

§ 1.263A-8

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§ 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 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 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 prop-

erty is not property described in section 1221(l) 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 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 persons 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 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) *In general.* 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 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) *In general.* 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 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 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 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 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 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 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) *In general.* 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 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.

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§ 1.263A-9 The avoided cost method.

(a) *In general*—(1) *Description.* The avoided cost method described in this section must be used to calculate the amount of interest required to be cap-

italized 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) *In general.* 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 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