

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.

[T.D. 8584, 59 FR 67210, Dec. 29, 1994; 60 FR 16575, Mar. 31, 1995]

#### § 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 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. 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 all production activities reasonably expected to be undertaken are complete (i.e., generally, no earlier 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 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 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 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 weather conditions, scheduled plant shutdowns, 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 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 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 cease. 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, D may suspend the capitalization of interest with respect to the units from July 1, 1995, through September 30, 1996.

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**§ 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 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 under-

taken 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). 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 cost 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 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