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 rquired 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.

[T.D. 8584, 59 FR 67212, Dec. 29, 1994; 60 FR 16575, Mar. 31, 1995]

§ 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 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). 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 taxpayer than 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 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, 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.* 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 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 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, 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.

[T.D. 8584, 59 FR 67213, Dec. 29, 1994; 60 FR 16575, Mar. 31, 1995]

§ 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.

[T.D. 8584, 59 FR 67215, Dec. 29, 1994]

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

(a) *Effective dates*—(1) Sections 1.263A–8 through 1.263A–15 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–7 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 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.

(3) Section 1.263A–9(a)(4)(ix) generally applies to interest incurred in taxable years beginning on or after May 20, 2004. In the case of property that is inventory in the hands of the taxpayer, § 1.263A–9(a)(4)(ix) applies to taxable years beginning on or after May 20, 2004. Taxpayers may elect to apply § 1.263A–9(a)(4)(ix) to interest incurred in taxable years beginning on or after January 1, 1995, or, in the case of property that is inventory in the hands of the taxpayer, to taxable years beginning on or after January 1, 1995. A change in a taxpayer's treatment of interest to a method consistent with § 1.263A–9(a)(4)(ix) is a change in method of accounting to which sections 446 and 481 apply.

(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) *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