Z was unable to establish, as provided in paragraph (a) of this section, a definite plan identifying the number and location of other wells planned on Tract B. In 1996, Corporation Z began drilling Well 2. On May 1, 1997, Well 2, a productive well, was placed in service and all production activities reasonably expected to be undertaken with respect to Well 2 were completed. By that date, also, Well 1 was abandoned.

(ii) Well 2 is a first productive well (within the meaning of paragraph (c) (2) (i) of this section). Well 1 is a nonproductive well drilled prior to a first productive well. Under paragraph (c) of this section, Corporation Z must treat both Well 1 and Well 2 as part of the first productive well unit on the section 614 property. In accordance with paragraphs (c) (3) and (c) (4) of this section, the production period of the first productive well unit begins on the date physical site preparation activities are undertaken with respect to Well 1 in 1995 and ends on May 1, 1997, the date that Well 2 is placed in service and all production activities reasonably expected to be undertaken are completed. In accordance with paragraph (c) (5) of this section, **[*170]** the accumulated production expenditures for the first productive well unit include, among other capitalized costs, the entire section 614 property costs capitalized with respect to Tract B and all common feature costs incurred with respect to the section 614 property through May 1, 1997.

(iii) Any well that Corporation Z begins after May 1, 1997, is a separate unit of property. See paragraph (c) (2) (ii) of this section. Under paragraph (c) (3) (ii) of this section, the production period for any such well unit begins on the first day after May 1, 1997, on which Corporation Z undertakes physical site preparation activities with respect to the well unit. Moreover, Corporation Z does not include any of the section 614 property costs in the accumulated production expenditures for any well unit begun after May 1, 1997.

§ 1.263A-14 Rules for related persons.

Taxpayers must account for average excess expenditures allocated to related persons under applicable administrative pronouncements interpreting section 263A (f). See § 601.601 (d) (2) (ii) (b) of this chapter.

§ 1.263A-15 Effective dates, transitional rules, and anti-abuse rule.

(a) *Effective dates* -(1) Sections 1.263A-8 through 1.263A-15 **[*171]** generally apply to interest incurred in taxable years beginning on or after January 1, 1995. In the case of property that is inventory in the hands of the taxpayer, however, these sections are effective for taxable years beginning on or after January 1, 1995. Changes in methods of accounting necessary as a result of the rules in §§ 1.263A-8 through 1.263A-15 must be made under the terms and conditions prescribed by the Commissioner. Under these terms and conditions, the principles of § 1.263A-7T (e) generally must be applied in revaluing inventory property.

(2) For taxable years beginning before January 1, 1995, taxpayers must take reasonable positions on their federal income tax returns when applying section 263A (f). For purposes of this paragraph (a) (2), a reasonable position is a position consistent with the temporary regulations, revenue rulings, revenue procedures, notices, and announcements concerning section 263A applicable in taxable years beginning before January 1, 1995. See § 601.601 (d) (2) (ii) (b) of this chapter. For this purpose, Notice 88-99, 1988-2 C.B. 422, applies to taxable years beginning after August 17, 1988, in the case of inventory, and to interest incurred **[*172]** in taxable years beginning after August 17, 1988, in all other cases. Finally, under administrative procedures issued by the Commissioner, taxpayers may elect early application of §§ 1.263A-8 through 1.263A-15 to taxable years beginning on or after January 1, 1994, in the case of inventory property, and to interest incurred in taxable years beginning on or after January 1, 1994, in the case of property that is not inventory in the hands of the taxpayer.

(b) *Transitional rule for accumulated production expenditures* -(1) *In general.* Except as provided in paragraph (b) (2) of this section, costs incurred before the effective date of section 263A are included in accumulated production expenditures (within the meaning of § 1.263A-11) with respect to noninventory property only to the extent those costs were required to be capitalized under section 263 when incurred and would have been taken into account in determining the amount of interest required to be capitalized under former section 189 (relating to the capitalization of real property interest and taxes) or pursuant to an election that was in effect under section 266 (relating to the election to capitalize certain carrying charges).

(2) **[*173]** *Property used to produce designated property.* The basis of property acquired prior to 1987 and used to produce designated noninventory property after December 31, 1986, is included in accumulated production expenditures in accordance with § 1.263A-11 (d) without regard to whether the basis would have been taken into account under former section 189 or section 266.

(c) *Anti-abuse rule.* The interest capitalization rules contained in §§ 1.263A-8 through 1.263A-15 must be applied by the taxpayer in a manner that is consistent with and reasonably carries out the purposes of section 263A (f). For example, in applying § 1.263A-10, regarding the definition of a unit of property, taxpayers may not divide a single unit of property to avoid properly classifying the property as designated property. Similarly, taxpayers may not use loans in lieu of advance payments, tax-exempt parties, loan restructurings at measurement dates, or obligations bearing an unreasonably low rate of interest (even if such rate equals or exceeds the applicable Federal rate under section 1274 (d)) to avoid the purposes of section 263A (f). For purposes of this paragraph (c), the presence of back-to-back loans with different **[*174]** rates of interest, and other uses of related parties to facilitate an avoidance of interest capitalization, evidences abuse. In such cases, the District Director may, based upon all the facts and circumstances, determine the amount of interest that must be capitalized in a manner that is consistent with and reasonably carries out the purposes of section 263A (f).

Par. 6. Section 1.266-1 (a) is redesignated as § 1.266-1 (a) (1) and § 1.266-1 (a) (2) is added to read as follows:

§ 1.266-1 Taxes and carrying charges chargeable to capital account and treated as capital items.

(a) ☐ ☐ ☐

(1) ☐ ☐ ☐

(2) See §§ 1.263A-8 through 1.263 A-15 for rules regarding the requirement to capitalize interest, that apply prior to the application of this section. After applying §§ 1.263A-8 through 1.263A-15, a taxpayer may elect to capitalize interest under section 266 with respect to designated property within the meaning of § 1.263A-8 (b), provided a computation under any provision of the Internal Revenue Code is not thereby materially distorted, including computations relating to the source of deductions.

Par. 7. Section 1.1502-13 is amended by adding a sentence to the end of paragraph (c) (1) (i), and by adding **[*175]** a sentence to the end of paragraph (c) (2), to read as follows:

§ 1.1502-13 Intercompany transactions.

☐ ☐ ☐

(c) ☐ ☐ ☐

(1) ☐ ☐ ☐ (i) ☐ ☐ ☐ See, however, paragraph (c) (2) of this section for determining the amount of deferred gain or loss on a deferred intercompany transaction that involves interest capitalized under section 263A (f) (2) ☐ ☐ ☐ Additionally, see section 263A (f) and the regulations thereunder to determine the amount of deferred gain or loss on a deferred intercompany transaction that involves interest capitalized under section 263A (f).

☐ ☐ ☐

PART 602-OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 8. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805

Par. 9. Section 602.101 (c) is amended by adding entries in numerical order to the table to read as follows:

§ 1.602.101 OMB Control numbers.

□ □ □

(c) □ □ □

CRF part or section where identified and described	Current OMB control No.
1.263A-8 (b) (2) (iii)	1545-1265
1.263A-9 (d) (1)	1545-1265
1.263A-9 (f) (1) (ii)	1545-1265
1.263A-9 (f) (2) (iv)	1545-1265
1.263A-9 (g) (2) (iv) (C)	1545-1265
1.263A-9 (g) (3) (iv)	1545-1265

Margaret Milner Richardson,

Commissioner of Internal Revenue.

Approved:

Leslie **[*176]** Samuels,

Assistant Secretary of the Treasury.

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