Office of Chief Counsel
Internal Revenue Service
Memorandum

Release Number: **20150701F**

Release Date: 2/13/2015

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POSTF-105478-14

UILC: 162.06-01, 162.08-22, 162.08-04, 263.00-00, 263A.00-00, 165.13-00, 166.00-00

date: November 12, 2014

to: , General Engineer
, Revenue Agent

from:
(Large Business & International)

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subject: Deductibility of Unreimbursed Expenses

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

W =

X =

Y =

Z =

Joint Operating Agreement, or JOA =

Event =

Mitigation =

Property =

Unit =

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Date 1=

Date 2=

Date 3=

Date 4=

Date 5=

Date 6=

Year 1=

Year 2=

Year 3=

J% =
K% =
L% =
M% =
N% =
P% =

$aa =
$bb =
$cc =
$dd =
$ee =
$ff =
$gg =
$hh =

X Settlement Agreement =

Z Settlement Agreement =

Decisions =

ISSUES

1. Whether W may deduct under section 162 the unreimbursed costs it paid as Operator of Property (“the Unreimbursed Expenses”).

2. If section 162(a) would otherwise apply, whether the public policy doctrine or section 162(f) prevents deduction of the Unreimbursed Expenses.

3. Whether W may deduct a loss under section 165 for the Unreimbursed Expenses.

4. Whether W may claim a bad debt deduction under section 166 for the Unreimbursed Expenses.

5. Whether W should capitalize the Unreimbursed Expenses.

6. Whether any part of the Unreimbursed Expenses are intangible drilling and development costs under sections 263 and 612 and the regulations thereunder (hereinafter “IDC”).

CONCLUSIONS

1. The Unreimbursed Expenses are deductible under section 162.

2. The public policy doctrine and section 162(f) do not prevent the deduction of the

Unreimbursed Expenses.

3. The Unreimbursed Expenses are not deductible under section 165.

4. The Unreimbursed Expenses are not deductible under section 166.

5. W should not capitalize the Unreimbursed Expenses.

6. The Unreimbursed Expenses are not IDC.

FACTS

W was the designated operator of Property, which is an oil and gas lease. Effective on Date 1, W, X, Y and Z entered into the Joint Operating Agreement ("JOA').[1] Under the JOA, the working interest ownership percentages of Property were as follows: W- J%, Z – K %, Y- L%, and X- M%. Y assigned its interest to X on Date 2, which was prior to Event, which occurred on Date 3. X held a N% working interest in Property on Date 3, the beginning of Event.[2] W initiated drilling of an exploratory well in Property, shortly after Date 1.

W serves as the Operator of Property under the JOA, which lists the Operator's general rights and duties. The Operator is responsible for day-to-day operations. The Operator pays the costs of all activities and operations under the JOA, and each co-owner must reimburse the Operator in proportion to its participating interest share.

The JOA sets forth the Accounting Procedures for Property. The Operator shall bill the co-owners on or before the last day of the month for their proportionate share of the billable expenses for the preceding month. In general, each party must pay its proportionate share of all bills in full within 30 days of receipt, or the balance will accrue interest. The JOA describes categories of billable charges, which include amounts for damages and losses to joint property, ecological and environmental costs, and safety

[1] In general, a joint operating agreement is a contract between separate owners of oil and gas properties that are jointly operated. It sets out the parties' agreement with respect to operations, initial drilling, further development, accounting, and other matters.
[2] Under the JOA, the parties elected to be excluded from the application of Subchapter K, Chapter 1, Subtitle A, of the Internal Revenue Code.

costs.

W has certain rights if its co-owners fail to pay their obligations under the JOA. X and Z granted W a mortgage to their interests in Property, the oil and gas that the Property lease area may produce, and all immovable property located in the lease area. They also granted W a continuing security interest in their interests in oil and gas produced from the Property lease area, all accounts receivable accruing as a result of the sale of oil and gas, cash or other proceeds from the sale of oil and gas, and fixtures and other property on the Property lease area. If X or Z fail to make payment within 30 days of notice, they would not have further access to Property, confidential data, records, or other information, or be allowed to participate in meetings or vote until they make payment.

Until Date 3,

. On and around Date 3, Event occurred,

Between Date 4 and Date 5, W sent monthly invoices to X and Z for their share of costs related to the Event. X paid W approximately $aa of the invoiced amounts for exploratory drilling expenses, but declined to pay any costs related to the Event. Approximately $bb of unpaid invoices issued to X related to the Event remained after accounting for those payments. Approximately $cc of unpaid invoices issued to Z related to the Event remained.

