Internal Revenue Service

Number: **201451014**
Release Date: 12/19/2014

Index Number: 165.00-00
162.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:ITA:B02
PLR-111988-14

Date: August 22, 2014

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Dear :

This is in response to the letter dated March 18, 2014, submitted on your behalf by your authorized representative. In the letter you request two rulings. First, a ruling that the Taxpayer abandoned A and B in Date 1 within the meaning of section 165 of the Internal Revenue Code but that it is not entitled to claim the loss until its claims against C and D are resolved. Second, a ruling that it is entitled to claim its ordinary and necessary business expenses under section 162 regardless of the contingent possibility of recovery of these expenses from C.

FACTS – Abandonment Loss

Taxpayer represents the facts and information related to its request for rulings as follows:

Taxpayer, a corporation, is a wholly-owned subsidiary of E E and its affiliated group of corporations, including Taxpayer, electronically file a consolidated federal income tax return on a calendar year basis using the accrual method of accounting.

Taxpayer is a regulated public utility. It owns a F percent interest in A and B.

The G comprised three large pressurized water nuclear generating facilities. H was abandoned and decommissioned commencing in Date 2.

A was placed in service in Date 3 and its operating license was scheduled to expire on Date 4. B was placed in service in Date 5 and its operating license was scheduled to expire on Date 6.

Two replacement steam generators were installed and placed in service in each of A and B in Date 7 and in Date 8, respectively. C designed and manufactured the replacement steam generators.

In Date 9, a steam leak occurred in one of the heat transfer tubes in one of the B steam generators and B was safely taken off-line. All four steam generators were inspected and areas of significant, unexpected and excessive wear were found throughout. As a result, since Date 9, A and B have remained offline through the announced retirement of G on Date 10.

Taxpayer undertook an analysis of possible causes of the extraordinary wear and explored potential remedial actions. In Date 11, after months of analysis and tests, Taxpayer submitted a restart plan to the Nuclear Regulatory Commission (NRC). The NRC conducted public hearings and studied the merits of the restart application. In Date 12, the NRC ruled that restart would require amendments to the operating license of A. Faced with mounting costs and uncertainties, Taxpayer determined that continued efforts to repair or restart A and B were not feasible.

On Date 13, Taxpayer filed a Form I with the Securities and Exchange Commission announcing that it was going to issue a press release on Date 10 announcing that it was going to permanently retire G. On Date 14, the Taxpayer formally notified the NRC that it had permanently ceased operation of A and B effective Date 10. The defueling of A was completed on Date 15, and the Taxpayer sent a letter to the NRC on Date 16, certifying that the fuel had been removed from A. The defueling of B was completed on Date 17, and a letter certifying the nuclear fuel removal for B was sent to the NRC on Date 18. It is anticipated that the decommissioning process will take several decades.

Taxpayer severed a substantial number of operational employees who will not be engaged in the decommissioning of G. It sought and received a reduction in its state property tax base to reflect the impairment.

The Taxpayer wrote down its investment in G for financial purposes in the second quarter of Date 1.

Not all of the assets at G will be abandoned in connection with the permanent retirement of G. The Taxpayer set up the J to recover a portion of its investment in assets and inventory as a result of the decommissioning of G. The Taxpayer has represented that none of the property included in the J will be treated as abandoned property subject to this ruling request.

On Date 15, the Taxpayer submitted a Notice of Dispute to C for all damages caused by C's failed design and manufacture of the replacement steam generators that led to the shutdown and permanent retirement of A and B. The dispute resolution process initiated by the Notice of Dispute was unsuccessful so the Taxpayer initiated binding arbitration proceedings against C to recover damages. The arbitration proceedings were ongoing at the time the ruling request was filed.

G carries accidental property damage and carried accidental outage insurance issued by D. The accidental outage insurance was cancelled due to the permanent retirement of G. D has been placed on notice of potential claims for loss recovery under both policies.

There are also pending proceedings before the K to determine how otherwise unrecovered costs are addressed in the ratemaking process.

