

Reg. Section 1.263A-8(d)(3)

Requirement to capitalize interest

(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.