Internal Revenue Service

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Department of the Treasury
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Date:
April 21, 2021

LEGEND:

Taxpayer	=
Entity A	=
Entity B	=
Entity C	=
Payment	=
x	=
State	=
State Commission	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
n1	=

Dear :

This letter responds to your private letter ruling request and supplemental correspondence, submitted on behalf of Taxpayer. That letter requested several rulings concerning the tax treatment of the Payment by Taxpayer to Entity A under sections 162, 263, 167, and 197 of the Internal Revenue Code.

RULINGS REQUESTED

(1) The Payment is deductible as an ordinary and necessary business expense under section 162(a) in the year of payment.

(2) Alternatively, if the Payment must be capitalized under section 263(a), the amount of the Payment is amortizable under section 167 and § 1.167(a)-3 of the Income Tax Regulations over a period of 15 years.

(3) Alternatively, if the Payment must be capitalized under section 263(a) and the amount of the Payment is amortizable under section 167 and § 1.167(a)-3, but the amortization period is not 15 years, the amortization period ends on December 31, 2050.

(4) Alternatively, if the Payment must be capitalized under section 263(a) and the amount of the Payment is not amortizable under section 167 and § 1.167(a)-3, the amount of the Payment is amortizable under section 197.

FACTS

Taxpayer represents that the facts are as follows:

Taxpayer is a corporation headquartered in State and engaged in the business of x. Taxpayer owns two facilities (Unit 1 and Unit 2) located at an energy generating station (Station) in State. An unrelated entity, Entity B, owns a third facility (Unit 3) at Station.

In Year 1, State Commission issued a certificate (Certificate) granting Taxpayer the right to construct a fourth facility (Unit 4) at Station. This right was subject to Taxpayer's satisfaction of certain environmental conditions and to the requirement that Taxpayer obtain an order from State Commission confirming that the construction of Unit 4 was necessary for Taxpayer to provide property and services to its customers.

However, State Commission later mandated that Taxpayer transfer its right to construct Unit 4. Consequently, Taxpayer, Entity A, and Entity B entered into an amended joint development agreement (JDA) in Year 2 regarding the development of Unit 4. Pursuant to the JDA, Taxpayer transferred its rights to develop, finance, construct, and own Unit 4 to Entity A. Taxpayer and Entity A also entered into contracts under which: (1) Taxpayer would lease to Entity A the real property upon which Facility was to be built; (2) Entity A would pay Taxpayer to operate Unit 4; and (3) Entity A would pay Taxpayer

for the right to use or benefit from certain facilities located at Units 1 and 2 and would reimburse Taxpayer for certain costs incurred at Units 1 and 2 (collectively, the Contracts).

Also pursuant to the JDA, Taxpayer transferred Certificate to Entity A. Entity A became fully responsible for the satisfaction of the associated environmental conditions upon this transfer. Nevertheless, as set forth in the JDA, Taxpayer, Entity A, and Entity B entered into an agreement (Implementing Agreement) concerning these environmental conditions. The Implementing Agreement provides that Entity A will propose mitigation activities for acceptance, rejection, or modification by a committee composed of representatives of each of Taxpayer, Entity A, and Entity B. The Implementing Agreement also provides that the parties will share the costs of these mitigation activities according to a set ratio.

Unit 4 began operations in Year 3. Subsequently, as mitigation activities, Taxpayer, Entity A, and Entity B, each purchased individual undivided interests in two real properties (Properties). Entity A also purchased a large amount of water flow from Entity C to aid in mitigation. Under State law, Entity A is the sole owner of this water. Under an agreement between Taxpayer, Entity A, and Entity B, the water can only be used at the Properties to mitigate groundwater drawdown that occurs through the operation of Unit 4. In Year 4, Taxpayer paid Entity A $n1 (the Payment) for its allocable share of the costs of Entity A's acquisition of the water right, in accordance with the Implementing Agreement.

LAW

Section 162

Section 162(a) provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. See also § 1.162-1(a). In order to be deductible under section 162, an expenditure must be (i) paid or incurred during the taxable year; (ii) sustained in carrying on a trade or business; (iii) an expense; (iv) a necessary expense; and (v) an ordinary expense. Commissioner v. Lincoln Savings and Loan Association, 403 U.S. 345, 352 (1971).