LAW AND ANALYSIS – Abandonment Loss

Section 165(a) of the Internal Revenue Code provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Section 1.165-1(d)(2)(i) of the Income Tax Regulations provides that if a casualty or other event occurs which may result in a loss and, in the year of such casualty or event, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to such reimbursement may be received is sustained, for purposes of *section 165*, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received. Whether or not such reimbursement will be received may be ascertained with reasonable certainty, for example, by a settlement of the claim, by an adjudication of the claim, or by an abandonment of the claim.

A reasonable prospect of recovery exists when a taxpayer has bona fide claims for recoupment from third parties and when there is a substantial possibility that such claims will be decided in his favor. *Estate of Scofield v. Commissioner, 266 F.2d 154, 159 (6th Cir. 1959).*

If a taxpayer's claim is not speculative or wholly without merit, and if the taxpayer believes that the chance of recovering the loss is sufficiently probable to warrant bringing a lawsuit and prosecuting it with reasonable diligence to a conclusion, the deduction should be deferred until the conclusion of the lawsuit. *Jeppsen v. Commissioner, 128 F.3d 1410, 1414 (10th Cir. 1997)*.

Section 1.165-2(c) provides that for the allowance under *section 165(a)* of losses arising from the permanent withdrawal of depreciable property from use in the trade or business or in the production of income, *see section 1.167(a)-8*.

Section 1.167(a)-8(a)(4) provides that in order to qualify for the recognition of loss from physical abandonment, the intent of the taxpayer must be irrevocably to discard the asset so that it will neither be used again by him nor retrieved by him for sale, exchange or other disposition.

Rev. Rul. 87-117, 1987-2 C.B. 61, holds that for purposes of *section 165(a)*, the fact that a public utility company that has abandoned a partially constructed nuclear power plant obtains a rate increase that is based in part on the costs of the abandoned plant does not cause it to have been compensated for by insurance or otherwise as that phrase is used in *section 165(a)*.

The abandonment of real property interests where ownership has not been transferred has been addressed in a variety of circumstances. An abandonment was found where the taxpayer filled and sealed a water well excavation in *Rev. Rul. 56-599, 1956-2 C.B. 122*; dismantled an asphalt plant, moved it to another location and did not reassemble it, *Seminole Rock & Sand Co. v. Commissioner, 19 T.C. 259 (1952)*, acq., *1953-1 C.B. 6*; stopped working on a mine, reduced the work force and budget to maintain it, sold the mine equipment for salvage, decided to abandon the mine by vote of board of directors, and wrote the mine off the company books, *A.J. Industries, Inc. v.*

United States, 503 F.2d 660 (9th Cir. 1974); and locked and boarded hotel, placed barricades around it, cut off utilities, terminated insurance, discontinued maintenance, and made no efforts to sell or lease it, *Hanover v. Commissioner, T.C. Memo. 1979-332*.

Legal restrictions upon the physical disposition of property such as a nuclear plant will not in themselves preclude a finding of abandonment if all other facts and circumstances demonstrate an intention to irrevocably retire property from use and the requisite overt acts related to abandonment have occurred. The acts necessary to evidence the intent to abandon property need only be appropriate to the particular circumstances. A nuclear power plant is a heavily regulated asset, and one which Taxpayer cannot simply walk away from, board up, or dismantle.

In the present case, Taxpayer has indicated that it intended to abandon A and B. It has taken steps to abandon the units by removing the nuclear fuel from the units. It has submitted documents to the NRC that prevent it from operating G. It altered its insurance for the unit to a level indicative of its nonoperational status. Finally, it issued press releases concerning the abandonment of the plant, wrote-off the assets on its books and included statements about the abandonment in its financial statements.

The Taxpayer has taken actions to render A and B nonoperational. It has announced its intention to permanently shut down G. The nuclear generators have been shut down since the leak at B was discovered. It has commenced the initial activity phase of radiological decommissioning with the appropriate filing with the NRC. Taxpayer severed a substantial number of operational employees who will not be engaged in the decommissioning of G. It sought and received a reduction in its state property tax base to reflect the impairment.

