Office of Chief Counsel
Internal Revenue Service
Memorandum

Release Number: **20130501F**

Release Date: 2/1/2013

PREF-102765-12

UILC: 162.00-00, 162.21-00, 263.00-00, 263A.00-00

date: December 07, 2012

to: , Internal Revenue Agent
(Large Business & International)

from: Associate Area Counsel ( )
(Large Business & International)

---

subject: Significant Advice Reviewed - I.R.C. § 162
- Tax Year

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent. This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

ISSUES

1) cash payment to is deductible under I.R.C. § 162.

   a) Whether the $ payment qualifies as an ordinary and necessary business expense under I.R.C. § 162(a).

   b) Whether I.R.C. § 162(f) prevents the deduction of the $ payment.

   c) Whether the public policy doctrine prevents the deduction of the $ payment.

d) Whether any portion of the $ payment represents a capital expenditure under I.R.C. § 263(a).

e) Whether any portion of the $ payment must be capitalized under I.R.C. § 263A.

f) Whether the $ payment is deductible in the tax year.

<u>CONCLUSION:</u> cash payment to is deductible under I.R.C. § 162.[1]

a) To the extent that it does not involve a capital expenditure, the $ payment qualifies as an ordinary and necessary business expense under I.R.C. § 162(a).

b) The $ payment is compensatory, and I.R.C. § 162(f) does not prevent its deduction.

c) The public policy doctrine codified in I.R.C. § 162(f) does not prevent the deduction of the $ payment.

d) If any portion of the $ payment represents a capital expenditure under I.R.C. § 263(a), it would otherwise be deductible under I.R.C. § 165.

e) If any portion of the $ payment is capitalizable under I.R.C. § 263A, the costs would be recovered either on abandonment or at the time of the sale or exchange of the property.

f) The $ payment should be treated as deductible in the tax year.

<u>FACTS</u>

LAW AND ANALYSIS

Ordinary and Necessary Business Expenses

The first issue is whether the $ payment from to qualifies as an ordinary and necessary business expense under I.R.C. § 162(a). Taxpayers may deduct all ordinary and necessary expenses of carrying on a trade or business that are paid or incurred in the tax year. I.R.C. § 162(a). However, a deduction is not permitted for capital expenses under I.R.C. § 263(a) or expenses specifically precluded by another statute.

Ordinary and necessary business expenses may include amounts expended by a Taxpayer to avoid or settle litigation. Old Town Corp. v. Commissioner, 37 T.C. 845, 858-59 (1962). "This is true even when no litigation has commenced, as long as the business felt the claim had some possibility of success, made the payment to avoid the damages or liability, and had an objectively reasonable belief that the expense was necessary." Cavaretta v. Commissioner, T.C. Memo. 2010-4 (citing Old Town Corp., 37 T.C. at 858-59). Whether a Taxpayer may deduct payments made in settlement of a claim under I.R.C. § 162 depends on the "origin of the claim." United States v. Gilmore, 372 U.S. 39, 47-48 (1963).

In this case, to the extent that the expenses were not for capital expenditures, the $ cash payment by to was an ordinary and necessary business expense. Litigation had not commenced between and regarding the invoices that had sent to for its share of the expenses related to the . However, a claim by had some possibility of success based on the and entered into the Settlement Agreement to cap its liability for compensatory damages. In addition, clearly held the reasonable belief that the payment was necessary. Thus, the payment represents an ordinary and necessary business expense under I.R.C. § 162(a).

I.R.C. § 162(f) Nondeductible Fine or Penalty

The next issue is whether I.R.C. § 162(f) prevents the deduction of the $

payment. I.R.C. § 162(f) provides that "[n]o deduction shall be allowed under [I.R.C. § 162](a) for any fine or similar penalty paid to a government for the violation of any law." The term "government" includes a political subdivision of, or corporation or other entity serving as an agency or instrumentality of, a governmental entity. Treas. Reg.§ 1.162-21(a)(3). The term "fine or similar penalty" includes amounts paid in settlement of the Taxpayer's actual or potential liability for a fine or penalty. Treas. Reg. § 1.162-21(b)(1)(iii).

In addition, the term "fine or similar penalty" includes payments made by a Taxpayer to a nongovernmental entity in lieu of a fine or penalty imposed by the government. See e.g. Waldman v. Commissioner, 88 T.C. 1384, 1389 (1987) (Taxpayer's payments to victims as court-ordered restitution held nondeductible); But see Stephens v. Commissioner, 905 F.2d 667 (2d Cir. 1990) (Taxpayer's court-ordered restitution payment made to a corporation was remedial and held to be deductible).

In contrast to nondeductible fines and penalties, compensatory damages that are intended to return the parties to the status quo do not constitute fines or penalties. True v. United States, 894 F.2d 1197, 1204 (10th Cir. 1990); Treas. Reg. § 1.162-21(b)(2).

In this case, the origin of the underlying liability is the $ invoices that sent to and 's liability for compensatory damages . In addition, it was possible that would continue to bill for 's portion of damages . Exam's review of the invoices indicated that had not billed for any fines or similar penalties. The invoices reflect expenses The settlement also indemnified against claims for compensatory damages by private plaintiffs. Thus, s $ settlement payment with was paid in settlement of actual or potential liability for damages , not its actual or potential liability for a fine or similar penalty.

The $ payment was not a fine or penalty paid to a governmental entity. In addition, the payment was not paid to in lieu of a fine or penalty

All of the evidence indicates that the $ settlement payment from to is a voluntary compensatory payment to resolve potential claims that may have had against . This payment did not include a fine or similar penalty, or any payment made in lieu of a fine or penalty. I.R.C. § 162(f) does not prevent the deduction of the payment.

