INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Number: **200629030**
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Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No.:
Year Involved:
Date of Conference:

LEGEND:

Taxpayer =
Facility =
Location a =
State a =
Agency =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Year 6 =
Date 1 =
Date 2 =
Equipment a =
Equipment b =
Equipment c =

Equipment d	=
Statute	=
Code § a	=
Code § b	=
Regulation § c	=
Regulation § d	=
Amount a	=
Amount b	=
Amount c	=
d	=
Amount e	=
Amount f	=
g	=
Amount h	=
Amount i	=
j	=

ISSUES:

(1) Whether any portion of the costs incurred by Taxpayer for the performance of a "beneficial environmental project" (BEP) is an amount analogous to a nondeductible fine or similar penalty as defined under § 162(f) of the Internal Revenue Code.

(2) Whether Taxpayer may include in the basis of assets it produces under § 263A, or as the basis of property under § 1012, any portion of the BEP costs that is an amount analogous to a fine or similar penalty.

CONCLUSION(S):

(1) A portion of the costs incurred by Taxpayer for the performance of a BEP is an amount analogous to a nondeductible fine or similar penalty as defined under § 162(f).

(2) Taxpayer may not include in the basis of assets it produces under § 263A, or as the basis of property under § 1012, the portion of the BEP costs that is an amount analogous to a fine or similar penalty.

FACTS:

Taxpayer operates a Facility in Location a, State a. The Facility began operating in Year 1 and has operated under air quality permits from the State a Agency since Year 2. In Date 1, as part of the Facility's air quality permit update process under Title V of the Clean Air Act, the Agency asked Taxpayer to review changes made during the Year

3 timeframe to its Equipment a .[1] Taxpayer agreed to conduct the review and voluntarily expanded it to cover the entire Facility dating back to Year 4. The results of this review indicated that Taxpayer may not have obtained required air quality permits for certain facility changes made during Year 5, including (a) physical and operational changes to Equipment b, and (b) other changes to Equipment c. The practical effect of these alleged permitting issues was that the emissions from the Facility may have been in excess of those allowed by the Clean Air Act.

Under the State a Statute, the Agency is entitled to initiate an enforcement proceeding on behalf of State a and may seek injunctive relief to compel parties to bring their plant emissions within the standards of the Clean Air Act and/or monetary penalties for noncompliance. Code § a. Before the Agency could conduct its own investigation or open an enforcement proceeding based on Taxpayer's self-audit, however, Taxpayer approached it with a settlement offer. Instead of paying a civil penalty and spending approximately Amount a to bring its existing systems into compliance, Taxpayer proposed to undertake a BEP, a major project to convert its Equipment b to a design that would reduce emissions well below the Clean Air Act standards. Taxpayer proposed to transfer half of the resulting emissions credits to the Agency, and to use the other half of the credits to expand the Facility by adding Equipment d.

Ordinarily, to determine whether or not to assess a civil penalty and the amount of the penalty or settlement thereof, the Agency is required by Code § a to consider certain factors. These factors include the history of previous violations or noncompliance, the nature and gravity of the violation, the gross revenues generated by the violator, the degree of culpability, the risk to human health or property, the reporting or concealment of the violation, attempts to mitigate damages, and the monetary benefits realized through noncompliance. Code § a. If the Agency determines that a civil penalty will be assessed, it uses a matrix to determine the amount. Regulation § c. The matrix categorizes each penalty event (each day of pollution in excess of the limit allowed by the Clean Air Act) as major, moderate, or minor in terms of the nature and gravity of the violation and the degree or risk to human health or property. *Id.* Then, the penalty amount is adjusted within a range set out in the matrix by considering certain violator-specific facts and circumstances. *Id.*

The Agency is authorized to settle environmental enforcement actions with BEPs alone, or with BEPs and the payment of a cash penalty. Under Code § b, such settlements

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[1] The Clean Air Act, 42 U.S.C. § 7401 (2000) *et seq.*, requires states to develop and submit to the EPA an operating permit program which meets the requirements of Title V of the Act. The Act also requires states to adopt their own implementation plans, approved by the EPA, for the enforcement of primary ambient air quality standards as promulgated by the Environmental Protection Agency (EPA). 42 U.S.C. § 7410(a).

shall be considered a civil penalty for tax purposes.[2] A BEP is a project that provides for environmental mitigation and that the defendant is not otherwise legally required to perform. Regulation § d. A BEP cannot include improvements that a respondent would be required to perform as injunctive relief in the enforcement proceeding at issue (i.e., the costs of bringing its existing equipment into compliance), and the BEP must meet certain requirements set forth in the regulations. *Id.* As a practical matter, in this situation, where the proposed BEP is the installation or upgrading of equipment to replace the old equipment that precipitated the emissions violation, the compliance portion of the enforcement action/settlement agreement is subsumed within the BEP. Ordinarily, an agreement to undertake a BEP does not excuse a respondent's obligation to remedy a violation by bringing its existing equipment into compliance.