W's position on the unpaid invoices is that the expenses were billable costs under the JOA. X and Z maintained that such costs were not billable under the circumstances surrounding the Event, and did not reimburse W for any of the costs billed related to the Event. This dispute over the unpaid invoices continued throughout the remainder of Year 1 and into Year 2.

W reached settlements with X and Z resolving their disputes related to the Event. The settlement between W and X was memorialized in the X Settlement Agreement, effective on Date 5. The settlement between W and Z was memorialized in the Z Settlement Agreement, effective on Date 6.

Under the terms of the X Settlement Agreement, X agreed to remit, transfer and assign to W: (1) $dd in cash by a specified date in Year 2, (2) all of its interest in Property, with an agreed value of $ee, and (3) rights, title and interest (a) in possible Claims against third parties relating to the Event and (b) related to any insurance policy (except X insurance policies). As part of the transfer of all of its interest in Property, X also agreed to transfer its interest in any and all wells, fixtures, pumps, platforms, equipment, and other fixtures to W. W agreed to use the $dd of cash to pay claims of persons whose injuries and damages relate to the Event.

Under the terms of the Z Settlement Agreement, Z agreed to remit, transfer and assign to W: (1) $ff in cash within 45 days, (2) all of its interest in Property, with an agreed value of $gg, and (3) rights, title and interest (a) in possible Claims against third parties relating to the Event and (b) related to any insurance policy (except for Z's own policies).

Exam evaluated the stated values of X's and Z's transferred interests in Property, and decided not to challenge the agreed values contained in the settlement agreements. Exam found that W had acquired its interest in Property through an earlier like-kind exchange, and that the stated value of the interest for that earlier exchange was proportionally comparable to the value the parties assigned to X's and Z's transferred interests in the Settlement Agreements. Exam decided to respect the agreed values of the transferred interests based in part on the information reported on Form 8824 for the like-kind exchange in which W acquired its interest in the Property lease.

W claimed a "bad debt deduction under section 165" in the amount of $hh on its Year 2 return, the amount that was billed to its co-owners but was not paid after taking into account the amounts received under the settlement agreements. This amount derives from the total invoiced amounts, minus cash payments from the co-owners

under the Settlement Agreements, minus the agreed value of the interests in the Property lease that X and Z transferred pursuant to the Settlement Agreements.

X and Z claimed ordinary and necessary business expense deductions under section 162 in Year 2 for their cash payments to W under the Settlement Agreements. In Year 3, local Counsel issued Exam written legal advice concluding that the amount paid by X was deductible under section 162(a). W did not claim a deduction for 100% of the costs associated with the Event. It claimed a deduction under section 162 for J% of the costs, and a deduction under section 165 *for the difference* between the remaining P% of the costs, and the amounts of cash and specified value of the working interests it received in the two Settlement Agreements. Thus, W here is not claiming a deduction for the amounts that X and Z deducted.

LAW AND ANALYSIS

Issue 1: Whether W may deduct the Unreimbursed Expenses it paid as joint venture operator of the Property well under section 162.

Section 162(a) of the Code and Treas. Reg. §1.162-1(a) allow a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. A deduction is not permitted for capital expenses under section 263(a) or for expenses specifically precluded by another statute.

The existence of a trade or business is a factual inquiry involving profit motive and the scope of activities.[3]

Any ordinary and necessary, non-capital expenses

are deductible under section 162.

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[3] See, e.g. Comm'r v. Groetzinger, 480 U.S. 23, 27 (1987); Gajewski v. Comm'r, 723 F.2d 1062 (2d Cir.1983), cert. denied, 469 U.S. 818 (1984), on remand, 84 T.C. 980(1985).

There is no question that W incurred the costs at issue. There also is no question that W is entitled to deduct costs attributable to its J% share of the expenses related to the Property lease, to the extent those amounts do not otherwise represent capital expenditures. These amounts are ordinary and necessary expenses of W's business since they directly relate to its own J% working interest in the lease. Exam questions, however, whether W may deduct in Year 2 the amount of unpaid joint interest billing that was attributable to the remaining P% of working interests.

As Operator under the JOA, W was required to pay all expenses and bill its co-owners for their share of expenses. W would not ordinarily deduct 100% of the expenses of operating the Property lease, because it was typically reimbursed for P% of those expenses within 30 days under the JOA. W's expense payment and the accounts receivables related to the co-owners' shares generally would be offsetting.

To be deductible under section 162, a trade or business expense must be both ordinary and necessary. Section 162(a); Welch v. Helvering, 290 U.S. 111 (1933) Whether an expense is ordinary involves a factual inquiry regarding time, place, and circumstance, as well as the normalcy of the type of expense in a taxpayer's particular business. [4] An expense does not have to be of a type that a taxpayer pays frequently.[5] "Necessary" means that the expense is appropriate and helpful, rather than absolutely essential,[6] though in this case it seems clear that the invoiced costs were essential.

Expenses incurred for the benefit of another are not deductible under section 162 unless the taxpayer has actually paid those expenses for the taxpayer's own proximate benefit in connection with its own trade or business. See, Austin Co. v. Comm'r, 71 T.C. 955, 967 (1979), acq., 1979-2 C.B. 1.[7] Exam has suggested that, if it were certain that

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[4] See, Deputy v. DuPont, 308 U.S. 488, 496 (1940); Lilly v. Comm'r, 343 U.S. 90, 93 (1952), rev'g188 F.2d 269 (4th Cir.1951), aff'g14 T.C. 1066 (1950).
[5] Welch v. Helvering, 290 U.S. 111, 114 (1933).
[6] Welch v. Helvering, 290 U.S. 111, 113 (1933)
[7] See also, PLR 8635004 (section 162 deduction for payment of employees share allowed in a later year notwithstanding absence of any express agreement); PLR

the co-owners had a fixed obligation to pay the invoiced costs, W cannot deduct its unreimbursed payment of those costs under section 162. The argument is that voluntary payments are not ordinary and necessary. First, the payments are not truly voluntary payments. W was obliged to make the payments as Operator of the lease, under the terms of the JOA. W did not control whether it was reimbursed. In addition, as Operator

Assuming arguendo that the payments were voluntary, that does not necessarily mean that the payments are not an ordinary and necessary expense of carrying on a trade or business.[8] Authorities in the area of voluntary payments are not uniform. Some cases suggest that voluntary payments are never ordinary and necessary. See, e.g., Bonaire Development Co. v. Comm'r, 679 F.2d 159 (9th Cir.1982) (involving voluntary prepayments for management fees, where no payment obligation existed in tax year). Other cases hold that voluntary payments or prepayments are deductible if made for a business purpose, if the payment is not unilaterally retrievable (such as in the case of a refundable deposit), and if payment does not result in a distortion of income. See, Keller v. Comm'r, 725 F.2d 1173 (8th Cir. 1984); Schenk v. Comm'r, 686 F.2d 315, 319 (5th Cir.1982); Pauley v. United States, 11 AFTR 2d 955 (S.D.Cal.1963) (allowing current deduction of prepaid IDC because the drilling company required prepayment).

Lack of an underlying legal liability does not necessarily preclude the deduction. See, Champion Spark Plug Co. v. Comm'r, 30 T.C. 295, 298 (1958), aff'd per curiam, 266 F.2d 347 (6th Cir.1959) (explaining that a legal liability is not a prerequisite to finding that an "expenditure is ordinary and appropriate to the conduct of the taxpayer's business").[9]

The Tax Court has allowed a deduction for a law firm's payment to investors deceived by a firm client, where the investors relied on the firm's advice. Pepper v. Comm'r, 36 T.C. 886(1961). The Tax Court has also denied a deduction for an attorney's reimbursement of a client's investment loss when the attorney recommended the investment. Slater v. Comm'r, 11 T.C.M. 241 (1952), rev'd on other issues, 222 F.2d 470 (2d Cir.1955). The distinction appeared to be the connection of the payment to the taxpayer's business.

In this case, W's liability for the costs was not entirely certain at the time of payment, but the settlement agreements resolved the uncertainty of the amount by which W would be reimbursed. Under section 162(a), amounts expended by a taxpayer

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8437008 (deduction allowed for taxpayer's voluntary payment of income taxes, to preserve customer relations, originally due from recipients of promotional trips taxpayer had awarded).

[8] E.g., Waring Products Corp. v. Comm'r, 27 T.C. 921, 929 (1957).

[9] Deductions have been allowed for voluntary payments in a variety of circumstances. See, e.g., Rev. Rul. 67-98, 1967-1 C.B. 29 (permitting deduction for rewards for finding lost business property). Rev. Rul. 69-60, 1969-1 C.B. 49 (allowing a deduction for railroad's cost of installing labels on freight cars before regulations required it).

engaged in a trade or business to avoid or settle litigation may be deductible as an ordinary and necessary business expense. See, e.g., Ditmars v. Comm'r, 302 F.2d 481, 485 (2d Cir. 1962); Old Town Corp. v. Comm'r, 37 T.C. 845 (1962), acq., 1962-2 C.B. 5.

In this case, to the extent that the expenses were not for capital expenditures, the Unreimbursed Expenses were an ordinary and necessary business expense. W was required to make initial payment of expenses related to Property under the JOA, and its co-owners would reimburse it for their portion of expenses,
. X, Z and W disagreed about whether the invoiced expenses attributable to X's ownership share should be excluded from the normal operation of the JOA. To avoid litigation between the parties and direct admissions of responsibility, W, X, and Z resolved the reimbursement amount through settlement. Thus, the Unreimbursed Expenses represent an ordinary and necessary business expense under section 162(a).

Section 461(a) provides that a deduction must be taken for the proper taxable year under the taxpayer's method of accounting. Whether an accrual method taxpayer has incurred an expense is determined under the all events test, which provides that the item generally is taken into account in the taxable year in which

1) all the events have occurred that establish the fact of the liability,

2) the amount of the liability can be determined with reasonable accuracy, and

3) economic performance has occurred with respect to the liability.[10]

In this case, though W paid upfront the P% of the Event costs, which X and Z declined to reimburse, the amount of reimbursement, if any, was contested by X and Z during Year 1. W's ultimate liability for the P% of costs was not established (though its proximate liability to pay the costs as Operator was established in the JOA).

Generally, expenses are not deductible under section 162 to the extent that they are reimbursable. See Rev. Rul. 78-388, 1978-2 C.B. 110. This rule applies even in cases in which the reimbursement will be paid in a subsequent year. See, Flower v. Comm'r, 61 T.C. 140 (1973). Here, there was a dispute as to whether W was entitled to reimbursement by X and Z for a portion of the Event costs as determined under the JOA.
In Year 1, however, W believed that it was entitled to a reimbursement by X and Z of a portion of the Event costs. It was not until W reached a settlement with X and Z in Year 2 that W knew that it would only receive a partial reimbursement. Accordingly, we conclude that the Unreimbursed Expenses were not deductible by W until Year 2.

Issue 2: If section 162(a) would otherwise apply, whether the public policy doctrine or section 162(f) prevent deduction of the Unreimbursed Expenses.

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[10] Section 461(h); Treas. Reg. §1.461-1(a)(2)(i).

The public policy doctrine denies a deduction if allowing the deduction would "frustrate sharply defined national or state policies proscribing particular types of conduct." Comm'r v. Tellier, 383 U.S. 687, 694 (1966), (quoting Comm'r 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. Comm'r, 343 U.S. 90, 97 (1952)).[11] The public policy doctrine is a narrow avenue to deny deduction, and we have found no governmental declaration that supports denying a deduction here. Congress codified the public policy doctrine under section 162(f).[12]

Section 162(f) prohibits a deduction under section 162(a) for a fine or similar penalty paid to a government for the violation of any law. Treas. Reg. §1.162-21(b)(1) defines a "fine or similar penalty" to include any amount

> (i) paid pursuant to conviction or a plea of nolo contendere for a crime in a criminal proceeding;
> (ii) paid as a civil penalty imposed by federal, state, or local law;
> (iii) paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal); or
> (iv) forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty.

Compensatory damages paid to a government do not constitute a fine or penalty.[13]

To evaluate the characterization of a settlement payment for purposes of section 162(f), it is necessary to examine the origin and character of the liability giving rise to the payment. Bailey v. Comm'r, 756 F.2d 44, 47 (6th Cir. 1985).[14] Payments under laws designed to compensate injured parties for damages are exempt from section 162(f).[15] Payments under laws designed to be punitive or to deter misconduct are likely covered by section 162(f).[16]

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[11] See also, Tucker v. Comm'r, 69 T.C. 675, 679 n.4 (1978); Adolf Meller Co. v. United States, 600 F.2d 1360, 1363 (Ct. Cl. 1979).
[12] Tax Reform Act of 1969, Pub. L. 91-172, 1969-3 C.B. 10.
[13] Treas. Reg. § 1.162-21(b)(2).
[14] See also, Ostrum v. Comm'r, 77 T.C. 608 (1981); Middle Atlantic Distributors v. Comm'r, 72 T.C. 1136, 1144-45 (1979); Uhlenbrock v. Comm'r, 67 T.C. 818, 823 (1977).
[15] See, e.g., Mason and Dixon Lines, Inc. v. United States, 708 F.2d 1043, 1047 (6th Cir. 1983) (liquidated damages for violating state truck weight limits were compensatory based on the structure and language of the relevant provision).
[16] See, e.g., True v. United States, 894 F.2d 1197, 1205 (10th Cir. 1990) (amounts paid for violating the Federal Water Pollution Control Act were penalties because "on balance" the civil penalty provision served "a deterrent and retributive function similar to

The term “fine or similar penalty” can include 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. Comm’r, 88 T.C. 1384, 1389 (1987) (taxpayer’s payments to victims as court-ordered restitution held nondeductible); But see, Stephens v. Comm’r, 905 F.2d 667 (2d Cir. 1990) (taxpayer’s court-ordered restitution payment made to a corporation was remedial and held to be deductible). Compensatory damages that are intended to return the parties to the status quo do not constitute fines or penalties, however. True v. United States, 894 F.2d 1197, 1204 (10th Cir. 1990); Treas. Reg. §1.162-21(b)(2).

As explained above, the Unreimbursed Expenses were a portion of amounts paid for Mitigation. The Unreimbursed Expenses did not include a fine or penalty paid to a governmental entity, or any payment in lieu of a fine or penalty. Section 162(f) therefore does not prevent the deduction of the payments.

Issue 3: Whether W may deduct a loss under section 165 for the Unreimbursed Expenses.

Issue 4: Whether W may claim a bad debt deduction under section 166 for the Unreimbursed Expenses.

We consider these two issues together because of how W reported the deduction for Unreimbursed Expenses, and because the two sections are closely related in this context.

As mentioned in the Facts section above, W claimed a deduction for the Unreimbursed Expenses on its return with the note “bad debt deduction under section 165.” Section 165(a) provides that there will be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. Only losses evidenced by closed and completed transactions, or otherwise fixed by identifiable events, are deductible.[17]

Under the JOA, W paid costs related to the Property lease, and sought reimbursement from its co-owners in proportion to their ownership interests. W treated the invoiced amounts as accounts receivable. W apparently treated the unpaid part of what it viewed as an accounts receivable as a business loss under section 165.

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a criminal fine"); Colt Indus., Inc. v. United States, 11 Cl. Ct. 140, 146-47 (1986), affd, 880 F.2d 1311 (Fed. Cir. 1989)(civil penalties under the Clean Air Act and the Clean Water Act had a punitive purpose and were nondeductible); Huff v. Comm’r, 80 T.C. at 824 (civil penalty had a punitive purpose based on a state supreme court decision holding that the statute imposing the penalty was designed to penalize defendants).

[17] See, Rev. Ruling 74-80, 1974-1 C.B. 117.

Sections 165 and 166 can both apply to a debt loss. Arkansas Best Corp. v. Commissioner, 485 US 212 (1988) holds that an asset is a capital asset unless it falls within one of the statutory exemptions found in section 1221. The section 1221 exemptions include inventory, trade accounts, self-created artistic works, debts held as inventory, certain accounts and notes receivables and trade debts acquired in the ordinary course of business for services or the sale of inventory, certain commodities derivatives, and hedging transactions.[18] Generally all other debts are treated as capital assets unless excluded under another statutory provision. If a debt does not qualify as a "security," then it generally is governed by the bad debt deduction rules. Section 166. A business bad debt is deductible as an ordinary deduction, and can be deducted when partially worthless. Section 166(a)(1) and (2); Treas. Reg. §1.166-5(c).

If a debt is an ordinary asset, a taxpayer will recognize an ordinary loss when the debt is determined to be either wholly or partially worthless. Section 166. Partial worthlessness is only available if the debt is not considered a security.[19] The amount of such loss is determined by reference to the amount of the adjusted basis of the debt determined under section 1011.

For either section 165 or section 166 to apply, a bona fide debt must exist. Bona fide debt is a debt that arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. See, Treas. Reg. §1.166-1(c). A debt may be created by contract or by operation of law. See, Birdsboro Steel Foundry & Machine Co. v. United States, 3 F. Supp. 640 (1933). Debt for federal income tax purposes requires an existing, unconditional, and legally enforceable obligation to repay.[20] In this case, W, X, and Z disagreed about the existence of a debt, not merely about the amount of a debt.

Whether a particular debt is a bona fide debt for tax purposes "depends on the facts and circumstances of each case, with the taxpayer bearing the burden of proof." Kean v. Comm'r, 91 T.C. 575, 594 (1988).[21] Courts considering this issue consider a variety of relevant factors, with no single factor controlling. The Tax Court has summarized some of these factors as follows:

> [1] The names given to the certificates evidencing the indebtedness; [2] presence or absence of a fixed maturity date; [3] source of payments; [4] right to enforce payments; [5] participation in management as a result of the advances; [6] status of the advances in relation to regular corporate creditors; [7] intent of the parties; [8] identity of interest between creditor and stockholder; [9] thinness of capital structure in relation to

[18] Section 1221(a).
[19] Treas. Reg. §1.165-5(b) and Section 166(e).
[20] See, Roth Steel Tube Co. v. Comm'r, supra at 630; First Nat'l. Co. v. Comm'r, 289 F.2d 861, 864-865 (6th Cir.1961); Burrill v. Comm'r, 93 T.C. 643, 666 (1989).
[21] See also, Dixie Dairies Corp. v. Comm'r, 74 T.C. 476, 494 (1980), acq. 1982-2 C.B.

> debt; [10] ability of corporation to obtain credit from outside sources; [11] use to which advances were put; [12] failure of debtor to repay; and [13] risk involved in making advances.

Calumet Indus., Inc. v. Comm'r, 95 T.C. 257, 285 (1990).[22]

Here, the parties had an agreement to repay costs related to the Property lease . They documented their agreement that W would pay costs upfront, their intent that X and Z would repay W for their portion of expenses, the timeframe for repayment, provisions for interest, and consequences of default.

Both Settlement Agreements state that they reflect the parties' desire to resolve their disputes related to and arising out of the Event and their duties under the JOA, and specifically state that the settlements do not constitute an admission of any liability or responsibility. The Settlement Agreements each assign a value to the transferred lease interests, but do not specifically allocate the cash payments to the invoiced amounts under the JOA. The Settlement Agreements specifically recite the parties' dispute about whether the invoiced amounts related to the Event are an actual obligation that X and Z must pay W. Based on these facts, we do not believe that the invoiced amounts, to the extent they relate to the Event, constitute a bona fide debt for which nonpayment would give rise to a loss under section 165 or a bad debt deduction under section 166.

Issue 5: Whether W should capitalize the Unreimbursed Expenses.

(a) Whether W should capitalize the Unreimbursed Expenses under section 263(a).

Exam's proposed position is that W has not sustained a loss from a closed and completed transaction, since it received the additional P% leasehold interest as partial satisfaction of X's and Z's obligations under the operating agreement. As a result, W now owns 100% of the Property lease. Exam's theory presumes that in a sale or exchange, W cancelled X's and Z's liabilities to W when W acquired X and Z's combined P% working interest in the Property lease.

Capital expenditures are not deductible. Section 263. Taxpayers generally must add capital expenditures to the basis of the capital asset with respect to which they are incurred. Capital expenditures are economically recovered either through depreciation or through the calculation of gain or loss on the asset's disposition. Woodward v. Comm'r, 397 U.S 572, 574-75 (1970).

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[22] See also, Stinnett's Pontiac Serv., Inc. v. Comm'r, 730 F.2d 634, 638 (11th Cir. 1984).

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." Section 263(a). An expense is capital if it adds to the value or the useful life of property, or adapts property to a new or different use. Treas. Reg. §1.263(a)-1(b). Capital expenses are generally incurred for the taxpayer's future benefit.[23] 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).

The Unreimbursed Expenses primarily related to costs to clean up and contain the Event. Taxpayers may be able to deduct environmental remediation costs if the taxpayer caused the contamination and remediated the contaminated property to return it to the state it was in prior to the contamination. Rev. Rul. 94-38, 1994-1 C.B. 35.[24]

Generally, a taxpayer must capitalize remediation costs for contamination in existence when the plaintiff acquired the property. United Dairy Farmers, Inc. v. United States, 267 F.3d 510 (6th Cir. 2001). In Pacific Transport Co. v. Commissioner, 483 F.2d 209 (9th.Cir. 1973), rev'g per curiam, T.C. Memo. 1970-41, cert. denied, 415 U.S. 948 (1974), the court held that a buyer's knowledge of a liability supported capitalization. In addition, taxpayers should capitalize remediation costs if (1) remediation allowed the taxpayer to put the property to a new and better use, whether or not the taxpayer caused the contamination; or (2) the remediation was part of a general plan of renovation, rehabilitation, or improvement. See, Kerr-McGee Corp. v. United States, 77 Fed. Cl. 309, 317 (2007). These cases are distinguishable from the present case since W is the party whose actions created the necessity of paying the remediation expenses. The present case is not a situation in which the amount paid for

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[23] INDOPCO, Inc. v. Comm'r, 503 U.S. 79 (holding that, generally, an expense is capital in nature when "the purpose for which the expenditure is made has to do with the corporation's operations and betterment for the duration of its existence or for the indefinite future or for a time somewhat longer than the current taxable year.").

[24] Rev. Rul. 94-38**,** 1994-1 C.B. 35, involved X, a manufacturer that built its plant on clean land, then contaminated the land with hazardous waste from its manufacturing operations. To comply with presently applicable and reasonably anticipated environmental requirements, X remediated the contaminated soil and groundwater, and constructed groundwater treatment and monitoring facilities. The Ruling permitted a current deduction for cleaning up the land and treating the groundwater, but required capitalization of the costs attributable to the construction of groundwater treatment facilities. Cf., Rev. Rul. 98-25, 1998-1 C.B. 998, which permitted a manufacturer that had produced waste by-products in the course of its operations to take a current deduction under section 162 for the expenses of removing, cleaning, and disposing of old underground storage tanks, and acquiring, installing, and filling new underground tanks, where environmental regulations set storage and monitoring standards for the waste.

a property was reduced because the buyer assumed the responsibility for remediation expenses that resulted from conduct of a party other than the buyer. In addition, remediation costs incurred to construct tangible personal property, such as ground water treatment facilities, are capital expenditures under section 263(a). Rev. Rul. 94-38, 1994-1 C.B. 35. Expenditures incurred by a taxpayer in carrying on its trade or business to remediate property that it contaminated and that do not increase the value or change the use of the property may be classified by that taxpayer as ordinary and necessary business expenses instead of capital expenditures. Kerr-McGee Corp., 77 Fed. Cl. at 317.[25] Here the purpose of the remediation costs was not to increase the value of the property.

Exam agrees that the valuation assigned to the P% interest that W acquired from X and Z as part of the settlement is reasonable. W did capitalize its remediation expenses to the extent of the value assigned to the P% interest. As discussed above, at the time of the settlement, there was a bona fide dispute as to whether X and Z were required under the JOA to reimburse W for the remediation costs. Since W did capitalize the fair market value of the P% interest, and there was a bona fide dispute as to whether X and Z were responsible for any of the remediation costs, we conclude that W is not required to capitalize the unreimbursed remediation costs to the extent that they exceed the value assigned to the P% interest.

A small amount of the Unreimbursed Expenses represents tangible equipment expenses that appear to relate to Mitigation, which included remediation efforts in which the tangible equipment was used. This amount was not intended to aid production, and the tangible equipment used cannot be removed or reused. The remediation expenses clearly were not part of a plan of improvement. From the known facts, it does not appear that the remediation expenses allowed the taxpayer to put the property to a new and better use. The tangible equipment expenses thus do not qualify as capital expenditures under section 263(a).[26]

(b) Whether W should capitalize the Unreimbursed Expenses under section 263A.

The Uniform Capitalization Rules apply to inventory and other property produced by the taxpayer or acquired for resale. Section 263A(a) and (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. Section 263A(a)(1)(A), (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. Section 263A(a)(1)(B), (a)(2).

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[25] Cf., TAM 199952075 (concluding that taxpayer may currently deduct under section 162 the costs of cleaning up post-acquisition environmental contamination on its property, but must capitalize under section 263 and the applicable rules under section 263A cleanup costs that are allocable to pre-acquisition contamination).

[26] Even if a small portion of the tangible equipment used in capping the well could have been reused again, the amount likely would be deductible as an abandonment loss when the well was plugged in Year 2. Section 165(a).