Public Policy Doctrine

The next issue is whether the deductibility of the $ payment is prohibited by the public policy doctrine. Under the public policy doctrine, a deduction was denied if allowing the deduction would “frustrate sharply defined national or state policies proscribing particular types of conduct.” Commissioner v. Tellier, 383 U.S. 687, 694 (1966), (quoting Commissioner v. Heininger, 320 U.S. 467, 473 (1943)). The national or state policies must be “evidenced by some *governmental* declaration of them.” Id. (quoting Lilly v. Commissioner, 343 U.S. 90, 97 (1952)). The “test on nondeductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction.” Id. (quoting Tank Truck Rentals v. Commissioner, 356 U.S. 30, 35 (1958)). Under this approach, the limitation based on violation of public policy doctrine is very narrow.

In the Tax Reform Act of 1969, Pub. L. 91-172, 1969-3 C.B. 10, Congress codified the public policy doctrine under I.R.C. § 162. See, e.g. Tucker v. Commissioner, 69 T.C. 675, 679 n.4 (1978); Adolf Meller Co. v. United States, 600 F.2d 1360, 1363 (Ct. Cl. 1979). Thus, because I.R.C. § 162(f) does not apply to the $

payment , the public policy doctrine is also not applicable to prevent the deduction.

Capital Expenditures

The third issue is whether there are any capital expenditures included in the $ settlement payment. Capital expenditures are not deductible. I.R.C. § 263. Generally, capital expenditures must be added to the basis of the capital asset with respect to which they are incurred and must be taken into account for tax purposes through either depreciation or the calculation of gain/loss on the disposition of the asset. Woodward v. Commissioner, 397 U.S 572, 574-75 (1970).

Determining whether a payment is a business expense or a capital expenditure is a fact intensive inquiry. Capital expenditures include “permanent improvements or betterments made to increase the value of any property.” I.R.C. § 263(a). An expense is considered a capital expense if it adds to the value of useful life of property or adapts property to a new or different use. Treas. Reg. § 1.263(a)-1(b).

On the other hand, the costs of incidental repairs, which neither add to the value of property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deductible as an expense. Cinergy Corp. v. United States, 55 Fed. Cl. 489, 516 (2003).

If a small portion of the tangible equipment could have been used again, it would be *de minimis*. In addition, the amount would be deductible as an I.R.C. § 165(a) abandonment loss

Uniform Capitalization Rules

The fourth issue is whether I.R.C. § 263A requires capitalization of any portion of the $ settlement. The Uniform Capitalization Rules apply to inventory and other property produced by the Taxpayer or acquired for resale. I.R.C. § 263A(a), (b). For property that is inventory in the hands of the Taxpayer, direct costs and indirect costs properly allocable to the property shall be included in inventory costs. I.R.C.

§ 263A(a)(1)(A), (2). For other property, direct costs and indirect costs properly allocable to the property generally shall be capitalized to the basis of the property. I.R.C. § 263A(a)(1)(B), (2).

Treas. Reg. § 1.263A-1(e)(3)(i) provides that indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production or resale activities. Examples of costs that must be capitalized include production facility repair and maintenance costs and scrap and spoilage costs, such as waste removal costs. Treas. Reg. § 1.263A-1(e)(3)(ii)(O), (Q). Treas. Reg. § 1.263A-2(a)(3)(i) provides that any cost required to be capitalized by I.R.C. § 263A must be capitalized regardless of whether the cost was incurred before, during, or after production. The costs are allocable to the property produced during the taxable year in which the costs were incurred. Treas. Reg. § 1.263A-1(c)(1).

Rev. Rul. 94-38, 1994-1 C.B. 35, held that costs to clean up land and to treat groundwater contaminated with hazardous waste from a taxpayer's manufacturing business were deductible business expenses because the costs did not materially add value to the land, prolong the useful life of the land, or adapt the land to a new and different use. Rev. Rul. 2004-18, 2004-1 C.B. 509, clarifies that Rev. Rul. 94-38 dealt with whether the costs must be capitalized under I.R.C.§ 263(a). It did not address the treatment of the costs as inventory costs under I.R.C. § 263A. In Rev. Rul. 2004-18, the Service held that costs incurred to clean up land that a taxpayer contaminated with hazardous waste by operation of the taxpayer's manufacturing plant must be included in inventory costs under I.R.C. § 263A.

In conclusion, since the contamination was not caused by the production of inventory, no part of the $ settlement is capitalizable to oil inventory produced by .

It is arguable, however, that the remediation expenses were incurred during the production of the well property and are thus capitalizable under I.R.C. § 263A to the property produced. However, to the extent the costs are capitalizable to , the costs would be recovered either on abandonment or at the time of the sale or exchange of the property.

[redacted]

[redacted]

Timing

The final issue is whether the $ payment is deductible in the tax year. For a Taxpayer using the accrual method of accounting, a liability is incurred, and taken into account for Federal income tax purposes, in the taxable year in which (1) all the events have occurred that establish the fact of liability, (2) the amount of the liability can be determined with reasonable accuracy, and (3) economic performance has occurred with respect to the liability. Treas. Reg. § 1.461-1(a)(2). For purposes of determining whether an accrual-based Taxpayer can treat the amount of a liability as incurred, the all events test is not treated as met any earlier than the taxable year in which economic performance occurs with respect to the liability. I.R.C. § 461(h)(1); Treas. Reg. § 1.461-4(a)(1).

In this case, the Settlement Agreement was signed in and the amount of the settlement was determined at that time. Economic performance should be treated as having occurred in . Economic performance may not have occurred for any portion of the $ payment allocable to ’s indemnification of for future claims. [redacted] Thus, the $ payment should be treated as deductible in the tax year.[2]

Please call if you have any further questions.

Associate Area Counsel
(Large Business & International)

By:

(Large Business & International)