The term "ordinary" refers to an expenditure that is normal, usual, or customary. Deputy v. du Pont, 308 U.S. 488, 495, 60 S. Ct. 363, 84 L. Ed. 416, 1940-1 C.B. 118 (1940). An expenditure may be ordinary if it is commonly and frequently incurred in the type of business involved. Id. (citing Welch v. Helvering, 290 U.S. 111, 114, 54 S. Ct. 8, 78 L. Ed. 212, 1933-2 C.B. 112 (1933)).

The term "necessary" means appropriate and helpful to the development of the taxpayer's business. Commissioner v. Tellier, 383 U.S. 687, 689, 86 S. Ct. 1118, 16 L. Ed. 2d 185 (1966) (quoting Welch, 290 U.S. at 113); Commissioner v. Heininger, 320 U.S. 467, 471, 64 S. Ct. 249, 88 L. Ed. 171, 1944 C.B. 484 (1943).

In Rev. Rul. 95-32, 1995-16 I.R.B. 8, the Service ruled that payments by a public utility as part of programs to promote energy conservation and energy efficiency were business expenses that are deductible under section 162. These programs were aimed at reducing electrical costs to the taxpayer's customers, as well as addressing environmental and societal concerns with the adverse environmental effects of increased electrical generation. These programs also enabled the taxpayer to reduce its future operating and capital costs.

Section 461(a) provides that a deduction shall be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.461-1(a)(2) provides that under an accrual method of accounting a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

Section 461(h)(1) provides that in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not he treated as met any earlier than when economic performance with respect to the item occurs.

Section 461(h)(4) provides that the all events test is met with respect to any item if all events have occurred which determine the fact of the liability and the amount of such liability can be determined with reasonable accuracy.

Section 1.461-4(g)(7) provides guidance for certain liabilities for which payment is economic performance. In the case of a liability for which specific economic performance rules are not provided, economic performance occurs as payment is made to the person to whom the liability is owed under § 1.461-4(g)(7).

Based on the information submitted, we conclude that the Payment is an ordinary and necessary business expense under section 162. Taxpayer made the Payment in Year 4 in carrying on its business. Furthermore, Taxpayer made the Payment pursuant to an agreement that Taxpayer expected would reduce its future operating costs. Specifically, the JDA provided for an agreement between Taxpayer and Entity A whereby Entity A would pay Taxpayer for the use of certain facilities and reimburse Taxpayer for costs incurred at these facilities. Taxpayer anticipated significant cost-savings as a result of this agreement. The Payment was therefore appropriate and helpful to Taxpayer’s business.

Furthermore, we conclude that Taxpayer may deduct the Payment in Year 4, the year in which it made the Payment pursuant to the Implementing Agreement. All events that establish the fact of Taxpayer’s liability for the Payment occurred by Year 4. The amount of the Payment was also determinable with reasonable accuracy in Year 4. In addition, the regulations do not provide specific economic performance rules for the

treatment of contractual obligations like Taxpayer's contractual cost-sharing obligations to Entity A. As a result, economic performance occurred with respect to Taxpayer's liability for the Payment when Taxpayer made this payment in accordance with § 1.461-4(g)(7).

LAW AND ANALYSIS

Section 263

Under section 161 of the Internal Revenue Code, if a cost is a capital expenditure, the capitalization rules of section 263 take precedence over the deduction rules of section 162. Commissioner v. Idaho Power Co., 418 U.S. 1, 17, 94 S. Ct. 2757, 41 L. Ed. 2d 535 (1974). Therefore, a capital expenditure cannot be deducted under section 162, regardless of whether the expenditure is ordinary and necessary in carrying on a trade or business.

Section 263(a) generally prohibits deductions for capital expenditures. In this case, the Payment presents issues that must be analyzed under §§ 1.263(a)-3 and 1.263(a)-4 of the Income Tax Regulations.

Section 1.263(a)-3(d) provides that, except as otherwise provided in that section, a taxpayer must capitalize amounts paid to improve a unit of tangible property. Section 1.263(a)-3(d) further provides that a unit of property is improved if amounts paid for activities performed after the taxpayer places the property in service: (i) are for a betterment to a unit of property; (ii) restore a unit of property; or (iii) adapt a unit of property to a new or different use.