The Agency ultimately accepted Taxpayer's settlement proposal. During the settlement negotiations, the Agency sent a Notice of Potential Penalty[3] to Taxpayer, detailing the alleged emissions violations and notifying Taxpayer of State a's right to seek injunctive relief and to assess penalties during an enforcement proceeding. As part of its internal process to obtain approval of the proposed settlement, the Agency prepared a memorandum for the State a Attorney General's Office outlining the factors they considered in determining whether a civil penalty would be assessed against Taxpayer and the amount of such a penalty. The memorandum concludes that a penalty was contemplated and the maximum amount in this particular case would be Amount b.

The parties signed a Settlement Agreement on Date 2. The Settlement Agreement provides that Taxpayer will undertake the BEP at a cost of at least Amount c. This figure represents d% of the BEP's then total estimated cost of Amount e. The agreement provides that Taxpayer would have had to spend approximately Amount a to meet the current Clean Act standards, and so designates the balance of Amount f of the total estimated costs as the amount of the BEP. The agreement further provides that the Agency accepts the BEP in full settlement of the claims outlined in its Notice of Potential Penalty.

Taxpayer capitalized the amount spent on the BEP under §§ 263(a) and 263A and began depreciating the project as it was placed in service, beginning in Year 6. Taxpayer included the depreciation in inventory costs under § 263A and § 1.263A-1(e)(3)(ii)(I) of the Income Tax Regulations. The IRS Operating Division (Field) contends it should deny g% of Taxpayer's claimed depreciation deduction. The Field's calculations are as follows: Taxpayer incurred a total of Amount h for the BEP. The estimated cost of bringing its former systems into compliance would have been Amount a (which would have constituted the injunctive relief portion, not the BEP portion, of the settlement). The Field subtracted Amount a from Amount h, reducing the BEP cost to

[2] Additionally, State a's website contains a section describing BEPs and characterizes all environmental settlements, whether they contain a BEP and a cash penalty or solely a BEP, as a "civil penalty for tax purposes."

[3] A Notice of Potential Penalty signals the opening of a formal enforcement proceeding.

Amount i or j% of the total amount. The Field seeks to deny Taxpayer's inclusion of g% of its depreciation (i.e., the portion of the balance of the construction costs allocable to the BEP, or the alleged punitive portion of the settlement), which Taxpayer added to its inventory costs and deducted as cost of goods sold or on hand at the close of the taxable year.

LAW AND ANALYSIS:

(1) Whether any portion of the costs incurred by Taxpayer for the performance of a "beneficial environmental project" (BEP) is an amount analogous to a nondeductible fine or similar penalty as defined under § 162(f).

Generally, taxpayers are taxed on net income and may deduct under § 162(a) all ordinary and necessary expenses paid or incurred in carrying on a trade or business, including judgments, settlements, and similar payments. Prior to 1969, courts used public policy grounds to deny deductions for business expenses if allowing the deduction would frustrate a sharply defined national or state policy. *See, e.g.*, *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958). The *Tank Truck Rentals* case involved the issue of whether a trucking company could claim a business expense deduction for payment of fines imposed for the violation of state motor vehicle weight limit laws. The Court examined the state laws at issue and concluded that the fines were imposed for punitive and deterrent purposes. The Court held that the IRS had been correct to disallow the deduction of a business expense on public policy grounds because allowing the deduction would frustrate "sharply defined national or State policies proscribing particular types of conduct, evidenced by some governmental declaration thereof." *Id.* at 33-34. In *Tank Truck Rentals*, the "sharply defined State policy" was the state's interest in punishing those who violate weight limit laws on its highways (thereby causing excess damage to the roadways) and deterring such unlawful conduct in the future. *Id.* The purpose of this public policy doctrine is to prevent favorable tax treatment from "blunting the sting" of a validly imposed penalty by allowing the taxpayer a deduction for federal income tax purposes. *Atzingen-Whitehouse Dairy, Inc. v. Commissioner*, 36 T.C. 173, 183 (1961).

In 1969, Congress enacted § 162(c) (illegal bribes, kickbacks, and other payments), § 162(f) (fines and penalties), and § 162(g) (treble damage payments under antitrust laws), effectively codifying the extent to which deductions under § 162(a) would be disallowed on public policy grounds. Section 162(f) provides that no deduction shall be allowed under subsection 162(a) for any fine or similar penalty paid to a government for the violation of any law. Section 1.162-21(b)(1) of the regulations provides that a fine or similar penalty includes an amount "paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal)."