Based on the above, it is held that Taxpayer sustained an abandonment loss within the meaning of *section 165(a) of the Internal Revenue Code* with respect to A and B (exclusive of the assets in the J) in Date 1. It demonstrated the requisite intent to abandon A and B, it effectuated that intent through numerous acts of abandonment and it has placed both units in a state of disability.

This holding is limited to the issue of whether an abandonment of A and B occurred and does not consider which specific assets are abandoned or the amount properly allocated thereto.

However, pursuant to *section 165(a)*, even though Taxpayer abandoned A and B, it will not be entitled to claim a deduction for the loss incurred if the loss is compensated for by insurance or otherwise. *See also section 1.165-1(d)(2).*

The Taxpayer is pursuing its claims against C in an arbitration proceeding. It has represented that it has a valid claim against C and a reasonable prospect of recovery against C.

The Taxpayer has filed separate proof of loss claims under the D outage policy and may pursue claims under the property accident policy. It has represented that it has a reasonable prospect of recovering damages from D.

The Taxpayer is also seeking recovery of costs that might not be recoverable from C or D in rate proceedings before K.

Given that the Taxpayer has a reasonable prospect of recovering damages from both C and D, the deduction of the abandonment loss should be deferred until the arbitration proceeding is concluded and the D insurance claims are resolved. Any recovery in rates before the K does not constitute a reasonable prospect of recovery by insurance or otherwise sufficient to require deferral of the abandonment loss deduction under *section 165. Rev. Rul. 87-117, 1987-2 C.B. 61*.

FACTS – Ordinary and necessary business expenses

In addition to the facts set forth above, Taxpayer represented the following:

Taxpayer has incurred and will continue to incur a variety of expenses associated with the decontamination, dismantlement, removal, disposal of the structures, systems and components, and the decommissioning of A and B. The contamination being remediated all occurred while Taxpayer owned and operated A and B. The vast majority of the expenses will merely restore the facility to its pre-contaminated state and will not adapt the property to a new or different use, increase its value beyond its pre-contaminated state, or prolong its useful life.

Taxpayer is the majority owner and operator of G, but is a minority owner of L and is the only common owner of L and G. Each nuclear generating station is separately licensed by the NRC and the decommissioning of each unit is separately regulated by the NRC. There is no commingling of operations or decommissioning between the two stations. Each joint venture has the power to select its own UNICAP method.

LAW AND ANALYSIS – Ordinary and necessary business expenses

Section 162 generally allows a deduction for the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

In *Rev. Rul. 94-38, 1994-1 C.B. 55*, the Service ruled that costs incurred to clean up land and treat groundwater that the taxpayer had contaminated with hazardous waste from its business were deductible under *§ 162* and not required to be capitalized under *§ 263,* except for the cost of constructing groundwater treatment facilities. The Service explained that the appropriate test under *§ 263* for determining whether the expenditures increased the value of property is to compare the status of the asset after the expenditure is made with the status of the asset before the condition arose that necessitated the expenditure. The environmental remediation costs did not materially add to the value of the land, appreciably prolong its life, or adapt it to a new or different use.

In *Rev. Rul. 2004-18, 2004-1 C.B. 509*, the Service clarified *Rev. Rul. 94-38*, explaining that otherwise deductible amounts may be subject to inventory capitalization under *§ 263A.*

In *Rev. Rul. 98-25, 1998-1 C.B. 998*, the Service ruled that costs incurred to replace underground storage tanks containing waste by-products, including the costs of

removing, cleaning and disposing of the old tanks, and the costs of acquiring, installing and filling the new tanks, were deductible as ordinary and necessary business expenses under *§ 162.*

In *Rev. Rul. 2005-42, 2005-2 C.B. 67*, the Service addressed five situations involving environmental remediation costs of taxpayers that manufactured inventory and concluded in each situation that remediation costs otherwise deductible under *§ 162* were nevertheless properly capitalizable as inventory costs under *§ 263A.* In situation 4, a stove manufacturer that ceased operations at one site continued to produce stoves at another site. The Service concluded that the taxpayer's remediation costs at the first site were incurred by reason of its production activities within the meaning of *§ 1.263A-1(e)(3)(i)* and thus were properly allocable to the inventory produced by the taxpayer at site two.

