

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) 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 263A(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 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 ($[\$600,000 + \$6,000,000 \times 5,000,000]$).

(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 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 non-traced 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.

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§ 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 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 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 multi-unit 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 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 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 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 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 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 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 (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 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 at-

tributable 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 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, and D must include an allocable share of the parking lots 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 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 (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 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 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 cost 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 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 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.

[T.D. 8584, 59 FR 67207, Dec. 29, 1994; 60 FR 16574, 16575, Mar. 31, 1995]

§ 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), 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 pro-

vided 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 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 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