Section 263(a) denies a deduction for any capital expenditures. Section 263(a) provides that no deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments to increase the value of any property or estate. In addition, § 263A requires a taxpayer to capitalize the direct and certain indirect costs of producing property.

Because the amounts paid out by Taxpayer for the construction of the BEP constitute capital expenditures under §§ 263(a) and 263A, these amounts cannot be deducted under § 162(a). Consequently, § 162(f), which only prohibits deductions under § 162(a), does not, by its own terms, apply to deny a tax benefit for the amounts at issue. Nevertheless, because § 162(f) represents a codification of the public policy doctrine, we believe the analyses used by the courts and the Service in determining whether certain expenses meet the definition of a fine or similar penalty for purposes of § 162(f) are relevant for determining whether any expenditure, or a portion thereof, constitutes a fine or penalty whose allowance as a tax benefit would frustrate public policy. Thus, if Taxpayer's expenditures as part of its settlement agreement are analogous to the types of fines or penalties that have been disallowed under § 162(f), then there is a compelling basis to disallow such expenditures under a public policy rationale.

In the present case, Taxpayer argues that its costs of performing the BEP did not constitute payments in settlement of a civil penalty. Specifically, Taxpayer notes that it had proposed the project before an enforcement proceeding was formally opened, that it undertook the BEP for good and sufficient business reasons independent of any potential penalty, that its liability for any penalty had not been established, and that the project would provide significant benefits for State a. While these facts may be accurate, they are not relevant in determining the character of settlement payments at issue. Rather, in order to evaluate the deductibility of a settlement payment, the courts and the Service have looked to the origin and character of the liability giving rise to the claim, not the taxpayer's motive for making the payment or the effect of the payment on the taxpayer's situation at the time the payment is made. *See, e.g.*, *Ostrom v. Commissioner*, 77 T.C. 608 (1981). *See also United States v. Gilmore*, 372 U.S. 39, 48-49 (1963); *Bailey v. Commissioner*, 756 F.2d 44, 47 (6th Cir. 1985). Therefore, in order to determine whether the costs of the BEP constitute payments in settlement of a non-deductible fine or penalty, the analysis must focus on the nature of the liabilities that resulted in the BEP, and not Taxpayer's motives for proposing or accepting the BEP or the benefits of the BEP to other parties.

In addition, for purposes of § 162(f), the courts and the Service distinguish between punitive and remedial payments labeled civil penalties or settlements of those penalties (the punitive vs. remedial test). Under the punitive vs. remedial test, a payment imposed for purposes of enforcing the law or as punishment for its violation is not deductible, while a payment imposed as a remedial measure or to compensate the government or another party is deductible, even if it is labeled as a fine or penalty. *See, e.g.*, *Talley Indus., Inc. v. Commissioner*, 116 F.3d 382, 385-86 (9th Cir. 1997); *Mason* *and Dixon Lines, Inc. v. United States*, 708 F.2d 1043, 1047 (6th Cir. 1983).[4] In order to determine the purpose of a payment under the punitive v. remedial test, courts first look to legislative intent, including the language of the statute or ordinance in question, its legislative history, and other court decisions construing the statute or ordinance. *Mason and Dixon Lines, Inc. v. United States*, 708 F.2d 1043, 1047 (6th Cir. 1983); *Huff v. Commissioner*, 80 T.C. 804, 824 (1983). Where a payment ultimately serves each of these purposes, the court looks to the purpose that the payment was designed to serve. *Talley Indus., Inc. v. Commissioner*, 116 F.3d at 385-86; *S & B Restaurant, Inc. v. Commissioner*, 73 T.C. 1226, 1232 (1980); *Middle Atlantic Distributors v. Commissioner*, 72 T.C. 1136, 1145 (1979).

Here, we evaluate Taxpayer's settlement by examining the origin of the Agency's underlying claims, which are alleged violations of the Clean Air Act and the State a Statute. An underlying purpose of the civil penalties imposed under the Clean Air Act is to punish violators and to deter future violations. *See, e.g., Colt Industries, Inc. v. United States*, 11 Cl. Ct. 140 (1986)("Pollution controls in this case are imposed for the general welfare by the exercise of sovereign powers. Civil penalties are to protect those interests, not to compensate for injuries to proprietary interests in business or property."), *aff'd on other grounds,* 880 F.2d 1311 (10th Cir. 1989). The Notice of Potential Penalty outlines numerous alleged State a statutory violations and provides that the Agency may seek injunctive relief (requiring Taxpayer to bring its systems into compliance with the emissions standards) or civil penalties, or both. The factors in Code § a to be considered in determining whether a civil penalty will be assessed do not include the quantification of any damages caused by the noncompliance. These factors include the history of previous violations or noncompliance, the nature and gravity of the violation, the gross revenues generated by the violator, the degree of culpability, the risk to human health or property, the reporting or concealment of the violation, attempts to mitigate damages, and the monetary benefits realized through noncompliance. Code § a. Moreover, the State a regulations also note that penalties must be sufficient to deter future violations and to achieve and maintain expeditious compliance. *See* Regulations § c. The fact that Taxpayer performed a BEP in settlement of potential civil penalties does not change their nature as civil penalties. Code § b expressly provides that all settlements of enforcement actions, including those that require BEPs, are to be considered a civil penalty for tax purposes. Based on these facts, we believe the purpose of the civil penalty, i.e., the portion of the BEP imposed in settlement of those potential penalties under the State a statute[5], was to punish Taxpayer and to deter future violations. There is no indication that any portion of