Based on the representations made, including additional information submitted, we conclude that § 1.263(a)-3 does not require Taxpayer to capitalize the Payment as an improvement to tangible property. Under the Implementing Agreement, Taxpayer is required to reimburse Entity A for an allocable share of the costs of Entity A's environmental mitigation activities. To comply with its environmental mitigation obligations, Entity A purchased a water right from Entity B to mitigate groundwater drawdown that occurs at the Properties due to the operation of Unit 4. Although Taxpayer owns an interest in the Properties where the water is used, the Payment is not for the betterment of the Properties, is not paid to restore the Properties, and is not paid to adapt the Properties to a new or different use as defined under § 1.263(a)-3. Rather, the Payment to Entity A is for mitigating environmental damage that occurs during operations at Unit 4. As such, the Payment is not for the improvement of Taxpayer's tangible property under § 1.263(a)-3.

Section 1.263(a)-4 provides rules for applying section 263(a) to amounts paid to acquire or create intangibles. Section 1.263(a)-4(b)(1) provides that except as otherwise provided in § 1.263(a)-4, a taxpayer must capitalize an amount paid to: (i) acquire an intangible (see § 1.263(a)-4(c)); (ii) create an intangible described in § 1.263(a)-4(d); (iii)

create or enhance a separate and distinct intangible asset within the meaning of § 1.263(a)-4(b)(3); (iv) create or enhance a future benefit identified in the Federal Register or the Internal Revenue Bulletin as an intangible for which capitalization is required; and (v) facilitate (as defined in § 1.263(a)-4(e)(1)) the acquisition or creation of an intangible.

Based on the representations and additional information submitted, we conclude that § 1.263(a)-4 does not require Taxpayer to capitalize the Payment. With respect to § 1.263(a)-4(c), Taxpayer has not acquired any asset from Entity A in a purchase or similar transaction. With respect to amounts paid to create an intangible, only section § 1.263(a)-4(d)(6) potentially applies. This section requires taxpayers to capitalize amounts paid to create certain contract rights. Under the present facts, the JDA created certain contract rights for Taxpayer. However, Taxpayer's payment of environmental mitigation costs under the Implementing Agreement was not an amount paid to create, originate, enter into, renew, or renegotiate the Contracts. Rather, the Payment is better categorized as an amount paid pursuant to the terms of the Contracts in order to carry out Taxpayer's responsibilities under the Contracts. Accordingly, § 1.263(a)-4(d)(6) does not apply to the Payment.

With respect to amounts paid to create a separate and distinct intangible asset, § 1.263(a)-4(d)(3)(i) defines a separate and distinct intangible asset as a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable state, federal or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged separate and apart from a trade or business. In this case, the water provided under Entity A's water right can only be used at the Properties to mitigate groundwater drawdown caused by operations at Unit 4. Entity A's right to use this water for environmental mitigation therefore has no value outside of the operation of Unit 4. Accordingly, this right is intrinsically incapable of being sold, transferred, or pledged separate and apart from the business. Section 1.263(a)-3(b)(1)(iii) therefore does not apply. In addition, the Payment does not create or enhance a "future benefit" identified in published guidance.

Lastly, with respect to amounts paid to facilitate the acquisition or creation of an intangible, § 1.263(a)-4(e)(1)(i) provides that, except as otherwise provided in § 1.263(a)-4, an amount is paid to facilitate the acquisition or creation of an intangible (the transaction) if the amount is paid in the process of investigating or otherwise pursuing the transaction. As discussed, Taxpayer's payment for its allocable share of environmental mitigation costs is not an amount paid to acquire an intangible from another party or an amount paid to create a separate and distinct intangible. Although Taxpayer and Entity A did enter into the Contracts pursuant to the JDA, Taxpayer's payment of its allocable share of environmental mitigation costs under the Implementing Agreement was not a cost of creating the Contacts nor a cost paid in the process of investigating or pursuing the creation of the Contracts. Further, Taxpayer's liability for the Payment arose after the creation of the Contracts under the terms of the Implementing Agreement. Accordingly, the Payment could not have facilitated the creation of the Contracts, and § 1.263(a)-4(e) therefore does not apply.

CONCLUSION

We conclude that Taxpayer may deduct the Payment as an ordinary and necessary business expense under section 162 in Year 4. Consequently, we need not reach rulings (2) through (4).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this ruling.

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

A copy of this letter must be attached to any Federal income tax return to which it is relevant. Alternatively, Taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. 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.

Sincerely,

Brinton T. Warren
Chief, Branch 3
(Income Tax & Accounting)

cc: