

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

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 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 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 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 production expenditures as of the end of the first quarter, $\frac{1}{4}$ of the adjusted basis of the bulldozer is allocated to project A, $\frac{3}{8}$ to project B, and $\frac{1}{2}$ 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 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 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 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.

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§ 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 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 sub-assembly 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 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 be-

gins 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. 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 benefited 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