[4] Although the *Tank Truck Rentals* decision pre-dates the enactment of § 162(f), the Court used the same type of analysis to determine that the purpose of the state statutes at issue was punitive instead of compensatory. *Tank Truck Rentals*, 356 U.S. at 34-35.

[5] The State a regulations and the settlement agreement specifically excludes from the BEP expenditures, and thus from the civil penalties, any amounts that represent injunctive relief. Regulation § d. Thus, we exclude from the penalty amount analysis the injunctive relief portion of the settlement, or Amount a, the amount Taxpayer would have spent to upgrade or replace its old equipment to meet the current Clean Air Act standards.

these civil penalties was intended to provide remediation or to constitute compensatory damages.

Taxpayer claims that § 162(f) is inapplicable here because the settlement agreement required Taxpayer to incur the costs to construct an asset, rather than pay a cash penalty to the government. However, the courts have interpreted § 162(f) more broadly. For example, several cases support the proposition that payments made to parties other than the government may constitute nondeductible fines or similar penalties within the meaning of § 162(f). *See, e.g.*, *Bailey v. Commissioner*, 756 F.2d 44 (6th Cir. 1985)(civil penalty imposed for violating a Federal Trade Commission consent order was not deductible even though taxpayer was permitted to apply the penalty toward the settlement of his liabilities in a class-action lawsuit); *Waldman v. Commissioner*, 88 T.C. 1384 (1987), *aff'd without published opinion*, 850 F.2d 611 (9th Cir. 1988)(criminal restitution payments made directly to victims was a non-deductible penalty); *Allied-Signal, Inc. v. Commissioner*, T.C. Memo. 1992-204, *aff'd in unpublished opinion*, 54 F.3d 767 (3d Cir. 1995). In *Allied-Signal*, the taxpayer had been convicted of environmental crimes and was sentenced to a fine in excess of $13 million. The taxpayer contributed $8 million to an environmental endowment fund with the understanding from the court that the proposed $13 million criminal fine would be reduced by the same $8 million. The Tax Court held that the payment was, "in substance," a fine or similar penalty under § 162(f), reasoning that it was an involuntary payment ordered or directed by a court, that any compensatory or remedial purposes the payment served was minimal, and that it was imposed for punishment and deterrence. *Allied-Signal,* T.C. Memo. 1992-204

Although these cases all involve cash payments, not the construction of assets, we believe the same rationale for prohibiting a tax benefit applies here. As the court noted in *Allied-Signal,*

> [w]hile the form of the payment does not necessarily fit within the letter of section 162(f), in substance petitioner paid a criminal fine. . . . To allow petitioner a deduction in this case "would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."

Id. In the present case, if Taxpayer had settled its civil penalty by making a cash payment to State a, that payment would be a nondeductible fine or penalty under the authorities outlined above. The result should not change because Taxpayer settled its civil penalty by agreeing to incur the costs of performing a project to benefit the environment instead of incurring a direct cash payment.

Having concluded that a portion of the cost of the BEP should be characterized as an amount analogous to a nondeductible fine or similar penalty as defined under § 162(f), the next issue is computing this amount. In order to make this determination, the courts and the Service have examined the facts and circumstances of each case to ascertain evidence of the parties' intent at the time of the settlement. *Talley Indus., Inc. v. Commissioner*, 116 F.3d 382 (9th Cir. 1997); Rev. Rul. 75-230, 1975-1 C.B. 93. Generally, a taxpayer seeking to deduct a lump-sum settlement payment has the burden of establishing entitlement to a deduction. *Talley Indus.*, 116 F.3d at 387. Thus, in this case, Taxpayer has the burden of proving what portion, if any, of the BEP costs was not intended to be characterized as a fine or similar penalty.

In general, the Office of Associate Chief Counsel issues technical advice in response to technical or procedural questions on the interpretation of the tax law. *See* section 3.00 of Rev. Proc. 2006-2, 2006-1 I.R.B. 89, 93. The Associate's Office does not usually issue technical advice on purely factual issues. Accordingly, we leave the final determination of the factual issue of what portion of the cost of the BEP should be characterized as analogous to a fine or similar penalty to the Field. The Field should examine all the evidence to determine the parties' intent at the time of the settlement, as well as determine whether Taxpayer has met its burden of proof to establish entitlement to a deduction. In making this determination, the Field should consider the memorandum prepared by the Agency for the State a Attorney General's Office concluding that, although the penalty calculations had not been finalized, the maximum penalty amount that the Agency would recommend was Amount b. In addition, the Field should consider any other written evidence of the parties' intent prepared contemporaneous with the settlement agreement.

(2) Whether Taxpayer may include in the basis of assets it produces under § 263A, or as the basis of property under § 1012, any portion of the BEP costs that is an amount analogous to a fine or similar penalty.

Even though we have concluded that a portion of Taxpayer's expenditures is analogous to a fine or similar penalty under § 162(f), the deduction of any such amount is not directly prohibited under § 162(f). As discussed above, because amounts incurred by Taxpayer for the construction of the BEP constitute capital expenditures under §§ 263(a) and 263A, these amounts cannot be deducted under § 162(a), and § 162(f) does not directly apply. Nevertheless, the Field contends that because a portion of the amounts spent on the BEP would be characterized as a fine or penalty under the definitions provided under § 162(f), these amounts should be excluded from basis under §§ 263A and 1012 on public policy grounds. In other words, allowing Taxpayer to recover these "fines or penalties" through cost of goods sold or other basis adjustment would frustrate the public policy of punishing violators and deterring future violations of the environmental laws.

a. Section 263A

The next issue considered in this request for technical advice is whether Taxpayer may capitalize under §§ 263(a) and 263A the amounts it incurs for the construction of the BEP notwithstanding that, as discussed above, § 162(f) would deny a deduction under

§ 162(a) for an amount analogous to a fine or similar penalty. Taxpayer asserts that the amounts at issue constitute capital expenditures under §§ 263(a) and 263A which are not subject to the limitation of § 162(f). For the reasons described below, Taxpayer may not include in the basis of assets it produces under § 263A any portion of the BEP costs that represents an amount analogous to a fine or similar penalty.

In this case, §§ 263(a) and 263A require Taxpayer to capitalize certain amounts in connection with the construction of the BEP. In particular, § 263(a) denies a deduction for capital expenditures by providing that taxpayers cannot deduct any amount paid out for new buildings or for permanent improvements or betterments to increase the value of any property or estate. *See also* § 1.263(a)-1(a). Section 1.263(a)-1(b) directs taxpayers to use § 263A and the regulations thereunder for cost capitalization rules for amounts for the production of self-constructed assets. Under § 263A(a)(2), Taxpayer must capitalize its direct costs of producing property together with such property's proper share of those indirect costs, part or all of which are allocable to such property.

The description of direct and indirect costs that must be capitalized under § 263A(a) is very broad and, without more, could potentially include costs that are not otherwise deductible under the Code. However, § 263A(a)(2) specifically provides that "[a]ny cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph." That is, an amount may not be capitalized under § 263A if it cannot otherwise be taken into account in computing taxable income. The regulations under § 263A clarify this by stating:

> Any cost which (but for section 263A and the regulations thereunder) may not be taken into account in computing taxable income for any taxable year is not treated as a cost properly allocable to property produced . . . under section 263A and the regulations thereunder. Thus, for example, if a business meal deduction is limited by section 274(n) to 80 percent of the cost of the meal, the amount properly allocable to property produced or acquired for resale under section 263A is also limited to 80 percent of the cost of the meal.

§ 1.263A-1(c)(2). Pursuant to this regulation, in order for a taxpayer to include a cost under § 263A, the cost must be eligible to be taken into account in computing taxable income by virtue of a Code section other than § 263A. Otherwise, taxpayers with property subject to § 263A (self-constructed assets or property acquired for resale) would be allowed to capitalize and take into account (via amortization, depreciation deductions, or increased basis recovery upon disposition) costs that may not be taken into account by taxpayers without § 263A property. The Service has consistently adhered to an interpretation of § 263A that does not allow for disparity in calculating taxable income between taxpayers with § 263A property and those without such property.

This interpretation of § 263A is consistent with the legislative history of § 263A(a)(2), which indicates that the flush language of § 263A(a)(2) was added to clarify "that a cost is subject to capitalization….only to the extent it would otherwise be taken into account in computing taxable income." H. R. Rep. No. 100-795, at 98 (1988). Indeed, the legislative history of § 263A(a)(2) clarifies that an amount that is not otherwise allowable in determining taxable income may not be capitalized and recovered through depreciation or amortization deductions, as a cost of sales, or in any other manner. *Id.* This reasoning would prohibit Taxpayer from including in the basis of assets it produces under § 263A any portion of the BEP costs that represents an amount analogous to a fine or similar penalty, the deduction of which is prohibited by § 162(f).

By contrast, some have interpreted the parenthetical to the flush language in § 263A(a)(2) – "but for this subsection"-- as incorporating prior law into the scope of costs that a taxpayer may capitalize under § 263A. Under such an interpretation, the flush language applies only to costs that a taxpayer could not capitalize under another provision of the Code, such as § 263(a), prior to the enactment of § 263A. In other words, if a cost could have been capitalized under § 263(a) prior to the enactment of § 263A, that cost may still be capitalized to property that is subject to § 263A. For the reasons discussed below, this view is not correct.

First, the language of § 263A and the regulations covers all direct and indirect costs allocable to property produced by a taxpayer; it is not limited to additional costs required to be capitalized after the effective date of § 263A. Section 263A, by its own terms, applies to direct costs as well as indirect costs allocable to property produced by the taxpayer. Likewise, the regulations under § 263A provide rules for both direct and all indirect costs. Direct costs and many indirect costs were, in fact, capitalized under prior law. Moreover, the regulations under other cost capitalization and cost recovery provisions, most notably § 263(a), refer to § 263A and the regulations thereunder for cost capitalization rules applicable to real or tangible personal property produced by a taxpayer. *See, e.g.,* § 1.263(a)-1(b); § 1.162-12(a); § 1.174-2(a)(5). Neither the Code nor regulations refers to the potential application of other capitalization provisions with respect to property subject to § 263A. The Code and regulations are structured as if § 263A contains the exclusive capitalization rules applicable to real or tangible personal property produced by the taxpayer.

Second, the Congress intended for § 263A to be a single, comprehensive set of capitalization rules for property produced by a taxpayer or acquired for resale. Prior to the enactment of § 263A, cost capitalization requirements varied between types of property and among industries. Congress believed that "a single, comprehensive set of rules should govern the capitalization of costs of producing, acquiring, and holding property…." S. Rep. No. 99-313, at 140 (1986). To that end, § 263A was enacted. Section 263A is often referred to as the "uniform capitalization rules" because their intent and effect is to apply a single, comprehensive set of rules to (1) property produced by the taxpayer and (2) property acquired for resale. "The Act applies a single set of capitalization rules to all costs incurred in manufacturing and constructing property." Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 503 (Comm. Print. 1987). Thus, looking to another provision of the Code or prior case law, would yield inconsistent capitalization rules and requirements for different types of property and in different industries, undermining the Congress's intent to establish uniform capitalization rules for all real or tangible personal property produced by the taxpayer. Likewise, looking to another provision of the Code or prior case law undermines the Congress's intent to establish a single, comprehensive set of rules for property acquired for resale.

Finally, the Congress believed that a single, comprehensive set of capitalization rules would make the income tax more neutral in its effect on business decisions. Thus, taxpayers would not be able to shop for different cost capitalization rules in deciding whether and what type of property to produce and in which business to invest. This congressional policy is supported by the flush language of § 263A(a)(2). If otherwise non-deductible costs were allowed to be capitalized under § 263A, taxpayers that produce property for use in their business would have an income tax advantage over taxpayers that purchase property for use in their business (as well as taxpayers engaged in service businesses).

These three reasons demonstrate that the flush language in § 263A(a)(2) should not be interpreted as incorporating prior law into the scope of costs that a taxpayer can capitalize under § 263A. Accordingly, in order for Taxpayer to capitalize an amount under § 263A, Taxpayer must otherwise be able to take that amount into account in determining taxable income. Absent the capitalization provisions of §§ 263(a) and 263A, the cost of the BEP would fall under § 162(a) as an ordinary and necessary expense paid or incurred during the taxable year in carrying on a trade or business. As discussed above, however, § 162(f) would prohibit a § 162(a) deduction for the portion of the cost that is an amount analogous to a fine or similar penalty. Therefore, because Taxpayer could not deduct the portion of the cost that is analogous to a fine or penalty under § 162 if it were not incurred by reason of a production activity, it may not capitalize that portion under § 263A(a). *See* § 263A(a)(2) and § 1.263A-1(c)(2).[6]

b. <u>Section 1012</u>

Even if the flush language of § 263A(a)(2) did not, by its terms, prevent Taxpayer from claiming basis for that portion of the cost of the BEP that was analogous to a fine or similar penalty, the public policy doctrine would still preclude Taxpayer from claiming basis under § 1012 for such amount.

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[6] Because the amounts that represent an amount analogous to fines or similar penalties are not capitalized into basis, they may not be recovered through depreciation. Accordingly, it is not necessary to rule on whether depreciation would be denied on other grounds.

As discussed above, the public policy doctrine is a common law rule that disallows deductions when “allowance would frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof." *Tank Truck Rentals*, 356 U.S. at 34. The Supreme Court has noted that "[d]eduction of fines and penalties uniformly has been held to frustrate state policy in severe and direct fashion by reducing the 'sting' of the penalty prescribed by the state legislature." *Id*. Thus, fines and penalties and amounts analogous to fines and penalties in particular are subject to disallowance under the public policy doctrine.

While the doctrine has been codified (and its scope limited) in the text of § 162 and certain regulatory provisions,[7] the public policy doctrine, as a common law rule of federal income tax law, limits tax benefits even in the absence of any statute or regulation providing for disallowance.

For example, Rev. Rul. 77-126, 1977-1 C.B. 47, addresses whether the forfeiture of illegal gambling devices for nonpayment of taxes results in losses deductible by the taxpayer under § 165. The ruling holds that although Congress codified and limited the public policy doctrine in the case of ordinary and necessary business expenses by amending § 162(c) and enacting §§ 162(f) and (g), the rules for disallowing a deduction under § 165 on the grounds of public policy are not so limited. The ruling disallows the § 165 deduction because allowing the taxpayer to deduct the losses would frustrate sharply defined public policy by “soften[ing] the sting” of the forfeiture.

Rev. Rul. 82-74, 1982-1 C.B. 110, addresses the federal income tax consequences that follow when taxpayer pays an arsonist to burn down an office building and collects, but is subsequently required to return, insurance proceeds. The ruling concludes that gain from collection of the proceeds is ordinary income and that repayment of the proceeds entitles taxpayer to a loss deduction equal to the amount of gain previously reported. Further, taxpayer’s basis in the building is reduced to zero because taxpayer’s loss is nondeductible. Even though § 1.165-3(b) would ordinarily increase the adjusted basis of the taxpayer’s building by the net cost incurred with respect to the destruction of the property, the ruling holds that the basis adjustment is precluded on public policy grounds because the allowance of an upward basis adjustment for the payment to the arsonist would severely and immediately frustrate the statutory scheme regarding arson and insurance fraud.

Courts likewise have employed the public policy doctrine to disallow various tax benefits that would be inconsistent with articulated public policy. For example, courts have held that a loss deduction will be denied when to allow the deduction would frustrate a sharply defined Federal or state policy. *E.g., Smith v. Commissioner*, 34 T.C. 1100 (1960), *aff’d per curiam* 294 F.2d 957 (5th Cir. 1961) (disallowing § 165 loss or § 166

[7] *See e.g.,* §§ 162(c), (f) *and* (g) *and* §§ 1.61-3(a), 1.212-1(p), 1.471-3(d), 1.213-1(e)(1)(ii) and 1.213-1(e)(2) of the regulations.

bad debt deduction for a tax penalty, in part, because the deterrent impact of the tax penalty would be softened, and violations of statutory duty would be encouraged). *See also Blackman v. Commissioner*, 88 T.C. 677 (1987), *aff'd*, 867 F.2d 605 (1st Cir. 1988) (disallowance of deduction for a casualty loss for destruction of home resulting from taxpayer lighting his wife's clothes on fire); and *Hackworth v. Commissioner*, T.C. Memo. 2004-173 (disallowance of loss deduction under § 165 for forfeiture of proceeds from illegal gambling operation). *Cf. Turnipseed v. Commissioner*, 27 T.C. 758 (1957) (public policy doctrine applied to disallow a personal exemption for a woman illegally cohabitating with the taxpayer; later codified as § 152(b)(5)); *Green v. Connally*, 330 F. Supp. 1150 (D.D.C. 1971), *aff'd per curiam sub nom., Coit v. Green*, 404 U.S. 997 (1971) (private schools maintaining racially discriminatory admissions policies that clearly violate Federal policy denied qualification under § 501(c)(3)).
In this case, allowing Taxpayer basis for expenditures that are analogous to a fine or penalty would permit Taxpayer to derive a tax benefit that would "soften the sting" of the intended penalty. Taxpayer should not be able to derive a tax benefit from such expenditures, either in the form of increases to cost of goods sold resulting from inclusion of depreciation in inventory, or in the form of a basis offset in the event there is a disposition of the BEP.[8]

In fact, whether the costs in issue may be included in cost of goods sold is addressed directly by regulation. Section 1.61-3(a) provides that in the case of a manufacturing business, gross income is determined "without subtraction of . . . amounts which are of a type for which a deduction would be disallowed under § 162(c), (f), or (g) in the case of a business expense." *See also* § 1.471-3(d) (providing that in valuing inventories cost does not include such amounts). These regulations are consistent with, and promote, the policy expressed in *Tank Truck Rentals* -- to not permit tax benefits to "frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof." 356 U.S. at 34. Moreover, that policy is fully applicable when determining whether costs analogous to a fine or penalty should be included in basis for purposes other than calculating cost of goods sold, such as when determining gain or loss. The public policy doctrine is implicated regardless of whether taxpayer pays a fine, incurs a cost otherwise included in cost of goods sold, or incurs a cost otherwise included in the § 1012 basis of an asset, and there is no justification for disparate treatment of these three situations.