In *United Dairy Farmers, Inc. v. United States, 107 F. Supp.2d 937 (S.D. Ohio 2000) aff'd, 267 F.3d 510 (6th Cir. 2001)*, the court held that ta taxpayer's expenses for remediation of contaminated soil must be capitalized under *§ 263* because the remediation permanently enhanced the properties' value. The taxpayer had purchased two convenience stores, each of which, unknown to the taxpayer, contained leaking underground storage tanks that had contaminated the soil. The deduction was rejected because the taxpayer had purchased the stores in a contaminated condition and was not merely restoring them to their condition at the time of purchase.

Expenses for which there is a fixed right of reimbursement are not deductible under *§ 162*. *Burnett v. Commissioner*, 356 F.2d 755 (5th Cir. 1966).

A taxpayer has a fixed right to reimbursement where a right has matured without further substantial contingency. *Charles Baloian Co. v. Commissioner*, *68 T.C. 620 (1977), nonacq., 1978-2 C.B. 3.*

There must be a fixed right to reimbursement so that the taxpayer's payment are in the nature of an advance to or payment on behalf of another. If there is no agreement but only a contingency that at some future the claim for reimbursement will be allowed in whole or in part, the taxpayer is entitled to deduct its expenditure. *Electric Tachometer v. Commissioner, 37 T.C. 158 (1961), acq., 1962-2 C.B. 4; Varied Investments, Inc. v. United States, 31 F.3d 651 (8th Cir,. 1994).*

Taxpayer has represented that it has incurred and will continue to incur a variety of expenses associated with the decontamination, dismantlement, removal, disposal of the structures, systems and components, and the decommissioning of A and B. The contamination being remediated all occurred while Taxpayer owned and operated A and B. The vast majority of the expenses will merely restore the facility to its pre-contaminated state and will not adapt the property to a new or different use, increase its value beyond its pre-contaminated state, or prolong its useful life. It has further represented that to the extent it incurs expenditures to purchase equipment used in the decommissioning process or to erect temporary facilities, those costs would be capitalized under *§ 263(a).* Similarly, it has represented that to the extent it incurs costs to construct an independent fuel storage installation for G nuclear waste, such costs

would be capitalized under *§ 263(a).* In light of these representations, the expenses that merely restore the facility to its pre-contaminated state and that do not adapt the property to a new or different use or increase its value beyond its pre-contaminated state or prolong its useful life are deductible pursuant to *§ 162* and are not subject to capitalization under *§ 263(a)*.

Taxpayer has represented that it is possible that a part of any recovery against C may represent compensation for ordinary and necessary business expenses it incurred following the abandonment of A and B. Taxpayer does not have a fixed right to reimbursement from C. Taxpayer has contingent claims against C that are being contested. This contested liability does not preclude the claiming of the *§ 162* expenses in the year they are incurred*. Electric Tachometer, Varied Investments, Inc.* Taxpayer has represented that any recoveries will be included in its income in accordance with *§ 451.*

No opinion is expressed about the tax treatment of the transaction under other provisions of the Code and regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction that are not specifically addressed by the above ruling. Consequently, no opinion is expressed regarding the applicability of § 263A to the decommissioning expenses at G.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by appropriate parties. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling is directed only to the taxpayers requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter should be attached to Taxpayer's federal income tax return for the taxable year in which the transaction covered by this ruling took place.

In accordance with the power of attorney, we are sending copies of this letter to Taxpayer's authorized representatives. We are also sending a copy of this letter to the appropriate operating division director.

Sincerely,

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Thomas D. Moffitt
Branch Chief, Branch 2
Office of the Associate Chief Counsel
(Income Tax & Accounting)