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 activities.[27] Treas. Reg. §1.263A-2(a)(3)(i) provides that any cost required to be capitalized by section 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).

As mentioned earlier, the Unreimbursed Expenses primarily related to costs to clean up the Event. 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 section 263(a). It did not address the treatment of the costs as inventory costs under section 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 section 263A.

Rev. Rul. 2005-42, 2005-2 C.B. 67, involved a series of five slightly different scenarios involving a manufacturer that produced stoves that were inventory in its hands. The manufacturing activities produced hazardous waste that the manufacturer had buried on site. To comply with environmental requirements, the corporation incurred costs to remediate the contaminated soil and groundwater at the site, to restore the site to essentially the same physical condition that existed prior to the contamination, and which did not materially add to the value of the site, appreciably prolong its life, or adapt it to a new or different use. During and after the remediation, depending upon the scenario, the corporation either continued to manufacture stoves at the site, or manufacture clothes washers, or temporarily or permanently ceased operations at the site, but in all cases continued manufacturing activity somewhere. Under all scenarios, the Service held that the remediation costs were incurred by reason of the performance of production activities and were, therefore, properly allocable under section 263A to the inventory produced during the taxable year the costs were incurred even when the property was not produced at the site being remediated.

In this case,

. In addition, oil in the ground is not inventory. Unsevered

[27] Examples 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).

oil and gas is treated as real property. See Treas. Reg. §1.263A-8(c)(2). Because no manufacturing function or inventory existed at the time the costs were incurred,

, Rev. Rul. 2005-42 accordingly seems inapposite here. Accordingly, no part of the Unreimbursed Expenses is capitalizable to oil inventory.

It is arguable that the Unreimbursed Expenses were incurred by reason of the production of tangible well property at Property and are thus capitalizable under section 263A to the tangible well property produced. To the extent that costs are capitalizable to the tangible well property, however, the costs would be recoverable as an abandonment loss . Section 165(a). Further, capitalization under section 263A here is inconsistent with allowance of the J% of the Event expenses under section 162. The Unreimbursed Expenses are merely an additional portion of the identical expenses for which Exam properly allowed W a current deduction. Therefore, we recommend that Exam not pursue application of section 263A to the tangible well property.

Issue 6: Whether any part of the Unreimbursed Expenses are IDC.

Taxpayer may elect under section 263(c) and Treas. Reg. §1.612-4 to currently deduct IDC. IDC from productive non-U.S. wells must either be recovered ratably over 10 years or, at the taxpayer's election, capitalized and added to the basis of the depletable property. Section 263(i). Integrated oil companies must capitalize 30 percent of the IDC on productive wells they have elected to expense, and deduct these costs ratably over 60 months. Section 291(b). .

Under the section 612 regulations, IDC include any cost incurred that in itself has no salvage value and is "incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas." Treas. Reg. §1.612-4(a). These expenses expressly include "wages, fuel, repairs, hauling, supplies, etc." that are used:

1) In the drilling, shooting, and cleaning of wells;
2) In such clearing of ground, draining, road making, surveying, and geological works as are necessary in preparation for the drilling of wells; and
3) In the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas. Treas. Reg. §1.612-4(a).

The installation cost of tangible equipment placed in the well is deductible, but the equipment itself is capitalized. Treas. Reg. §1.612-4(a)(3). The regulations specifically exclude certain items from classification as IDC: expenses, including installation charges, incurred for equipment, facilities, or structures that are not incident to or necessary for the drilling of oil or gas wells. Treas. Reg. §1.612-4(c)(1). These

costs would be fully capitalized. Treas. Reg. §1.612-4(c)(1).[28] Some items must be expensed in every case, such as costs for the operation of the wells and of other facilities on the property for the production of oil or gas. Treas. Reg. §1.612-4(c)(2).

Before the Event, W was incurring significant IDC in its drilling operations . The Unreimbursed Expenses were incurred . One could argue that these costs

, and thus IDC to W. It is not clear under the IDC regulations, though,

. In addition, a prerequisite to IDC treatment would be that these costs would ordinarily be capitalizable under section 263(a). For the reasons explained above under Issue 5, we do not believe that to be the case. Exam also has not proposed this treatment for the J% of costs for which W claimed a deduction under section 162. It would be inconsistent to apply this treatment to only the Unreimbursed Expenses.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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.

[28] See also, Rev. Rul. 70-414, 1970-2 C.B. 132.

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