Taxpayer argues that the Sixteenth Amendment to the United States Constitution and the statutory definition of income entitle it to full inclusion of the cost of the BEP in basis. We disagree and do not view the case law cited by Taxpayer in support of these arguments to be controlling.

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[8] As discussed above, depreciation deductions need not be addressed in this case. *See supra* note 6.

In *Hofferbert v. Anderson Oldsmobile, Inc.*, 197 F.2d 504 (4th Cir.), *aff'g*, 102 F. Supp. 902 (D. Md. 1952), taxpayer, a used car salesman, purchased cars at prices in excess of ceilings set by the Emergency Price Control Act of 1942. Taxpayer computed its gross income by including the entire cost of the automobiles, including the excess over the ceiling price, in its cost of goods sold. The Service disallowed these "excess costs." Citing the Sixteenth Amendment to the United States Constitution, the District Court held for the taxpayer and reasoned that the entire cost of an automobile had to be taken into account when computing gain because constitutionally the only thing that can be taxed by Congress is income.[9] The Fourth Circuit affirmed. However, rather than relying upon the Sixteenth Amendment, the court based its decision on statutory interpretation. Specifically, the court focused on the predecessor to § 61 (§ 22 of the Internal Revenue Code of 1939) and the absence of express statutory or regulatory language limiting the meaning of the term "cost" to costs legally paid. The court also pointed out that while the Emergency Price Control Act provided for civil and criminal penalties for its violation, it did not, as had other price control legislation, provide for the disallowance of tax benefits as an additional sanction.

In *Max Sobel Wholesale Liquors v. Commissioner*, 630 F.2d 670 (9th Cir. 1980), *acq*., 1982-2 C.B. 2, a seller illegally transferred extra merchandise to customers in order to circumvent state law providing for minimum prices. The Service asserted that § 162(c)(2) prevented the seller from including the value of the extra merchandise in cost of goods sold. The court held in favor of the taxpayer. The opinion cites *Pittsburgh Milk Co. v. Commissioner*, 26 T.C. 707 (1956), which held that when a seller rebates part of its customer's purchase price, the rebate is not a business expense, potentially deductible under § 162(a), but rather an exclusion from gross income. The court viewed the delivery of extra merchandise as the equivalent of a rebate. Consequently, the value of the extra merchandise was an exclusion from gross income rather than a potential deduction, and § 162(c)(2), which applies only to deductions, was not applicable. *See also* Rev. Rul. 82-149, 1982-2 C.B. 56 (acquiescing to *Max Sobel* and holding that price rebates are not subject to § 162(c)(2)).

Initially, it must be noted that these cases relied, not on the Sixteenth Amendment, but on statutory interpretations of the Code -- § 162(c)(2) in *Max Sobel*, and the term "cost" in *Anderson Oldsmobile*. Congress, however, has signaled in § 263A(a)(2) its intention that taxpayers not obtain an indirect tax benefit by capitalizing to basis amounts for which a deduction is prohibited. Both *Anderson Oldsmobile* and *Max Sobel* predate § 263A(a)(2) and therefore fail to take into account Congress' expressed intent to exclude costs from basis when necessary to protect public policy.

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[9] The Sixteenth Amendment empowers the Congress "to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

Moreover, *Max Sobel*'s conclusion that § 162(c)(2) does not apply to exclusions from gross income does not address the issue of whether the common law public policy doctrine prevents a taxpayer from including in basis amounts that are analogous to fines or penalties and thereby deriving a tax benefit that frustrates public policy. *Max Sobel* is further distinguishable insofar as the case in substance concerned a rebate paid to a buyer ("There is no material difference between *Pittsburgh Milk*, where the price is adjusted by a cash rebate, and the present case, where the price is adjusted by the delivery of extra merchandise." *Max Sobel*, 630 F.2d at 672.) The court held that it was necessary to take into account the rebate in order to avoid overstating the actual, economic selling price of the goods. That rationale, however, has no application to the facts of this case.

Anderson Oldsmobile is further distinguishable insofar as the court was swayed by legislative history indicating that Congress intended to exact a tax penalty on amounts paid in violation of certain price control legislation, but not on violations of other acts, including violations of the act in issue in that case.

Thus, in accordance with § 263A(a)(2), § 1.61-3 of the regulations, and the public policy doctrine enunciated in *Tank Truck Rentals*, Taxpayer may not include in the basis of assets it produces under § 263A or in the basis of property under § 1012, the portion of the BEP costs that represents an amount analogous to a nondeductible fine or penalty under § 162(f).

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.